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FORUM

REFORM OF THE NATURAL GAS POLICY ACT OF 1978

William Pannill*

I. INTRODUCTION

Our national policy since 1954 has been to control the price of natural gas at the wellhead.¹ The "in-line" price of the fifties was succeeded by the "guideline" price of the early sixties,² which was succeeded by batch rates set by producing areas in the late sixties, by uniform national rates in the early seventies, and finally by statutory rates in the Natural Gas Policy Act of 1978 (NGPA).³ Not surpris-

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1. Natural Gas Act of 1938, Pub. L. No. 75-688, 52 Stat. 821 (codified in 15 U.S.C. §§ 717-717w) (1976).

2. See *Public Service Comm'n v. FPC*, 373 F.2d 816 (D.C. Cir. 1967). "The concept of an in line price is an artificial one created by the Supreme Court, the Courts of Appeals, and the Commission for the sole purpose of protecting the consumer." *Id.* at 825. The procedure utilized by the FPC to determine the in-line price in a particular case was outlined by the court:

First the Commission chooses a time period and a geographical area which it considers relevant and lists all the prices at which gas was sold at that time and in that area. Then it eliminates prices which are "suspect" either because they are presently under litigation or Commission review or because they are similar to a price under a cloud. When the price array is completed the FPC makes several calculations, for example, the average price, the median price, the weighted average price, and the price at which substantial volumes of gas flowed in interstate commerce. The FPC adjusts some of these prices by assigning differing weights to the various prices which form the price array. At least one Commissioner in our case gave some weight also to a guideline price announced first in 1960 and subsequently revised. The Commission considers these weights and the adjustments, and then picks a price.

Id. at 824 (footnotes omitted).

3. See generally *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968) (Douglas, J., dissenting); *Atlantic Ref'g Co. v. Public Service Comm'n*, 360 U.S. 378 (1959); *Phillips Petroleum v. Wisconsin*, 347 U.S. 672 (1954); *Mobil Oil Corp. v. FPC*, 483 F.2d 1238 (D.C. Cir. 1973); *Wiscon-*

ingly, talk of reform once again fills the air.

This article examines certain defects in the Natural Gas Policy Act from the viewpoint that regulation of the price of natural gas has been an unwise policy. Nevertheless, because even an unwise policy can be carried out reasonably, this article criticizes and offers alternatives to selected sections of the NGPA that need change.

II. THE POLICY BACKGROUND

The western world depends heavily on oil and natural gas for fuel. Windmills and firewood have been proposed as energy substitutes, as have coal, steam, synthetics, and nuclear power, but none have yet replaced oil and gas in availability and cost. Under these circumstances, the purpose of legislation like the NGPA is to encourage production within a sensible regulatory order.⁴

Congress imposed price ceilings on natural gas to ensure that the consumers would not be burdened with inequitable fuel prices.⁵ Because much natural gas is sold for home use, the issue of the price to be charged by utility companies is politically sensitive. In this context, legislative efforts to increase the supply of natural gas while maintaining price controls meant that the Natural Gas Policy Act had to accomplish contradictory goals. The question for Congress, then, is whether the contradictory goals of low domestic gas prices and deregulation can ever be reconciled.⁶ If not, price controls will only lead to natural gas

sin v. FPC, 201 F.2d 183 (D.C. Cir. 1952), *cert. denied*, 345 U.S. 934 (1953); Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3432 (Supp. III 1979) [hereinafter cited as NGPA].

4. See generally Note, *Legislative History of the Natural Gas Policy Act: Title I*, 59 TEX. L. REV. 101 (1980).

5. *Id.* at 116. See also FPC v. Hope Natural Gas Co., 320 U.S. 591, 610 (1944), discussing the primary focus of the NGA "to protect consumers against exploitation at the hands of natural gas companies."

6. These twin goals were reiterated in hearings before the Subcommittee on Energy and Power of the House Committee on Interstate and Foreign Commerce on April 3, 1980. In opening the hearings, Subcommittee Chairman Dingell stated:

Incremental pricing is one of the very important elements of the compromise that was forged during the 95th Congress which resulted in the enactment of the Natural Gas Policy Act of 1978. . . . The act provides for the phased decontrol of wellhead prices of natural gas. . . . [I]ncremental pricing was designed by Congress to restrain the prices paid by pipelines for natural gas supplies, particularly after deregulation, and to protect residential consumers from the higher prices resulting from deregulation. Again, I reiterate it was to be a market ordering mechanism.

H.R. Rep. No. 171, 96 Cong., 2d Sess. (1980) at 1. These hearings were held to consider FERC's proposed "Phase II" rule regarding the incremental pricing of natural gas. The proposed rule was rejected by resolution of the House of Representatives on May 6, 1980. H.R. RES. 655, 95th Cong., 2d Sess. (1980). This resolution prevented the proposed rule from taking effect. Had FERC been allowed to implement its proposed rule, the incremental pricing regulations would

shortages and to dependence, both politically and economically, on foreign supplies of fuel. If price controls erode economic efficiency and political stability in this manner, it would be preferable to repeal them.

Effective reform of the NGPA must begin with a thorough reexamination of the erroneous assumptions that have accumulated for the past twenty-five years. Since 1954, the Supreme Court, the Federal Power Commission (FPC) and Congress have assumed that the producers' market for natural gas is not competitive, even though there is little persuasive evidence of oligopoly among gas producers.⁷ This faulty assumption is closely followed by the equally misleading assumption that producers will collect a windfall if they are allowed to charge prices that rise in response to pressure from the OPEC oil cartel. But if price action can balance supply and demand, the concern about inequity loses much of its force. An efficient and secure economy serves the national interest more than an abstract concern about profits. If the chance for profits leads to greater production, then the dependence on overseas oil will diminish and fuel prices may even fall. The falling prices for crude oil that followed deregulation in early 1981 show how deregulation might affect gas prices.

The real debate over natural gas pricing is an argument about equity. Advocates of price control believe it unfair for individuals to profit from natural resources. In many nations, this perception has resulted in common ownership of oil and gas.⁸ Being an argument over values, the quarrel has not been economic, but political. Only land-owners realize windfalls from random pools of oil and gas (or any other minerals). Producers earn their sales price by searching for unknown pools and producing them.

While Congress should begin with economics, it should also examine the statute⁹ produced by political compromise in 1978. In 1944, the Supreme Court had construed the Natural Gas Act of 1938 as requiring the FPC to set "just and reasonable rates" in the interstate gas

have been extended to include all industrial users except those specifically excluded by statute. H.R. REP. NO. 171 at 202.

7. Breyer & MacAvoy, *The Natural Gas Shortage and the Regulation of Natural Gas Producers*, 86 HARV. L. REV. 941 (1973).

8. One such nation is Mexico. The Constitution of the Mexican United States specifies: "The direct dominium of all of the natural resources . . . , belong to the Nation." Miranda, *The Mining Law of Mexico*, 14 ROCKY MTN. MIN. L. INST. 277, 279 (1968).

9. Natural Gas Policy Act of 1978, Pub. L. No. 95-621, 92 Stat. 3350 (codified at 15 U.S.C. §§ 3301-3432) (Supp. III 1979).

markets.¹⁰ The 1978 law was a cross between a Senate bill¹¹ which provided for deregulation of the interstate market and a House bill¹² which provided for total regulation of all markets with prices tied to an average cost of oil. Thus the final version was produced by a handful of legislators in conference committee without hearings or similar public scrutiny.¹³

This legislation left the Natural Gas Act standing but added a complicated set of prices and regulatory provisions to govern future sales. Perhaps the main virtue of the legislation is that it created such a complex and diffuse system of regulation that the successor to the FPC, the Federal Energy Regulatory Commission (FERC), has made little effort to tinker with the pricing categories. Producer rates have become largely a matter of definition. But many parts of this legislation must be changed if the statute is to continue as the framework for producer regulation.

III. PRICE REGULATION UNDER THE NATURAL GAS POLICY ACT OF 1978

Price is the heart of producer regulation. As Mr. Justice Jackson wrote in a famous opinion, "Farsighted gas-rate regulation . . . will use price as a tool to bring goods to market—to obtain for the public service the needed amount of gas."¹⁴ A price that brings the right amount of goods to the market is a success, and any other price is a failure. "If natural gas rates are intelligently to be regulated," Jackson wrote, "we must fit our legal principles to the economy of the industry and not try to fit the industry to our books."¹⁵ Congress ignored this advice; the NGPA uses price as a tool for punishing some producers and for classifying wells based on considerations unrelated to production.

A. "Old" Gas

The NGPA builds a new price structure onto the complex ceilings

10. *Phillips Petroleum v. Wisconsin*, 347 U.S. 672 (1954).

11. S. 2104, 95th Cong., 2d Sess. (1978).

12. H.R. 8444, 95th Cong., 2d Sess. (1978) (proposed by the Administration).

13. See Note, *Legislative History of the Natural Gas Policy Act: Title I*, 59 TEX. L. REV. 101, 115 (1981).

14. *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581, 612 (1945) (concurring opinion).

15. *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 690 (1944).

set by the Federal Power Commission under the Natural Gas Act.¹⁶ Gas previously regulated under the principle of cost-of-service in the Natural Gas Act has become known as "old gas."¹⁷ In general, section 104 permits "the just and reasonable rate" that would have been applicable to the sale on April 20, 1977, and increases the price to adjust for inflation in each succeeding month.¹⁸

16. Natural Gas Act of 1938, 15 U.S.C. §§ 717-717w (1976).

17. 15 U.S.C. § 3314 (Supp. III 1979). The term "old gas" was coined in the Permian Basin Area Rate Cases, note 3 *supra*, to signify gas from wells already committed to interstate contracts before the regulatory authority imposed new price incentives. The term has come to mean gas discovered under an old pricing policy. See *Shell Oil Co. v. FPC*, 491 F.2d 82, 86 (5th Cir. 1974).

18. (c) *Inflation adjustment*. The inflation adjustment applicable to each month, beginning with May 1977, and ending with the last month of the present quarter, is specified in the following table:

Table III.—*Inflation adjustment*

	Month of delivery	Factor ¹
1977:		
	May	1.00636
	June	1.00636
	July	1.00431
	August	1.00431
	September	1.00431
	October	1.00463
	November	1.00463
	December	1.00463
1978:		
	January	1.00597
	February	1.00597
	March	1.00597
	April	1.00889
	May	1.00889
	June	1.00889
	July	1.00581
	August	1.00581
	September	1.00581
	October	1.00581
	November	1.00581
	December	1.00581
1979:		
	January	1.00581
	February	1.00667
	March	1.00667
	April	1.00667
	May	1.00713
	June	1.00713
	July	1.00713
	August	1.00805
	September	1.00805
	October	1.00805
	November	1.00690
	December	1.00690

The term "old gas" is a misnomer. There is no such thing as "old" gas, because gas cannot be stored, except in limited circumstances. Gas is produced for immediate use and gas produced from a well drilled yesterday has the same heating properties as that from a well drilled fifty years ago and continuing to produce. In this sense, all gas is new and of equal value.

What was originally meant by the term "old gas" was "gas from old contracts." The FPC set lower rates for gas from old wells by looking to average historical costs so that "excessive producer profits could be minimized" ¹⁹ The FPC assumed that the producer had spent less to drill the old well so that the gas "cost" less. But this is merely an assumption. It may cost as much to produce gas today or in the future from old wells as new wells. Reworking an old well or adding compression can drive the cost of old gas up sharply. ²⁰ What the regulators had in mind was discovery cost, not production cost. Moreover, a producer does not average his costs over time to decide whether his investment is profitable. He looks to future income. The FPC's assumption made sense only if costs dropped after discovery. For those wells with rising costs, FPC price policy actually discouraged this production.

In the *Permian Basin Area Rate Cases*, ²¹ the Supreme Court approved an FPC decision to require differences in price for simultaneous sales of gas of identical quality on the ground that "any price above an

1980:

January	1.00690
February	1.00713
March	1.00713
April	1.00713
May	1.00774
June	1.00774
July	1.00774
August	1.00843
September	1.00843
October	1.00843
November	1.00744
December	1.00744

1981:

January	1.00744
February	1.00904
March	1.00904
April	1.00904

¹ By which price in preceding month is multiplied.

18 C.F.R. § 271.102(c) (1981).

19. 390 U.S. 747, 802 (1968).

20. See, e.g., M. ADELMAN, *THE WORLD PETROLEUM MARKET* (1973).

21. 390 U.S. 747 (1968).

average historical cost . . . would merely cause windfalls".²² Only Justice Douglas dissented, arguing that the FPC's methods were "apt to take us with Alice into Wonderland."²³ The rate structure sanctioned by the Court vividly illustrates Justice Jackson's criticism of FPC methods in the *Colorado Interstate* case.

To let rate-base figures, compiled on any of the conventional theories of rate-making, govern a rate for natural gas seems to me little better than to draw figures out of a hat. These cases confirm and strengthen me in the view I stated in the *Hope* case that the entire rate-base method should be rejected in pricing natural gas, though it might be used to determine transportation costs. These cases vividly demonstrate the delirious results produced by the rate-base method. These orders in some instances result in three different prices for gas from the same well. The regulated company is a part owner, an unregulated company is a part owner, and the land owner has a royalty share of the production from certain wells. The regulated company buys all of the gas for its interstate business. It is allowed to pay as operating expenses an unregulated contract price for its co-owner's share and a different unregulated contract price for the royalty owner's share, but for its own share it is allowed substantially less than either. Any method of rate-making by which an identical product from a single well, going to the same customers, has three prices depending on who owns it does not make sense to me.²⁴

The old-gas pricing policy never did make sense. The FPC even tried to discard it on occasion²⁵ but the Commission was unable to reprice cheap gas by ending what was termed "vintaging".²⁶ Congress incorporated this FPC policy²⁷ directly into the price structure of the

22. *Id.* at 797. See also Note, note 4 *supra* at 112 n.70.

23. 390 U.S. 747, 836 (1968).

24. *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581, 610 (1945) (concurring opinion).

25. See *Just and Reasonable National Rates for Sales of Natural Gas*, 51 F.P.C. 2212, 2218 (1974); *Appalachian and Illinois Basin Area Rates*, 48 F.P.C. 1299, 1310 (1972).

26. In *Shell Oil Co. v. FPC*, 491 F.2d 82 (5th Cir. 1974), the court defines "vintaging":

Vintaging by contract is the practice of pricing gas according to the date when the contract for its production was signed. Area rate orders have used contract vintaging in establishing a two-tiered rate structure. All gas produced under contracts signed before a certain date is pegged at one price, while the gas produced under later contracts gets a higher price. Theoretically the bifurcated pricing system encourages exploration and new production by granting a higher price for "new" gas.

Id. at 34 n.5.

27. Vintaging by contract was instituted by the Statement of General Policy, 24 F.P.C. 818 (1960).

Natural Gas Policy Act.²⁸

Yet the vintages have grown sour. The actual FPC rates established in the 1970's have almost no relevance to today's market price. For example, the base price of "flowing gas" sold under contracts dated before January 1, 1973, was set at 33.2 cents per Mcf when the Act took effect on December 1, 1978.²⁹ Application of the inflation adjustment increased this price to 41.8 cents by July, 1981,³⁰ but this ceiling price was only one sixteenth of the deregulated gas prices reported in 1980, when prices as high as \$7 per million Btu have been listed in FERC filings. The equivalent price for crude oil would be about \$2.45 per barrel.³¹

Whether gas can be produced above operating costs at such prices is not the real issue. To sell gas at a tiny fraction of the replacement value wastes a national resource. In fact, statutory policy grants a windfall to the consumer of "old" gas, who can buy a thousand cubic feet of irreplaceable fuel for the cost of, say, a telephone call. For no particular reason, the statute ratifies without change a questionable FPC policy that labels all gas discovered in the past "old" gas and assumes that the gas should be sold cheaply.

All that is old about this gas is the date of the sales contract. Yet the contracts may not be altered to improve the price until they expire by their own terms.³² Until the 1970's, natural gas was typically sold under contracts of twenty years duration. Some gas contracts even extended for the life of the leases. Thus under the statute, gas first sold in 1972 might continue to be sold at a tiny fraction of its real value until 1992 or later.

Only when contracts for "old" gas expire may the sales qualify under a so-called "rollover contract" for a higher price.³³ A rollover contract is one executed after the full term of the first contract has expired. Yet even these contracts price gas far below replacement value.

28. See 15 U.S.C. §§ 3301(3), (9), (10), (11) (Supp. III 1979).

29. 18 C.F.R. § 271.101(a), Table II (1981). A "small producer" price for flowing gas established under FPC rate orders is somewhat higher, i.e., 49.1 cents per MMBtu for July, 1981.

30. *E.g.*, Maximum Lawful Prices Under the Natural Gas Policy Act for August, September, and October, 1981, 46 Fed. Reg. 38,910 (1981) (to be codified in 18 C.F.R. § 271.101(a)). Contract prices as high as \$9.50 have been reported to the author.

31. A barrel of crude oil contains about six times the heating equivalent of a thousand cubic feet of natural gas, or 6 MMBtu. Thus, a \$7.00 gas price would be comparable to an oil price of \$42.00 a barrel.

32. See note 17 *supra* and accompanying text.

33. See note 45 *infra* and accompanying text.

For example, the rollover price for gas sold by large producers was set at 60.3 cents per million Btu in December 1978 and has been increased for inflation to 78.8 cents in 1981.³⁴ The comparable current price for crude oil would be \$4.50 a barrel.³⁵ Likewise, the Commission set a minimum price for gas some years ago to prevent underpricing. The minimum price in 1981 was 26.5 cents per million Btu. The equivalent oil price would be only \$1.53 a barrel for oil.

As Mr. Justice Jackson warned, this "rate" policy borders on absurdity.³⁶ An effective policy would remove not only these backward-looking prices but also the disparity between gas discovered before and after an arbitrary date. Natural gas is a depleting resource and prices must reflect a value based on replacement cost. If Congress wishes to manipulate the price, the regulated price should be set not on a rate-base theory but by estimating what price will be required to conserve and replace the resource.

B. *Intrastate Contracts*

In passing the NGPA, Congress exercised power under the commerce clause³⁷ to freeze existing intrastate contracts until 1985.³⁸ This action extends the commerce power to its very limits. In setting prices under existing intrastate gas contracts, Congress regulated commerce that is not interstate. Moreover, many existing contracts cannot affect interstate commerce because they expire after the price freeze. The ostensible purpose in regulating intrastate sales was to create a single national market for natural gas. But since existing intrastate sales are regulated more oppressively than interstate sales by a complete price-freeze,³⁹ the real purpose may have been to direct gas into interstate commerce. The constitutionality of this dubious provision has been attacked but upheld.⁴⁰

Section 105 of the Act freezes existing intrastate contracts as they stood on November 8, 1978, the day before the President signed the legislation. In so doing, Congress fixed intrastate prices at the levels

34. 18 C.F.R. § 271.101(a), Table II (1981).

35. See note 30 *supra*.

36. See note 15 *supra* and accompanying text.

37. U.S. CONST. art. I, § 8.

38. 15 U.S.C. § 3315 (Supp. III 1979).

39. *Id.*

40. *Oklahoma v. FERC*, 494 F. Supp. 636, 662 (W.D. Okla. 1980), *aff'd*, 661 F.2d 832 (10th Cir. 1981).

they had attained during the gas shortage of the 1970's. If the intrastate contract contained nothing like a favored-nations clause,⁴¹ which allows the contract price to be redetermined to match other prices in the field, then under section 105(b) the price under the contract is fixed at 1978 levels.⁴² The rapid inflation of 1979 and 1980 has caused these frozen prices to drop in real terms.

Section 105 discriminates against intrastate sellers. All categories of old interstate gas, and indeed all other prices under the statute, increase with inflation. There is no reason to freeze intrastate contract prices. An inflation adjustment means only that a price is indexed to the changing value of the dollar and thus is frozen in real terms. Therefore, intrastate prices, which are not indexed, are falling since a 1981 dollar will not buy what a 1978 dollar bought. This discrimination against intrastate sellers lacks a sound economic foundation. Moreover, it was arbitrary of Congress to distinguish in law between contracts that contained favored-nations clauses on the date of enactment and those that did not. If the seller needs to increase his price within the congressional ceilings, the buyer can usually be relied on to ensure that the change is economically necessary.⁴³

A sensible policy does not create arbitrary rules that may have harsh results. Section 105 should allow free amendment of intrastate contracts up to any general price ceiling. Whether a higher price is warranted for a particular intrastate sale should be decided by the market.

C. Rollover Contracts

Perhaps the most arbitrary exercise of congressional power appears in section 106 of the Act, which allows higher prices for "rol-

41. See 4 H. WILLIAMS & C. MYERS, OIL AND GAS LAW § 726 (1980):

1. A two-party favored nations clause provides that the price to be paid Seller by Buyer will be increased to match any higher price contracted to be paid by the same Buyer to any other seller in the same field or area.

2. A third-party favored nations clause requires the Buyer to meet any higher price contracted to be paid by any other buyer in the same field or area. This clause is essentially similar to the two-party favored nations clause except for the fact that a price increase may be triggered by any other buyer in the same field or area in the former case and only by the Buyer himself in the case of the two-party favored nations clause.

Where a contract contains a favored nations clause, § 105(b)(3) applies. 15 U.S.C. § 3315(b)(3) (Supp. III 1979). For an interpretation of the favored nations clause within the statutory provision, see *Superior Oil Co. v. Western Slope Gas Co.*, 604 F.2d 1281 (10th Cir. 1979); *Seventh Annual Tenth Circuit Survey—Lands and Natural Resources*, 58 DEN. L.J. 415 (1981).

42. 15 U.S.C. § 3315(b) (Supp. III 1979).

43. See Breyer & MacAvoy, note 7 *supra*.

lover" contracts.⁴⁴ The statute defines a rollover contract as a new contract covering "old" interstate and intrastate gas when the original contract expires.⁴⁵

First, section 106 imposes lower prices on interstate than on intrastate rollover contracts, which hardly fits the theory of a unified national market.⁴⁶ Second, Congress impliedly provided for significantly lower prices in section 106(b)(2) for intrastate gas sold by private persons than for intrastate gas sold by a state government or an Indian tribe. A state or Indian tribe may sell under an intrastate rollover contract at the ceiling set by section 102 for "new" gas.⁴⁷ For July, 1981, FERC had set this price at \$2.84 per million Btu.⁴⁸ By comparison, interstate rollover gas sells at the "just and reasonable" rate, which could vary from 75.8 cents to \$2.05 per million Btu. Intrastate rollover gas sells at the price set in the last month of the original contract, with a

44. 15 U.S.C. § 3316 (Supp. III 1979).

45. The term "rollover contract" means any contract entered into on or after November 9, 1978, for the first sale of natural gas that was previously subject to an existing contract which expired at the end of a fixed term (not including any extension thereof taking effect on or after November 9, 1978) specified by the provisions of such existing contract, as such contract was in effect on November 9, 1978, whether or not there is an identity of parties or terms with those of such existing contract.

Id. § 3301(12).

46. Compare *id.* § 3316(a) with *id.* § 3316(b).

47. Section 106(b)(2)(A) of the NGPA provides:

In the case of any first sale under any rollover contract of natural gas which was not committed or dedicated to interstate commerce on November 8, 1978, and which constitutes a State government's or Indian tribe's natural gas production, or royalty share or other interest (as of such day) in natural gas production, from real property (including subsurface mineral interests) owned on November 9, 1978, by such State government or Indian tribe (as the case may be), the maximum lawful price under this subsection for any such natural gas production, from real property (including subsurface mineral interests) owned on November 9, 1978, by such State government or Indian tribe (as the case may be), the maximum lawful price under this subsection for any such natural gas delivered during any month shall be the maximum lawful price per million Btu's, computed for such month under section (102) of this title (relating to new natural gas).

15 U.S.C. § 3316(b)(2)(A) (Supp. III 1979).

Under the § 102 ceiling price for new natural gas, the maximum lawful price is

(1) \$1.75 per million Btu's, in the case of April, 1977; and

(2) in the case of any month thereafter, the maximum lawful price, per million Btu's, prescribed under this subsection for the preceding month multiplied by the monthly equivalent of a factor equal to the sum of—

(A) the annual inflation adjustment factor applicable for such month; plus

(B) (i) .035 in the case of any month beginning before April 20, 1981 or

(ii) .04, in the case of any month beginning after April 20, 1981.

Id. § 3312(b). New natural gas is defined as gas to be produced from a new lease on the Outer Continental Shelf, *id.* § 3312(c)(1)(A); or, gas produced from new onshore wells, *id.*; or, gas produced from onshore reservoirs from which gas was not produced in commercial quantities before April 20, 1977. *Id.* § 3312(c)(1)(C).

48. 46 Fed. Reg. 24,174 (1981) (to be codified in 18 C.F.R. § 271.101).

floor of one dollar per million Btu.⁴⁹

If the reason for this discrimination is that state and Indian gas revenues go for public purposes and not private profit, why place any ceiling on these sales at all? The price ceiling shifts public revenues to private consumers in the East and Midwest. Moreover, the higher public ceiling has no economic rationale. States and Indian tribes, like landowners, do not produce gas, they collect economic rents, which are called royalties. If the ceiling set for producers will encourage enough production to balance supply and demand, then the ceiling set for state and Indian tribes may allow them a windfall, especially in view of their unproductive role in gas production. If, on the other hand, Congress set a proper ceiling for state and Indian royalties, the effect would be to penalize producers from state lands by freezing prices.

D. *New Gas*

Congress created some "new-gas" prices that are even more arbitrary than those for old gas. "New-gas" prices, except for stripper wells,⁵⁰ were established to provide ceiling prices that offered drilling

49. The general rule under § 106(b) of the NGPA for intrastate rollover contracts provides for alternative maximum lawful pricing:

(1) General Rule.—In the case of any first sale under any rollover contract of natural gas which was not committed or dedicated to interstate commerce on the day before the date of the enactment of this Act, the maximum lawful price under this subsection for such natural gas delivered during any month shall be the higher of—

(A)(i) the maximum price paid under the expired contract, per million Btu's, in the case of the month in which the effective date of such rollover contract occurs; and

(ii) in the case of any month thereafter, the maximum lawful price, per million Btu's, prescribed under this subparagraph for the preceding month multiplied by the monthly equivalent of the annual inflation adjustment factor applicable for such month; or

(B)(i) \$1.00 per million Btu's, in the case of April 1977; and

(ii) in the case of any month thereafter, the maximum lawful price, per million Btu's, prescribed under this subparagraph for the preceding month multiplied by the monthly equivalent of the annual inflation adjustment factor applicable for such month.

15 U.S.C. § 3316(b) (Supp. III 1979). An existing intrastate gas sales contract containing an escalator clause could reach the higher § 102 price in the last month of the contract's term. The price, however, would then be frozen and allowed to increase only with inflation. By contrast, the state and Indian production pricing increases fully under § 102(b). This pricing scheme is debated in note 48 *supra*.

50. The ceiling price for stripper well gas is set out in 15 U.S.C. § 3318 (Supp. III 1979). Stripper well natural gas is defined as nonassociated natural gas which is produced any month from a well if:

(A) during the preceding 90-day production period, such well produced nonassociated natural gas at a rate which did not exceed an average of 60 Mcf per production day during such period; and

(B) during such period such well produced at its maximum efficient rate of flow, determined in accordance with recognized conservation practices designed to maximize the ultimate recovery of natural gas.

incentives for the new national market. Congress did not use the rate-base method but attempted to equate supply and demand. The results are bewildering rather than delirious.⁵¹

E. *New Natural Gas*

The most important of the new statutory prices was to be that for "new natural gas" under section 102.⁵² The price base Congress selected for this category was \$1.75 per million Btu, which it took to be the average intrastate price for 1977.⁵³ This is the highest price under the Act for general categories of new gas and therefore is the main incentive for new exploration and production of natural gas.

By 1981, the section 102 price had fallen behind the equivalent price of crude oil. The section 102 level for July, 1981 of \$2.84 equates to an oil price of only \$17 a barrel. More importantly, many new wells do not qualify as new gas under section 102.⁵⁴ In well determinations reported to FERC in the first two years under the statute, new gas accounted for thirty-eight percent of the volumes estimated under well applications. About forty percent of the gas originated in offshore Texas and Louisiana.⁵⁵

The complex qualifying rules for section 102 have no particular basis in either science or economics. Thus, a new onshore gas well can qualify for section 102 pricing only if it is 2.5 miles from an existing gas well or completed in a producing reservoir one thousand feet deeper than the completions of any existing well within 2.5 miles.⁵⁶ This definition has no known basis in earth science. The distance selected was an obvious compromise, since the Administration had proposed five miles as the limit.

The rationale for the five mile limit was that producers had driven prices up by withholding known reserves of gas from the market. Advocates of price control reasoned that the gas shortage could not have

Id. § 3318(b)(1). "Nonassociated natural gas" is defined as that gas not produced in association with crude oil. *Id.* § 3318(b)(3)(C). Stripper well gas was granted a higher base of \$2.09 per million Btu's sold. *Id.* § 3318(a)(1). Consequently, this must be considered a special-relief price for old wells.

51. *See* FPC v. Hope Natural Gas Co., 320 U.S. 591, 653 (1944) (Jackson, J., separate opinion).

52. 15 U.S.C. § 3312 (Supp. III 1979). For the definition of new natural gas, see *id.* § 3312(c).

53. *Id.* § 3312(b)(1).

54. *See id.* § 3312(d).

55. Foster Nat. Gas Rep. No. 1293, 13 (Dec. 31, 1980).

56. 15 U.S.C. § 3312(c)(1)(B) (Supp. III 1979).

been caused by low FPC prices, since the federal courts had declared them to be "just and reasonable".⁵⁷ It was assumed that producers must have deliberately withheld gas from the market. Therefore, a circle with a radius of first 5, then 2.5 miles was drawn to prevent producers from capitalizing on incentive prices for gas reserves held off the market.

A dry hole can be drilled regardless of the number of producing wells that surround the location. Even as previous drilling may strongly suggest the presence of a gas reserve and reduce the risk, each well is an investment decision. Price should provide an incentive to takes risks in drilling new wells that will add to supply. By prohibiting wells within a radius of 2.5 miles, the NGPA actually offers an incentive to drill more dry holes, because it offers the best price for wells drilled with the least geological information. In Texas, which produces the largest volume of gas under the NGPA, only 1,790 new wells were drilled in the first two years under the statute,⁵⁸ compared with 6,555 development wells that could not qualify under section 102.⁵⁹ No economic justification can support pricing this production at lower rates than "new-gas" production since both the risk of failure and the cost vary. Congress has simply chosen to price some gas at cheaper rates.

Section 102 has provided some realistic incentive pricing by allowing the new gas price to apply to new onshore reservoirs discovered within the 2.5 mile radius.⁶⁰ But this exception denies new reservoir status if the reservoir was penetrated by an old well before April 20, 1977, and gas could have been produced in commercial quantities from the old well.⁶¹ This rule shows the true congressional motivation, which was to punish producers suspected of withholding gas. Producers should be encouraged to drill for any reserve that can produce natural gas in commercial quantities. Few, if any, producers who fall afoul of the withholding exemptions carried out deliberate withholding, and the only result of this provision has been to introduce an arbitrary and unnecessary distinction among wells.

57. *FPC v. Texaco*, 417 U.S. 380, 395 (1974); *see FPC v. Texaco*, 377 U.S. 33 (1964).

58. Foster, *supra* note 55, at 15.

59. *Id.*

60. 15 U.S.C. § 3312(c)(1)(C) (Supp. III 1979).

61. *Id.* § 3312(c)(1)(C)(i).

F. *New, Onshore Production Wells*

As explained above, most new wells drilled since 1977 qualified only as "new, onshore production wells."⁶² FERC issued 21,483 well determinations under section 103 in the first two years under the statute, and only 5,979 under section 102.⁶³ Section 103 was ostensibly intended to set a price for development wells, with exploratory wells covered by section 102. It is not explained in the statute or the Conference Committee why development wells should qualify for a lower price. If the only justification for this category of sales were to punish gas withholding, section 103 should be written out of the statute. It makes no more sense to price gas by vintages⁶⁴ based on geography than vintages based on drilling date. The policy of Congress should be to set a price that will promote production. Distinctions without economic function ought to be abandoned.

To show how damaging the production well category has been, consider the price of \$1.75 per Mcf provided for these wells.⁶⁵ This price, indexed for inflation, has in reality been frozen in 1977 dollars; unlike the new-well price, there is no provision for real increases. This limits the number of future prospects that will be drilled to those profitable at \$1.75 per million Btu in 1977 dollars. Thus, section 103 will limit supply from new wells. For consumers who buy section 103 gas at the equivalent of \$14.85 a barrel of oil, Congress again has merely furnished a cheap source of energy.

G. *High-Cost Gas*

Section 107 of the statute expressly deregulates wells completed below fifteen thousand feet.⁶⁶ The drafters do not tell us why they

62. Section 103 of the NGPA deals with "new, onshore production wells" generally and defines these as any new well, not located on the Outer Continental Shelf,

(1) the surface drilling of which began on or after February 19, 1977;

(2) which satisfies applicable Federal or State well-spacing requirements, if any; and

(3) which is not within a proration unit—

(A) which was in existence at the time the surface-drilling of such well began;

(B) which was applicable to the reservoir from which such natural gas is produced; and

(C) which applied to a well (i) which produced natural gas in commercial quantities or (ii) the surface drilling of which was begun before February 19, 1977, and which was thereafter capable of producing natural gas in commercial quantities.

Id. § 3313(c).

63. Foster, *supra* note 55, at 15.

64. See notes 26 and 27 *supra* and accompanying text.

65. 15 U.S.C. § 3313(b)(1)(A) (Supp. III 1979).

66. *Id.* § 3317(a).

chose this depth. This demarcation line would seem to be one in which experience would illuminate agency discretion. Deep gas should not be defined arbitrarily but by looking for the point at which drilling costs and large discoveries create a different kind of gas well, like offshore wells. That point might be twelve thousand or twenty thousand feet. The administrative process should define the term "deep well"⁶⁷ by deciding at what depth producers take a quantum leap in risk so that a market price cannot be predicted on past trends.

Congress gave FERC the power to define other categories of high-cost gas. FERC has recognized "tight" gas, which is produced from formations of low permeability that have low rates of production, as high-cost gas.⁶⁸ FERC has tied tight-gas prices to a multiple of the section 103 price for new onshore production wells.⁶⁹ The Commission reasoned that the tight-gas price should fall in line with the price of imported gas from Canada and Mexico. The current price for tight gas is 200 percent of the section 103 price, \$3.50 per million Btu in 1977 dollars and \$4.952 as of July, 1981.⁷⁰ This price certainly encourages tight-gas exploration. The question that the "high-cost" categories raise is one of misallocation of resources. Why should producers be encouraged to search for unusually difficult supplies when the same price might produce far greater conventional supplies of gas? This question is particularly apt in the case of deep gas. The price of deregulated deep gas has reached \$7 to \$9 per million Btu. Is this the right incentive? The lower tight-gas incentive price may offer the wrong incentive by urging producers into impermeable sands. Section 107 at least offers an example of the kind of regulatory discretion suggested by Mr. Justice Jackson:

Far-sighted gas-rate regulation will concern itself with the present and future, rather than with the past, as the rate-

67. The NGPA defines "high-cost natural gas" as that:

- (1) produced from any well the surface drilling of which began on or after February 19, 1977, if such production is from a completion location which is located at a depth of more than 15,000 feet;
- (2) produced from geopressured brine;
- (3) occluded natural gas produced from coal seams;
- (4) produced from Devonian shale; and
- (5) produced under such other conditions as the Commission determines to present extraordinary risks or costs.

Id. § 3317(c).

68. *Id.*

69. This gas is priced based upon an "adjusted" price in July, 1981, of \$2.476 per MMBtu for § 103 gas.

70. See [1981] 21 FED. POWER SERV. 5-289 (Dkt. No. RM79-76).

base formula does. It will take account of conditions and trends at the source of the supply being regulated. It will use price as a tool to bring goods to market—to obtain for the public service the needed amount of gas. Once a price is reached that will do that, there is no legal or economic reason to go higher; and any rate above one that will perform this function is unwarranted. If the supply comes from a region where there is such overproduction that owners are ready to sell for less than a fair return on their investment, there is no reason why the public should pay more. On the other hand, if the supply is not too plentiful and the price is not a sufficient incentive to exploit it and fails to bring forth the quantity needed, the price is unwisely low, even if it does square perfectly with somebody's idea of return on a "rate base." The problem, of course, is to know what price level will be adequate to perform this economic function.⁷¹

The creation of tight-gas prices at least constitutes recognition that some gas price-setting by FERC is flexible.

H. *Other Pricing Provisions*

The plan of the statute is that producers may collect any price for which they qualify under any section of the statute.⁷² For the NGPA prices of sections 102, 103, 107, and 108, a producer must show that each well qualifies for an incentive price.⁷³ For existing sales, the producer must show that the sale falls within the categories of old FPC prices or is subject to an existing intrastate contract.⁷⁴ If he fits in none of these categories, then the well price is based on the "other" gas price of section 109.⁷⁵ Congress set this price at \$1.45 per million Btu, indexed for inflation.⁷⁶ This price is hopelessly out-of-date, having been set in 1975. A different basis ought to be found for setting this price, perhaps patterned after section 107.

The Commission does have authority to raise most prices, except those of existing intrastate contracts,⁷⁷ if the increase is "just and rea-

71. *Colorado Interstate Co. v. FPC*, 324 U.S. 581, 612 (1945) (Jackson, J., concurring) (affirming FPC reduction of rates under NGA).

72. *See* [1981] 21 FED. POWER SERV. 5-289 (Dkt. No. RM79-76); 18 C.F.R. § 271.102(a) (1980).

73. 15 U.S.C. §§ 3312, 3313, 3317, 3318 (Supp. III 1979).

74. *Id.* §§ 3314-3316.

75. *Id.* § 3319.

76. *Id.*

77. *Id.* § 3311(b)(9).

sonable within the meaning of the Natural Gas Act".⁷⁸ The term "just and reasonable" refers to the doctrine of cost-based pricing,⁷⁹ the rate-base method that paralyzed FPC discretion to set prices on any but a historical basis.⁸⁰ The legal standard of "just and reasonable" pricing has no place in a realistic regulatory scheme.⁸¹

IV. ADMINISTRATIVE PROVISIONS

The Act delegates to the states the authority to conduct hearings to grant well-pricing applications.⁸² Congress phrased this delegation to allow federal use of state resources to administer federal programs. If Congress can command a state to carry out federal programs, the state is treated not as a sovereign but as an administrative province. FERC has, therefore, taken the position that state production agencies merely have authority to make determinations under the Act, as a matter of federal-state cooperation.⁸³ In fact, the statutory language makes it clear that the states can waive their authority only if FERC gives its consent.⁸⁴ This delegation to state agencies, with ultimate review in the federal courts, has been held to be permissible under the judicial article of the Constitution and the commerce clause.⁸⁵

For penalties, the drafters created draconian remedies. Each day

78. *Id.* § 3319(b)(2)(B). *But see id.* § 3311(b)(5) which stipulates that for gas qualifying under more than one provision of the Act, the provision resulting in the highest price applies.

79. The Natural Gas Act of 1938, 15 U.S.C. §§ 717-717w (1976), "introduced the use of cost-based price ceilings. . . . [T]hese prices, designated as 'just and reasonable' under section 4(a) of the NGA, were calculated in the traditional public utility method—the pipelines could recover only their actual costs plus a reasonable rate of return and depreciation." Note, *Legislative History of the Natural Gas Policy Act: Title I*, 59 Tex. L. Rev. 101, 107 (1980).

80. See note 80 *supra*.

81. *E.g.*, *City of Chicago v. FPC*, 385 F.2d 629 (D.C. Cir. 1967), *cert. denied sub nom.*, *Public Service Comm'n v. FPC*, 390 U.S. 945 (1968).

82. 15 U.S.C. § 3411(c) (Supp. III 1979). "The Commission may delegate to any State agency (with the consent of such agency) any of its functions with respect to sections 3315, 3316(b), and 3319(a)(1) and (3) of this title;" *id.* § 3413(c)(1): "A Federal or State agency having regulatory jurisdiction with respect to the production of natural gas is authorized to make determinations referred to in subsection (a) of this section."

83. See *Oklahoma v. FERC*, 494 F. Supp. 636 (W.D. Okla. 1980), which challenged the constitutionality of the NGPA's imposition of price controls on and regulation of wholly intrastate gas. The Oklahoma, Louisiana, and Texas challenge to the NGPA as an invasion of state sovereignty and intergovernmental immunities, citing to *National League of Cities v. Usery*, 426 U.S. 833 (1976), was unsuccessful. 494 F. Supp. at 659.

84. 15 U.S.C. § 3413(c)(2)(B).

85. *Oklahoma v. FERC*, 494 F. Supp. 636, 656-59 (W.D. Okla. 1980) (upholding Congressional authority to limit jurisdiction of suits involving federal law to federal courts, to delegate certain adjudicatory and legislative duties to state administrative agencies, without imposing the federal appellate process on a state agency determination), *aff'd*, 661 F.2d 832 (10th Cir. 1981).

is deemed a separate violation for both civil and criminal purposes.⁸⁶ The civil penalty consists of a fine of five thousand dollars a day for violation of "any provision of this Act, or any provision of any rule or order under this Act"⁸⁷ Natural gas sales last for years, and civil penalties for violation of the thousands of FERC rules should be scaled back. For example, a penalty of \$36.5 million could accrue over twenty years of contract violations.

Congress defined the term "knowing" for civil violations as actual knowledge or "the constructive knowledge deemed to be possessed by a reasonable individual who acts under similar circumstances".⁸⁸ The same definition is carried over into the criminal penalties provided by the statute, except that two years imprisonment is added as an alternative to the imposition of a fine of five thousand dollars a day.⁸⁹ Not even lawyers or accountants could have complete constructive knowledge of this opaquely written set of price rules, and Congress should dispense with the constructive violation.

The statute also lacks limitation provisions for some civil violations. While section 504(b)(6)(D) of the Act stipulates a limitations period of three years, it also provides that the limitations period never runs if the violator has made any untrue statement or omission of material fact.⁹⁰ The filing requirements of the Commission have become so complex that this provision opens the way to staggering penalties over many years without an effective statute of limitations. A traditional approach to limitations should be reinstated.

V. DEREGULATION PROVISIONS

The NGPA was styled by Congress as a deregulation measure that imposed only temporary price ceilings. But in fact, the statute only deregulates limited classes of sales beginning in 1985.⁹¹ Old gas, for example, will be left under permanent regulation, perpetuating the low prices and errors of the Natural Gas Act for decades. By deregulating some gas and not other gas, the statute continues to subsidize the consumer with cheap fuel.

86. 15 U.S.C. §§ 3414(b)(6)(C) & (c)(4) (Supp. III 1979).

87. *Id.* § 3414(b)(6)(A)(i).

88. *Id.* § 3414(b)(6)(B).

89. *Id.* §§ 3414(c)(1)(A)-(C).

90. *Id.* § 3414(b)(6)(D).

91. *Id.* § 3331.

Section 121 eliminates price controls for new natural gas qualifying under section 102, most categories of high-cost gas sold under section 107, and gas subject to existing intrastate contracts if the contract price exceeds one dollar per million Btu on the last day of 1984.⁹² The question remains that if Congress used power over intrastate commerce only as an emergency measure why should any intrastate commerce be permanently regulated?

Other gas is deregulated haphazardly. Gas from new onshore production wells is deregulated only if the gas was not committed or dedicated to interstate commerce on April 20, 1977.⁹³ Gas from different depths bears different deregulation dates.⁹⁴ All gas subject to section 104 (existing interstate sales), section 108 (stripper wells) and section 109 (other gas) falls under the permanent and inadequate price ceilings imposed by Congress. Most of the prices look back to April, 1977, or before. There can be no economic justification for such distinctions. Deregulation should be complete and not exclude some sales arbitrarily.

Since most wells will have been qualified under section 103, the definition of the phrase "committed or dedicated to interstate commerce"⁹⁵ becomes crucial. Under the Natural Gas Act, much acreage was "committed" to interstate contracts even though this acreage was not productive. As the gas shortage deepened, the FPC took the position that this gas was "dedicated" because of service rendered by means of facilities of interstate commerce⁹⁶ under the jurisdiction of the FPC. The FPC asserted jurisdiction over acreage dedicated to interstate contracts claiming that all production from the acreage had to be sold to interstate pipelines subject to FPC price ceilings. Any acreage ever subject to an interstate contract was thus impressed with the equivalent of an interstate servitude.

The Supreme Court upheld the FPC's jurisdiction in *California v. Southland Royalty Co.*⁹⁷ by holding that a lessee could dedicate acreage in perpetuity by making a jurisdictional "sale" in interstate commerce even though the landowner had never formally acquiesced in the com-

92. *Id.*

93. *Id.* § 3331(a)(2).

94. *Id.* §§ 3331(a) and (c).

95. *E.g., id.* §§ 3301(18).

96. *Id.* § 3314.

97. 436 U.S. 519, 525-28 (1978). *See also* *Amerex, Inc. v. FERC*, 603 F.2d 127 (10th Cir. 1979), *cert. denied*, 444 U.S. 1102 (1980).

mitment. This decision brought millions of undrilled acres under perpetual FPC jurisdiction. This doctrine would subject unwitting sellers to federal price ceilings years or even decades after an unregulated sale took place.⁹⁸

In the NGPA, Congress attempted to relieve producers of the uncertainty of the *Southland Royalty* decision by providing that where a lease had expired and reverted to the landowner by May 30, 1978, the gas would not be considered "committed or dedicated" to interstate commerce under certain conditions.⁹⁹ FERC has taken the position that gas sold before the Act took effect fell under FERC jurisdiction and subjected the sellers to paybacks or other penalties.¹⁰⁰ This position appears unsound in light of the Conference Committee's statement:

Natural gas not committed or dedicated to interstate commerce as of the day before the date of the enactment of this Act is never made subject to the Commission's jurisdiction under Sec. 1(b) of the Natural Gas Act.¹⁰¹

Nonetheless, the FERC position has been upheld by a recent decision by the United States Court of Appeals for the Fifth Circuit.¹⁰² If FERC asserts its position after deregulation in 1985, then hundreds of wells qualified under section 103 will be perpetually regulated because section 103 gas is only deregulated if it was "not committed or dedicated to interstate commerce on April 20, 1977".¹⁰³ Thus price controls may continue for section 103 wells based on whether they were drilled on dedicated acreage, a consideration without economic significance. The doctrine of dedication should be repealed entirely.

This "deregulation" statute leaves unclear what gas is deregulated; economic efficiency will be best served by deregulating all gas.

VI. CONCLUSION

The deregulation provisions, like the rest of the statute, represent a political compromise. Economic efficiency and even lower prices will be best achieved by deregulating all gas. "Such considerations may be

98. 436 U.S. at 531-46 (Stevens, J., dissenting).

99. 15 U.S.C. § 3301(18)(B)(IV)(iii) (Supp. III 1979).

100. See *Conoco, Inc. v. FERC*, 622 F.2d 796 (5th Cir. 1980).

101. H.R. REP. NO. 1752, (5th Cong.), 2d Sess. 123, reprinted in [1978] U.S. CODE CONG. & AD. NEWS, 8983, 9039-40. See also *Conoco, Inc. v. FERC*, 622 F.2d 796, 799 (5th Cir. 1980).

102. *Falcon Petroleum v. FERC*, 642 F.2d 780, 784 (5th Cir. 1981).

103. 15 U.S.C. § 3331(a)(2)(A) (Supp. III 1979).

relevant to rate-base theories, but will not be very satisfying to a coming generation that will look back and judge our present regulatory method in the light of an exhausted and largely wasted gas supply.”¹⁰⁴ It is time for Congress to rise above expediency.

104. *Colorado Interstate Co. v. FPC*, 324 U.S. 581, 615 (1945) (Jackson, J., concurring).