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Richard Greer Morgan  
*O'Connor & Hannan*

Martha Priddy Patterson  
*Time Incorporated*

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The Natural Gas Policy Act of 1978: Four Years of Practice and Two Years to Make Perfect

By Richard Greer Morgan* and Martha Priddy Patterson**

INTRODUCTION

The natural gas industry has been subject to direct or indirect regulation since 1938, but the passage of the Natural Gas Policy Act of 1978 (NGPA)¹ has precipitated more confusion, disagreement and uncertainty than existed during the forty years prior to its passage. In effect for only four years, the NGPA contains provisions which will release price controls on forty to sixty percent of all natural gas produced in the United States by 1986. Further, the NGPA's deregulation provisions have caused, and will continue to cause, substantial problems and heated debate.

Three potential problems with the NGPA are apparent to those active in the area of natural gas regulation. First, because the NGPA price controls embrace all natural gas, including intrastate natural gas, a substantial disparity may arise between interstate pipelines and intrastate purchasers in acquiring additional gas supplies. This results primarily because most interstate pipelines purchase a comparatively large volume of so-called "old" gas which, under the NGPA, remains priced at the lower rates established by previous regulation under the Natural Gas Act (NGA).² When interstate pipelines purchase more costly newer gas, they average that cost with the old gas cost, allowing the interstate pipeline to sell its gas at prices lower than the cost

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of new gas. Intrastate pipelines generally have little, if any, old
gas and must, therefore, buy higher priced gas. Certain intra-
state pipelines have had difficulty acquiring gas. Even if it can be
acquired, these pipelines have difficulty selling to their customers
because their weighted average price of gas at times has exceeded
the price of alternate fuels.

A second problem envisioned, when and if natural gas price
controls terminate in whole or in part, is the so-called "price
spike" or "fly-up." The theory behind this perceived problem is
that most gas purchase contracts contain some type of price esca-
lation clause which is triggered by a rise in the price of other gas
which is sold after decontrolled gas is no longer subject to price
control.3 In other words, virtually all natural gas prices will,
one deregulated, escalate to the highest price paid for any de-
regulated gas. This would, of course, exacerbate the existing dis-
parity in the relative abilities of interstate pipelines and intra-
state purchasers to acquire new gas supplies. Numerous argu-
ments support the need for such escalator clauses to protect pro-
ducers, but other arguments support the need for a uniform price
cap on such escalators.

The third problem perceived under partial or complete de-
regulation is market ordering. This problem involves both the
ability of pipelines to avoid the loss of industrial customers if the
price of gas exceeds the price of alternative fuels and the relative
abilities of interstate pipelines and intrastate purchasers to com-
pete for additional gas supplies.4

3 CONG. RESEARCH SERVICE AND THE NAT'L REGULATORY RESEARCH INSTITUTE, 97TH
CONG., 2d SESS., NATURAL GAS REGULATION STUDY 143-44, (Comm. Print 97-GG 1982)
[hereinafter cited as NATURAL GAS REGULATION STUDY]. The study relies upon two an-
alyses of a statistically valid sample of 20,000 natural gas contracts on file at the Federal
Energy Regulatory Commission (FERC). The contracts are for old gas or rollovers of con-
tracts which have expired but have been reexecuted; nonetheless, the contracts represent
70% of the total gas supply. About 90% of the contracts contain an area rate clause price
escalator; between 61.6% and 72.4% of the contracts also contain a renegotiation price
clause which ties the price of the gas to the average price paid for gas of the same quality in
the same area as demonstrated in one to three contracts provided by the producer to the
pipeline or to the price of certain alternate fuels.

4 R. Means, Analysis of the Bidding Disparity Between Interstate and Intrastate
Pipelines (April 2, 1982) (unpublished working draft) and Texas Energy and Natural Re-
sources Advisory Council, Impact of the NGPA on Current and Projected Material
Markets: Comment Pursuant to the Notice of Inquiry, Docket No. 82-26-000 (Aug. 1982).
These problems as well as regulatory problems faced by the Federal Energy Regulatory Commission (FERC)\(^5\) stem primarily from the NGPA. However, the entire history of natural gas regulation suggests that many of the same issues would be encountered today even without the NGPA. By artificially depressing the price of natural gas through legislation and regulation, consumers have been encouraged to increase natural gas consumption while being denied any concept of the true value of the commodity. As a result, they are ill-prepared to face total energy reality.

This Article reviews the history of natural gas regulation prior to enactment of the NGPA, the specifics of the NGPA, the attempts of the FERC to implement the NGPA and the current administrative and congressional approaches to regulation. The future of natural gas regulation cannot be reasonably predicted. The very difficulty and anxiety surrounding the adoption of the NGPA illustrates the conflicting and competing constituencies, interests and policies involved in natural gas regulation and militates against such predictions. However, observations will be made whenever possible.

I. BRIEF HISTORY OF NATURAL GAS PRICING

A. Origins of Wellhead Price Regulation—the Natural Gas Act and the Phillips Case

Conflicts between interstate and intrastate natural gas markets are not new. Indeed, the incentive for the first federal legislation regulating natural gas was the regulatory gap caused by the states' inability to regulate the price of natural gas entering interstate commerce and the states' attempts to regulate the price of gas delivered from other states. The United States Supreme Court consistently held state attempts to regulate natural gas

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\(^5\) FERC, the successor agency to the Federal Power Commission (FPC), was created by the Department of Energy Organization Act of 1977, Pub. L. No. 95-91, § 204, 42 U.S.C. §§ 7101, 7134 (Supp. 1982). Throughout this Article, the FPC will be used to describe the agency prior to 1977; FERC will be used to describe the agency interchangeably both before and after this date. Commission will be used to describe either.
which crossed state lines to be an unconstitutional burden on interstate commerce.  

After reviewing the problems of gas regulation, focusing primarily upon natural gas transportation costs which often greatly exceeded the actual cost of the gas involved, Congress enacted the NGA. The Act applied to the transportation and sale for resale of natural gas in interstate commerce but specifically exempted "the production or gathering of natural gas." The bill defined "natural gas companies" as "a person engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale." Administration of the Act lodged with the Federal Power Commission (FPC), which was granted broad authority to establish "just and reasonable rates" for interstate transportation and interstate sales for resale of natural gas. It also was authorized to grant certificates of public convenience and necessity for the sale and transportation of natural gas, construction of pipelines in interstate commerce and abandonment of service.

The FPC did not interpret its authority as extending to establishing wellhead prices for natural gas sales to interstate pipelines by an independent producer, e.g., producers not affiliated with interstate pipelines. The FPC did interpret its authority as allowing regulation of natural gas produced by a pipeline over which the FPC exercised regulatory authority, even if such sales occurred within a single state. The Supreme Court rejected the FPC's narrow view of its own powers and interpreted FPC's jurisdiction over natural gas producers as extending beyond that

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9 Id. § 717a(b) (1976).
10 Colorado Interstate Gas Co. v. FPC, 324 U.S. 581, 600-04 (1945) (holding that the FPC could include gas well and gathering facilities in determining an interstate gas company's rate base, thereby indirectly regulating the wellhead price).
11 Interstate Natural Gas Co. v. FPC, 331 U.S. 682, 689-93 (1947).
previously exercised by FPC. In the landmark case of Phillips Petroleum Co. v. Wisconsin, the Supreme Court overturned the FPC's determination that Phillips Petroleum, an independent gas producer which produced and gathered natural gas but which did not engage in interstate transportation of the natural gas, was not a natural gas company within the meaning of the Natural Gas Act and thus not subject to the FPC's direct pricing authority. In so holding, the Court relied upon "the statutory language, the pertinent legislative history and the past decisions of this Court." The Court rejected the argument that Congress intended to regulate only interstate pipeline companies, stating that "if such were the case we have difficulty in perceiving why the commission's jurisdiction over the transportation or sale for resale in interstate commerce of natural gas is granted in the disjunctive."

In evaluating the FPC's history of producer regulation, it is valuable to note that neither the NGA nor the Phillips decision provided guidance as to the methodology to be used by the Commission in setting producer prices. Certainly, gas producers did not fit the concept of traditional utility regulation employed under the NGA to establish rates for pipelines. Nonetheless, the FPC did not attempt to construct a new pricing structure to fit gas producers. Rather, being familiar with such utility regulation, the FPC attempted to apply that same regulatory pricing methodology to producers. The FPC began setting cost-based rates for the more than 8,000 individual producers just as it did for the far less numerous interstate pipeline transportation companies. As might be expected, the FPC immediately fell behind in its task. This attempt to set individual rates at a just and reasonable level based upon each producer's cost of service was

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13 Id. at 677.
14 Id. at 681.
15 The Court's allegations of congressional intent regarding the NGA's coverage of wellhead pricing is weak, to say the least. In Permian Basin Area Rate Cases, 390 U.S. 747, 755-56 (1968), the Court ultimately admitted the NGA's provisions "do not specifically extend to producers or to wellhead sales of natural gas," noting rather that the Act specifically excludes production and gathering of natural gas.
not only inaccurate, but impossible to administer.

Recognizing the futility of individual cost-based rates, the FPC searched for more realistic methods to implement its regulatory authority. Initially, the FPC turned to "in-line" prices to speed the regulatory process.16 This method employed categorical producer price ceilings for states and certain areas. If producers filed contracts for sales of gas at or below these ceilings, the Commission accepted the contracts. As time passed, the in-line concept grew in popularity at the Commission and became the embryonic model for the first area-wide price determination.

In 1960, the FPC proposed setting rates on an average cost basis for a given area, the so-called area rate method.17 It was not until 1965, eleven years after the FTC first began regulating the sales price of natural gas for resale that the Commission formally adopted this new pricing method.18 The area rate methodology designated various geographical areas with relatively homogeneous producing characteristics such as the Permian Basin, South Louisiana and the Rocky Mountains. Exploration and development costs in that area, including the cost for unsuccessful drilling, were averaged and combined with a predetermined rate of return to establish rates for the area.

Using composite cost data from the area involved, the Commission established a vintage pricing system whereby gas produced from wells dedicated to interstate commerce after January 1, 1961, received a higher, incentive oriented price and all older gas received a lower price. The Commission also established a minimum just and reasonable rate for all gas sold in the area, finding that existing contracts which included a rate below the minimum were contrary to the public interest.19 These rates were immediately challenged in court. The Supreme Court in *Permian

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17 Area Rate Proceeding No. AR 61-1, 24 F.P.C. 1121 (1960).
18 Area Rate Proceeding No. AR 61-1, 34 F.P.C. 159 and 1068 (1965).
19 Interestingly, while the parties challenged many aspects of the FPC calculations on area rates, apparently they did not challenge the FPC's authority to abrogate contracts by setting a minimum rate. The Permian Basin Area Rate Cases, 390 U.S. 747 (1968) discusses the relationship of contracts and regulation with regard to the application of indefinite price escalation clauses, but makes no mention of minimum rates. See Id. at 784.
Basin Area Rate Cases\textsuperscript{20} upheld the concept of area rates and vintaging established by the FPC.

The Commission conducted similar exhaustive analyses for each designated area.\textsuperscript{21} In each decision, the Commission specifically created price vintaging on the theory that higher prices for new wells provided an incentive for producers, whereas lower prices were appropriate for gas produced from wells where the producer had already made an investment. The Commission also set a minimum price for all sales of natural gas.

The Commission's decisions in the Appalachian-Illinois Basin\textsuperscript{22} rate cases and in Southern Louisiana II\textsuperscript{23} altered the use of price vintaging. In both decisions, the Commission announced the need to raise old gas prices to generate greater cash flow and stimulate future exploration and development. Even more important, in the former decision the Commission announced its intention to eliminate gradually all price vintaging.\textsuperscript{24} Despite this policy statement, the Commission returned to the vintaging concept in later producer rate cases.

From area rates the FPC moved to the establishment of national rates, still basing these rates in the first instance upon the evaluation of several cost components.\textsuperscript{25} The Commission chose

\textsuperscript{20 Id. at 747.}
\textsuperscript{22 Rates for the Appalachian and Illinois Basin Areas, 48 F.P.C. 1299 (1972), aff'd sub nom., Shell Oil Co. v. FPC, 491 F.2d 82 (5th Cir. 1974).
\textsuperscript{23 46 F.P.C. 86 (1971).
\textsuperscript{24 Rates for the Appalachian and Illinois Basin Areas, 48 F.P.C. at 1309.
not to eliminate price vintaging. The Court affirmed this methodology in Shell Oil Company v. FPC. The second national area rate rulemaking also was challenged and upheld in American Public Gas Association v. FPC. In that case, the Commission employed not only recent exploration and development costs, but also took into account the declining discovery rate for new gas reserves. Most significantly, the Commission determined the value of the incentive prices it set on the basis of a discounted cash flow. As a result, gas prices doubled from those established in the first national rate case.

This history of wellhead price regulation reveals several significant facts: 1) even without the NGPA, there would be a disparity between the price of old and new gas; 2) the Commission has never implemented prices for wellhead sales of natural gas which reflect the commodity or actual value of the gas in a timely fashion, and 3) if the method used by the Commission in the second national rate case was used currently to set prices, rather than the NGPA price system, wellhead prices of all natural gas would be higher. Indeed, absent the legislative constraints on gas consumption by industrial consumers, the market ordering mechanisms might have already come into play. Those mechanisms might well have alleviated through market conditions the problems perceived in natural gas deregulation.

B. Shortages and Curtailments

By the early 1970s, serious natural gas shortages were occurring in the interstate market. At the same time, the intrastate market, unregulated by the FPC, was enjoying for the most part adequate, if not bountiful, supplies of natural gas. However, the price for that gas far exceeded that of regulated interstate gas.

The FPC had established elaborate curtailment procedures. It first issued Order No. 431 directing interstate pipelines to re-

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26 520 F.2d 1061 (5th Cir. 1975), cert. denied sub nom. California Co. v. FPC, 426 U.S. 940 (1976).
port on curtailments.\textsuperscript{30} \textit{FPC v. Louisiana Power and Light}\textsuperscript{31} upheld the Commission's broad authority to regulate curtailments. However, as shortages continued, the FPC of necessity established curtailment priorities to allocate the scarce gas on a uniform basis among a single pipeline's purchasers.\textsuperscript{32} The priorities basically placed residential users first and industrial boiler fuel users last.\textsuperscript{33} The Commission was generally considered not to have the authority to allocate natural gas among interstate pipelines or between intrastate and interstate pipelines. Believing low gas prices in the interstate market partly caused the shortages, the Commission took several regulatory measures designed to encourage producers to explore for and dedicate gas to the interstate market.\textsuperscript{34} Apparently, these measures had little impact upon the reserves of gas dedicated to the interstate market. The shortages worsened.

Meanwhile, Congress struggled with deregulating natural gas pricing as a partial solution to the curtailment problem; however, the volatile nature of the politics involved made it impossible to act upon the question.\textsuperscript{35} Congress did at least take stop-gap measures on the curtailment problem by enacting the Emergency Natural Gas Act of 1977.\textsuperscript{36} The Act gave the President authority to allocate natural gas supplies upon the declaration of a "natural gas emergency." The Act also permitted "emergency purchases" by interstate pipelines and local distribution companies directly from producers or from intrastate pipelines with-
out jurisdictional consequences under the NGA. The allocation provisions of this Act were never used; however, a number of emergency sales were made pursuant to the Act. Distribution companies, interstate pipelines and intrastate pipelines cooperated with each other to alleviate shortages wherever possible. Whether the high degree of cooperation reflected genuine marketplace order or fear of additional regulation is unknown.

C. The Creation of the NGPA

In large part, the seriousness of the curtailment spurred the President and Congress to act. In April of 1977, President Carter submitted to Congress a proposed National Energy Act, which included concepts later enacted in the NGPA, the Public Utilities Regulatory Policies Act and the Powerplant and Industrial Fuel Use Act. This plan would have eliminated the inter/intrastate distinction by pricing all new gas at a per Btu price equivalent to the average refiner acquisition cost of crude oil. The plan also included new pricing rules for old gas.

Introduction of this plan set off political wrangling the likes of which have rarely occurred over any piece of legislation. Without an appreciation of the intense debates and political confrontations surrounding the adoption of the NGPA, it is impossible to understand the complexity of that Act.

The natural gas proposals of the President's national energy plan were examined and reported in the House of Representatives by both the Interstate and Foreign Commerce Committee and an Ad Hoc Energy Committee set up by the House leadership to review the President's energy plan. The House reported the President's bill basically intact; attempts at the committee level to deregulate natural gas were turned back. The fight in the House would have become more pitched if the strategy of the deregulation proponents had not been to save their energies for a

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stronger fight in the Senate which, as expected, had more deregulation proponents.

In June of 1977, the Senate Committee on Energy and Natural Resources began consideration of the President's bill and of another deregulation bill called the Pearson-Bentsen Bill. The Energy Committee, in an unusual move, reported the President's bill without the traditional recommendation that it be adopted. Then began a Senate floor fight which became legendary for its vituperativeness, its myriad amendments, its all night sessions and an ultimate resolution through byzantine parliamentary maneuvers. These efforts resulted in adoption of an amended Pearson-Bentsen provision allowing phased deregulation of new gas prices and limiting controls only to the interstate market.\(^{39}\)

The House and Senate conferees arrived at the conference with totally different gas regulation bills. In short, the House bill extended regulation to the intrastate market but raised gas prices, while the Senate gradually deregulated new gas. The interminable conference meetings between the House and Senate conferees made the unusual parliamentary moves and fevered battles in the separate houses seem like calm, rational debate. The bill was in conference from the fall of 1977, until October of 1978, an unprecedented amount of time for a piece of regulatory legislation.

The conferees frequently met with the President, the Secretary of the Department of Energy and the Chairman of the Federal Energy Regulatory Commission to discuss political compromises and the practical application of various proposals. After nearly a year of deliberations, on October 10, 1978, the staff released the conference report,\(^{40}\) which was approved by the Senate in principle on September 27, 1978, and by the House on October 15, 1978. On November 9, 1978, the President signed the bill into law.

The intricacy of the resulting NGPA is almost unprecedented in regulatory legislation. The conflicting needs and desires of constituents, coupled with the crisis in energy supplies in general and natural gas supplies to the interstate market in particular,


could have resulted in nothing less. The labyrinth of the NGPA accurately reflects the maze of policies and concerns which Congress attempted to implement and address. The more complex the policies to be implemented, the more complex is the legislation needed. The NGPA reflects this basic principle. Those seeking to change the NGPA provisions must recognize the history of the legislation's development.

II. Pricing Provisions of the NGPA and Their Subsequent Interpretation

A. In General

The NGPA represents a relatively new and very complex system of regulation for the natural gas industry. Theoretically, Title I raised prices for producers and Title II, incremental pricing, attempted to moderate those prices for residential customers. Neither theory proved realistic as time passed because gas prices were tied to the price of crude oil at the time of enactment, a mere seventeen dollars per barrel. Indeed, the incremental pricing concept may have worked against residential customers by forcing large industrial consumers, who bear a disproportionate amount of fixed costs, out of the market.

The NGPA eliminates a large portion of FERC's price setting discretion with the statutory provisions setting more value-based gas prices. The NGPA also brings previously unregulated intrastate gas under federal regulation and establishes a long-range schedule for partial deregulation of certain gas sales.

NGPA section 101 establishes a mechanism for determining the annual inflation adjustment factor applicable to certain NGPA ceiling price categories and sets forth key definitions and rules of general applicability. On a quarterly basis, FERC calculates and publishes the effective ceiling prices. States may establish first sale prices lower than those that NGPA provides.\(^\text{41}\)

Section 101(b)(9) provides that contract prices prevail when they are lower than NGPA maximum lawful prices. This section

partially codifies judicial precedent known as the *Mobile-Sierra-Memphis* doctrine. That doctrine established under the NGA the primacy of private contract terms in the Commission's application of regulatory provisions. Accordingly, federal statutes and regulations that govern the natural gas industry ostensibly do not abrogate contract terms; parties are free to agree to any contract terms not contrary to applicable regulations.

While many NGPA provisions and the Commission's regulations implementing the NGPA are being challenged in the courts, the NGPA has withstood the challenge to its constitutionality made in *Oklahoma v. FERC*. Plaintiffs, the states of Oklahoma, Texas and Louisiana, sued for a declaratory judgment, alleging that the NGPA was unconstitutional. The states claimed: 1) the commerce clause did not authorize Congress to establish maximum prices for intrastate gas; 2) even if such action were valid under the commerce clause, the NGPA violated the doctrine of intergovernmental immunity, which prohibited the federal government from usurping traditional state functions; 3) the NGPA violated the tenth amendment by coercing states to enact legislation and expend funds to implement a federal regulatory program, and 4) allocation and distribution of intrastate gas into interstate pipelines exceeded Congress's authority under the commerce clause and violated the states' sovereign immunity under the tenth amendment, the equal protection clause and the due process clause.

The district court awarded summary judgment to FERC and upheld the constitutionality of the NGPA. The Tenth Circuit Court of Appeals affirmed the district court's holding on each count. The court limited its determination based upon the commerce clause issue to two factors: whether Congress had a rational basis for determining that the pre-NGPA unregulated market

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43 But see NGA § 5(a), 15 U.S.C. § 717d(a) (1976); Permian Basin Area Rate Cases, 390 U.S. at 784.
of intrastate gas burdened interstate commerce; and, if so, whether the means adopted by Congress were reasonably suited to the task of eliminating this burden. The court found that a rational basis did exist for determining that the intrastate gas market affected interstate commerce and the regulatory scheme was a reasonable means to eliminate the burden thus imposed. To determine whether the NGPA violated the doctrine of intergovernmental immunity and state sovereignty, the court relied upon *National League of Cities v. Usery*, which requires a determination of whether Congress has usurped the power of a state to perform essential governmental functions. The court concluded that the power to regulate gas produced and sold intrastate is not the type of traditional state function which *Usery* protects from congressional interference.

**B. NGPA Section 102—New Natural Gas**

NGPA section 102 establishes a maximum lawful price for new onshore and offshore natural gas. To qualify for the NGPA section 102 price, the first sale of gas from a new onshore well or reservoir or from a new lease on the Outer Continental Shelf (OCS) or from certain other OCS leases must be new gas as defined in section 102. FERC is responsible for calculating new gas ceiling prices according to a statutory formula based upon a base price multiplied by an escalation factor. The ceiling prices escalate on a monthly basis by a factor equal to the sum of an annual inflation adjustment factor for the month and a real growth factor. As of January of 1983, the maximum lawful price for section 102 gas was $3.299 per MMBtu.

While FERC has strictly applied the provisions of section

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46 661 F.2d at 836.
48 Id. § 3312(c) (Supp. IV 1980).
102, a recent case from the Tenth Circuit Court of Appeals, True Oil Co. v. FERC, has applied a more liberal reading to what constitutes new gas. In that case, FERC had denied section 102 qualification to a well which had produced but not sold gas during testing prior to the April 20, 1977, qualification date for new well production. The court noted the NGPA required production "in commercial quantities," not mere production, to disqualify this type of new gas from the section 102 price. The court found that the well had produced only 350 Mcf of gas before the well was shut in to await a pipeline connection. The court rejected FERC's argument that the well could have produced in commercial quantities prior to April 20, 1977.

C. NGPA Section 103—New Onshore Production Wells

NGPA section 103 provides an alternative price category for new wells which do not qualify under section 102 because they are within two and a half miles of existing wells or are not drilled to the requisite completion depth. To qualify for the NGPA section 103 ceiling price, the wells must have been first drilled on or after February 19, 1977, must meet federal or state well spacing requirements and must not have been within a proration unit existing at the date of initial drilling. Generally, the ceiling price for NGPA section 103 gas is equal to that set in NGPA section 102 for new natural gas, except that section 102 new gas is adjusted for both inflation and a real growth factor, while NGPA section 103 natural gas is adjusted only for inflation. The January of 1983 maximum lawful price for section 103 gas was $2.722 per MMBtu.

The FERC has applied a stringent rule equating initial drilling or "spudding" with surface drilling done on a one time only

50 663 F.2d 75 (10th Cir. 1981).
52 663 F.2d at 78.
54 Id. § 3313(c).
55 See note 49 supra.
56 "Spudding" is a term used to connote the initial boring to a depth of approximately 100 feet in drilling an oil or gas well. H. WILLIAMS & C. MEYERS, MANUAL OF OIL AND GAS (4th ed. 1978).
Thus, the FERC treated an abandoned well as being first drilled on the date it was originally spudded and not the date of reentry after abandonment. However, the Fifth Circuit Court of Appeals in *L&B Oil Co. v. FERC*, recently held FERC's rule was too restrictive. The court held that the classification of gas produced from an abandoned, unsuccessful well subsequently reentered by the producers was not determined by the spud date of the abandoned well. Therefore, L&B's drilling through the plug in the old, unsuccessful well amounted to the initiation of a new well.

To support its finding, the court pointed out that L&B had incurred virtually all of the normal exploration costs and made all of the production efforts in 1979 and that the efforts and expenditures, including directional drilling, resulted in a producing well. According to the court, the NGPA explicitly intended to provide price incentives for new production. Except for the original spud date, as interpreted by the Commission, the well met all the NGPA section 103 statutory criteria. Denying the incentive price for making minimal use of a dry hole would violate the purpose of the statute. Even though the court limited its holdings in the *L&B* decision to the circumstances of that case, the decision provides guidance and authority for a more liberal interpretation of the section 103 requirements.

D. **NGPA Section 104 and NGPA Section 106(a)—Natural Gas Committed or Dedicated to Interstate Commerce**

NGPA section 104 applies to gas which, on November 8, 1978, was committed or dedicated to interstate commerce and for which a just and reasonable rate was in effect. Essentially, NGPA section 104 incorporates, with adjustments for inflation, the rates previously established under the NGA. The maximum lawful price for section 104 gas may be the higher of either the

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58 665 F.2d at 758.
59 Id. at 764.
60 Id.
just and reasonable rate per MMBtu established by the Commission which was or would have been applicable to the first sale of gas on April 20, 1977, adjusted for inflation, or any just and reasonable rate established for the gas by the Commission after April 20, 1977, and before November 9, 1978. FERC has the authority under the NGPA to set a higher applicable ceiling price so long as the higher price is "just and reasonable within the meaning of the NGA." FERC has issued a notice of inquiry seeking discussion on establishing higher just and reasonable prices for section 104, 106(b) and 109 gas.

The applicable maximum lawful price for NGPA section 106(a) interstate rollover gas is the higher of the just and reasonable rate established by the Commission and applicable on the date the rollover occurs (adjusted for inflation), or fifty-four cents per MMBtu as of April of 1977, adjusted monthly thereafter by the inflation factor. As with section 104 gas, FERC may set a higher rate for rollover gas if such rate is "just and reasonable within the meaning of the NGA."

Under NGPA section 104, FERC has the authority to provide special relief rates for producers seeking to charge a rate in excess of the maximum lawful, just and reasonable price. However, this relief vehicle has been virtually useless because the Commission has failed to issue regulations establishing a procedure for obtaining special relief. The Commission may abandon the special relief rulemaking if it moves ahead with increasing "just and reasonable" rate levels under section 104(b)(2).

The prices provided in section 104 are well below the prices provided in other sections of the NGPA. In effect, Congress merely adopted the historical ratemaking used by the Commis-

62 Id.
65 Id. § 3316(c).
66 Id. § 3314(b)(2).
67 See note 123 infra and accompanying text discussing the Commission's failure to issue these regulations, as well as its failure to resolve other issues.
sion to establish these prices. Some believe this lower priced gas provides interstate pipelines with a “cushion” to keep the weighted average cost of gas low despite purchases of expensive new or uncontrolled gas.

E. NGPA Section 105—Sales Under Existing Intrastate Contracts

NGPA section 105 establishes ceiling prices for sales of natural gas under intrastate contracts which existed as of November 8, 1978, or the successors to those contracts. Section 105(b)(1) establishes the general price rule for intrastate sales in which contract prices were not higher than the section 102 new gas price on the date of the NGPA enactment. The maximum lawful price for such gas is the lower of the price under the terms of the existing contract or the NGPA section 102 ceiling price. If the contract price on the date of enactment was greater than the new natural gas price under section 102, section 105(b)(2) applies, setting the price for such gas at the higher of the current section 102 price or the original November of 1978 contract price, times an inflation factor.

One of the most significant issues facing parties to intrastate gas sales contracts involves state severance tax reimbursements. Special rules apply to the recovery of or adjustment for severance taxes for natural gas sold under existing intrastate contracts or successors to such contracts and under intrastate rollover contracts. On January 1, 1980, the Commission issued a notice of proposed rulemaking to determine what prohibition, if any, should be made with respect to recovery of severance taxes for intrastate sales. The Commission’s preliminary view was not to limit recovery of severance taxes for sales under NGPA section

69 Id. § 3315(b)(1).
70 The regulations governing intrastate gas sales specifically state that reimbursement for severance taxes is in addition to maximum lawful prices. See 18 C.F.R. § 271.1102 (1981).
105(b)(2) of gas priced higher than section 102 new gas because that section's pricing mechanism more closely resembled other NGPA pricing mechanisms. On the other hand, FERC believed a severance tax adjustment should not be permitted for sales under NGPA section 105(b)(1) of gas priced lower than section 102 gas, except to the extent the section 102 limitation prevented a seller from collecting the full contract price. FERC reasoned that the price payable under NGPA section 105(b)(1) was a freely negotiated contract price and the proceeds payable to the seller under the contract are presumed sufficient to reimburse the seller adequately for severance taxes.

In November of 1980, FERC issued Order No. 108, which provides that under existing intrastate contracts, successors to such contracts and intrastate rollover contracts, sellers may not collect state severance taxes in addition to the maximum lawful price, unless 1) the contract already had a separate provision allowing for tax reimbursement, or 2) the severance tax increases were made through legislation enacted after the NGPA. FERC reasoned that the starting point for NGPA section 105 ceiling prices was a level chosen by the parties and thus the total proceeds paid to the seller could be presumed to include full reimbursements for taxes levied as of the enactment of the NGPA. Order No. 108 stated that specific tax reimbursement provisions are not required in a gas sales contract, but some contractual authorization is required. A contract amendment is permitted to provide the necessary authorization. FERC, in the first instance, will leave contract interpretation to the parties. A dispute over contract interpretation is to be resolved by the state courts.

The regulations resulting from Order No. 108 were to be effective for natural gas deliveries on or after January 1, 1981. In late December of 1980, however, shortly before the severance tax regulations were to become effective, FERC stayed the effective

73 Id.
75 Id.
date of Order No. 108 pending a rehearing. The stay was issued on the condition that all payments for first sales of gas delivered on or after January 1, 1981, be subject to refund with interest to the extent payments exceed ceiling prices determined in the proceeding. As of December of 1982, FERC had not acted. As a result, enormous refund liabilities are mounting for sellers and purchasers.

Another problem with section 105 is that the NGPA price ceiling for the previously uncontrolled intrastate market does not encourage enhanced production or continued production of marginal wells. Section 105 imposes a heavy penalty on intrastate sales made at a very low price. Obviously, prior to the NGPA, parties to intrastate contracts could simply renegotiate the contract to provide incentives for enhanced production. Recognizing that fact, Order No. 107 attempted to provide an incentive for production enhancement on old intrastate wells. Order No. 107 issued regulations theoretically designed to encourage production of reserves which otherwise would not be developed or would be lost because existing NGPA section 105 prices were too low to cover the costs of production enhancement. The new "incentive" price for intrastate "qualified production enhancement gas" pursuant to the regulations is the lower of the renegotiated contract price or the section 109 price.

There are three major problems with this "relief" extended to intrastate sellers: 1) the "incentive" price is not high enough to be a true incentive; 2) the Commission has required extensive and cumbersome filings prior to undertaking enhanced production work, and 3) the Commission imposed a maximum recovery for enhanced production revenues actually received equal to 200% of the section 103 new gas prices. Given these difficulties, it

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77 Because of a lack of FERC guidance prior to issuance of Order No. 108, the Commission did not require a seller to refund those reimbursed state severance taxes relating to gas delivered prior to January 1, 1981, which exceeded the tax amounts now receivable under the amended rules.
79 Id.
should not be surprising that relatively few producers have taken advantage of this incentive.80

F. NGPA Section 107—High Cost Natural Gas

In NGPA section 107, Congress established four specific categories of high cost natural gas eligible for the special NGPA incentive price.81 Those categories include gas produced from depths below 15,000 feet, gas produced from geopressed brine, occluded natural gas, gas produced from coal seams and gas produced from Devonian shale.82 Pursuant to the NGPA, these categories of gas were decontrolled with the adoption of Phase I incremental pricing rules for industrial boiler fuel. In addition, Congress vested the Commission with discretionary authority to establish section 107 incentive prices for gas produced under conditions the Commission determines to represent extraordinary risks or costs. Such prices need not be cost based.83

To date, FERC has exercised this discretionary authority only to establish a special incentive price for gas produced from designated “tight formations” in which the producing geological structures are extremely dense. One other FERC proposal to exercise section 107 discretionary pricing for “near deep gas,” gas from wells between 10,000 and 15,000 feet deep, has met with strong disapproval.84 A third proposal to provide special rates for certain offshore gas from deep water wells has been languishing at the Commission for more than two years with no resolution, although it generated little controversy when proposed in early 1980.85 Thus, the only action taken by the Commission concerns tight formation gas.

80 As of August 4, 1982, the Commission had received 245 determinations involving production enhancement volumes. A total of 24,348 Mmcf of gas was indicated on these applications. The Commission received 140 in 1982 and 105 in 1981. Given the thousands of old intrastate wells, this is not a large number of petitions.


83 Id.

84 See text accompanying notes 137-40 infra.

At the end of 1982, the Commission had designated more than one hundred formations, including additions, as tight formations eligible for the special incentive price under NGPA section 107. Order No. 99 established an incentive price for production from so-called "tight-gas" formations of 200% of the NGPA section 103 price or the effective negotiated contract price, whichever is lower. An effective negotiated contract price is one established in the contract either by reference to FERC's incentive pricing authority under section 107 or by a fixed rate or fixed price escalation. Order No. 99 and its amendment is important not only because it sets a substantially higher price for natural gas produced from tight formations but also because it sets out the Commission's guidelines for qualifying for such higher prices.

Two applications for rehearing of Order No. 99 were filed by producers who objected to, among other things, the Commission's failure to set an incentive price by reference to the crude oil or fuel oil market prices and to the requirement of a negotiated contract price. By forcing the use of certain words and provisions in the contract, the producers asserted that the Commission violated section 101(b)(9) of the NGPA and the Mobile-Sierra-Memphis doctrine under which private contractual rights of producers and pipelines are preserved as long as those rights do not result in the collection of a price in excess of the maximum lawful price.

In Order No. 99-A, the Commission denied rehearing and rejected the producers' contentions, including the attack on the negotiated contract price requirement. The Commission reasoned that because its authority under section 107(b) is limited to setting incentive prices necessary to encourage addi-

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88 See note 42 supra and accompanying text.
tional production, the negotiated contract provision ensures that the price collected under the contract is necessary to increase gas production. The Commission also noted that parties are not barred from renegotiating their contracts to qualify for the incentive price.

In *Pennzoil v. FERC*, the Fifth Circuit Court of Appeals affirmed FERC Order No. 99. The court concluded that the Commission has authority to require contract pricing provisions to assist it in identifying gas whose production entails such extraordinary risks or costs that it would not be undertaken absent the availability of special incentive prices. The court found that the Commission exercised such authority in a manner reasonably related to attaining congressional objectives and was neither arbitrary nor capricious. The court also held that the history of the contract price requirement shows that the requirement itself is a part of the definition of gas entitled to the special incentive price. The requirement was promulgated, not under FERC authority to prescribe the incentive, but rather to satisfy the Commission's duty to define gas qualifying for that special price in a manner consistent with the express mandate of the NGPA. If the contract did not authorize price increases as incentives to enhance production, presumably the parties believed enhanced production did not merit higher prices.

G.  NGPA Section 108—Stripper Well Gas

NGPA section 108 establishes a maximum lawful price for any first sale of gas which qualifies as stripper well gas. Stripper well gas is non-associated natural gas produced from a well which, during the preceding ninety-day production period, did not produce more than sixty Mcf per production day. In addition, during the prescribed period the well must have produced at its maximum efficient rate of flow determined in accordance with recognized conservation practices designed to maximize the ultimate recovery of natural gas.
The NGPA permits stripper wells to continue to qualify for the section 108 incentive price if production increases above sixty Mcf per day because certain recognized enhanced recovery techniques were applied. The Commission has defined recognized enhanced recovery techniques as processes or equipment, or both, which when performed or installed by the producer, increase the rate of production of gas from the well. Normal well maintenance, repair, replacement of equipment or facilities or initial well completion, are not considered enhanced recovery techniques.

H. NGPA Section 109—Other Categories of Gas

NGPA section 109 is designed to establish maximum ceiling prices for certain categories of gas including:

1.) natural gas produced from any new well not otherwise qualifying for a higher ceiling price under the NGPA;

2.) gas which on November 8, 1978, was committed or dedicated to interstate commerce and for which a just and reasonable rate under the NGA was not in effect;

3.) natural gas which on November 8, 1978, was not subject to an existing contract and not committed or dedicated to interstate commerce;

4.) natural gas produced from the Prudhoe Bay Unit on the North Slope of Alaska and transported through the system approved under the Alaskan Natural Gas Transportation Act of 1976.

In January of 1983, the section 109 price was $2.254 per MMBtu.

The crucial question in interpreting section 109 is the scope of its applicability. The Commission has adopted a narrow reading of the section because it fears that under a broad interpretation, a producer could circumvent a lower price applicable under sections 104, 105 or 106 by drilling a new well, even though the

\[93\] Id. § 3318(b)(2).
\[94\] Id. § 3319.
\[95\] Id. § 3319(a)(1)-(4).
\[96\] See note 49 supra.
well would not qualify as a new onshore production well under section 103 or would not produce new gas under section 102.\textsuperscript{97} Thus, section 109 covers first sales of natural gas described in that section only to the extent that such first sales are \textit{not} covered by any other maximum lawful price available under other sections of Title I.\textsuperscript{98}

I. \textit{NPGA Title II Incremental Pricing}

1. \textit{Purposes: The Hierarchy of Natural Gas Uses}

The political trade-off for increased prices and eventual de-control of certain natural gas contained in Title I of the NGPA was the incremental price provision of Title II which was designed to appeal to residential consumers. Title II\textsuperscript{99} reflects a congressional policy of imposing pricing penalties upon certain uses of natural gas in favor of use by residential customers. This policy was to be implemented in phases. In Phase I, which was to be implemented within twelve months of the NGPA's enactment, certain incremental gas costs were imposed on "industrial boiler fuel facilities." Industrial boiler fuel facilities are those using natural gas to generate steam or electricity.\textsuperscript{100} Phase II, which the FERC was to propose within eighteen months of the NGPA's enactment, extended incremental pricing to other industrial uses determined by FERC.\textsuperscript{101} As discussed below, the Commission's Phase II rule was subject to congressional review under procedures which have been challenged in court.\textsuperscript{102}

Title II provides a detailed mechanism for implementing incremental pricing. NGPA section 203 establishes a threshold

\textsuperscript{97} Order No. 72, Final Regulations Implementing Section 109 of the Natural Gas Policy Act of 1978, 45 Fed. Reg. 18,915; 18,916 (1980).

\textsuperscript{98} Id. at 18,916; see Tenneco Exploration, Ltd. v. FERC, 649 F.2d 376 (5th Cir. 1981); Spradling Drilling Co., Declaratory Order Determining Maximum Lawful Price Eligibility Under the NGPA, Docket No. GP80-2, mimeo at 3, 14 FERC 61,145 (1981).


\textsuperscript{100} NGPA § 201, 15 U.S.C. § 3341 (Supp. IV 1980).


\textsuperscript{102} NGPA §§ 202(c), 507(b) & (c), 15 U.S.C. §§ 3342(c) & 3417(b),(c) (Supp. IV 1980).
price for each of eight categories of gas; amounts paid by interstate pipelines above these threshold levels must be passed through to facilities identified for incremental pricing, up to the point at which the rates and charges paid by any such facility equal the cost of alternate fuels. In limiting the effect of the incremental pricing surcharge, Title II was clearly not to drive industrial users from the natural gas market altogether, in which case higher priority users would bear the entire weight of increased costs.

The incremental pricing program has two purposes: 1) to mitigate the effects of rising gas costs brought about by Title I of the NGPA on residential consumers and small commercial consumers, and 2) to discourage lower-priority users of gas, thus preserving a greater share of market supplies for residential and small commercial use. Those features of the program were, from a congressional view, a politically necessary quid pro quo for higher wellhead prices.

However, Title II has not served the intended congressional purposes. Under Phase I, incremental pricing surcharges raised the prices paid by industrial boiler fuel users to the applicable alternative fuel ceiling prices as soon as the rule took effect. Yet, the benefit to a typical residential household using gas heat amounted to only eight dollars a year, and Phase II, it was projected, would add only ten dollars more in savings, an amount Congress found did not justify the extraordinary administrative costs of extending the program.

2. Phase I Rules: The Effect on Industrial Use

While the Phase I rule imposing additional costs on boiler

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103 The eight categories of gas are: (1) new natural gas; (2) natural gas under intrastate rollover contracts; (3) new, onshore production well gas; (4) LNG imports; (5) natural gas other than LNG imports; (6) stripper well natural gas; (7) high-cost natural gas, and (8) gas from the Alaska Natural Gas Transportation System. Separate threshold levels are determined for state surcharge paid to other pipelines. 15 U.S.C. § 3343(a) (Supp. IV 1980).
106 Id. at 31,639; see also 126 CONG. REC. H3639-3855 (daily ed. May 20, 1980) (de-
fuel facilities continues to deter industrial boiler fuel use of natural gas, the operational effect of incremental pricing by FERC is negligible. This is because state regulatory authorities, under their own incremental pricing authorities, are maintaining the rates charged to industrial boiler fuel users at levels that preclude application of the incremental pricing surcharge; regulated rates at the state level are near, or sometimes above, the alternative fuel price and, as such, Title II's incremental pricing provisions have virtually no effect.\textsuperscript{107} States often use such price discrimination of natural gas to achieve certain social objectives.\textsuperscript{108}

The actual effect of incremental pricing under the NGPA currently is to make the state incremental pricing programs feasible both politically and practically. With the federal program in place, the states retain the incentive to preempt the federal program by implementing and managing their own incremental pricing rules,\textsuperscript{109} thereby using the incremental revenues paid by industrial users the way they deem appropriate under state regulatory policies.

3. \textit{Phase II Rules: Consumer Energy Council v. FERC}

On May 6, 1980, the Commission issued its Phase II rule which would have imposed incremental pricing on all non-exempt industrial users of natural gas, including industrial process gas and feedstocks.\textsuperscript{110} The House of Representatives disapproved the Phase II rule by a resolution passed on May 20, 1980,\textsuperscript{111} pursuant to procedures set forth in NGPA sections 202(c)

\textsuperscript{107} See Rule Required Under Section 202 of the Natural Gas Policy Act, Incremental Pricing, supra note 105, at 31,624-25.
\textsuperscript{108} Natural Gas Regulation Study, supra note 3, at 243.
\textsuperscript{109} Rule Required Under Section 202 of the Natural Gas Policy Act, Incremental Pricing, supra note 105, at 31,625.
\textsuperscript{110} Id. at 31,622.
\textsuperscript{111} 126 CONG. REC. H3839-3855, supra note 106. Members of the House of Representatives questioned whether incremental pricing was needed at a time when there existed a "temporary surplus of gas deliverability." Id. at 3839. They also noted "serious questions" whether incremental pricing applied to nonboiler industrial uses "can effectively operate as a market ordering device." Id.
and 507(c)(3). This "one-house legislative veto" nullified the rule and left only boiler fuel uses subject to the incremental pricing surcharge.

Following the House of Representatives' resolution of disapproval, the Commission revoked the Phase II rule, declining to challenge the constitutionality of the one-house legislative veto provision. However, in Consumer Energy Council v. FERC the validity of FERC's revocation order was questioned. Representatives of industrial consumers and gas marketers intervened in support of the House resolution and the FERC action.

The Court of Appeals for the District of Columbia Circuit found the one-house legislative veto provision of section 202(c) unconstitutional. The court held that the provision violated the requirements of article I, section 7 of the Constitution by enabling one house of Congress to "enact a policy to which the other house and the President did not agree originally." The court also found that the one-house legislative veto violated the separation of powers doctrine by allowing Congress, or a single one of its houses, to control agency rulemaking directly rather than through the laws under which the agency operates.

4. Prospects for Incremental Pricing

Consumer Energy Council has been appealed to the Supreme Court and is to be decided in the October of 1982 term. Regardless of the Court's decision, Phase II of incremental pricing seems all but dead. Given the current deregulatory climate, FERC's most likely policy choice is either a substantial or total

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114 Id. at 448.
115 Id. at 469.
116 Id. at 471-72.
117 The decision in Consumer Energy Council has far-reaching significance for constitutional law and will likely receive a thorough review by the Supreme Court. The Court's analysis of the constitutional issues, however, will not necessarily reflect any legal or policy judgment on the Phase II rule itself.
revocation of the rule. Further, congressional opposition to incremental pricing does not appear to have moderated since the House passed its resolution of disapproval. If FERC does not modify or revoke the rule, Congress undoubtedly would attempt to amend Title II itself.

Phase II of incremental pricing appears to be a moot issue for two basic reasons. First, the price of gas in late 1982 had reached the price of alternate fuels in much of the United States, thus activating the exemption contained in the incremental pricing sections of the NGPA. Second, Congress, including some of the early proponents of incremental pricing, have determined such pricing does not achieve the original policy goals.

III. PROBLEMS PERCEIVED WITH THE NGPA

The combatants involved in the emergence of the NGPA made little effort to change the NGPA during the first two years after its enactment. An unusual spirit of "wait and see" and cooperativeness emerged. FERC issued interim regulations implementing the basic provisions of the Act with record speed. Moreover, FERC assisted both producers and state agencies who were making the initial determinations on jurisdictional classifications of gas, by establishing hotlines and holding regional seminars throughout the country. All parties appeared pleasantly surprised with the ease of implementation of this complex act during its first year.

The 1980 election year presented an opportunity for political opponents to begin attempts to change the NGPA. Candidate Reagan announced his opposition to natural gas price controls

118 Apparently, NGPA § 202 only requires FERC to issue a single Phase II rule. In the event of congressional disapproval of the rule first promulgated, the Commission "may" thereafter submit an amendment expanding the application of incremental pricing. Nothing in the legislative history suggests that the Commission must issue a substitute rule. Moreover, the Commission arguably would be powerless to issue a new Phase II rule after May 20, 1982; § 202(c)(2)(B)(ii) provides that such an amendment must be submitted to Congress not more than two years after the date of adoption of any congressional resolution of disapproval.

119 Interim regulations were proposed five days after the law was enacted and were published two weeks later on December 1, 1978. 43 Fed. Reg. 56,448 (1978).
and stated his intention to press for natural gas deregulation if elected. With his election, the gas producing industry eagerly awaited introduction of a gas deregulation bill. However, no such legislation has been forthcoming. The President’s announcement on March 1, 1982, that he would not forward gas deregulation legislation to the 97th Congress came as a fait accompli. Since legislative changes to the NGPA were not made in the 97th Congress, the current and potential problems of natural gas regulation under the NGPA become more urgent.

A. Deterioration of Regulatory Responsiveness to NGPA Issues

FERC’s regulatory responsiveness in implementing the NGPA as it exists is a critical concern to those directly affected by the regulation—producers, distribution companies, consumers of natural gas, pipeline companies and the practitioners representing them. Those who view only the macroeconomic effect of gas regulations are less concerned. Initial implementation of the NGPA was dynamic, but FERC has faltered significantly in subsequently addressing NGPA regulatory issues. FERC’s failure to resolve issues involving the treatment of certain gas costs and incentives cumulatively exacerbates and clouds the regulation versus deregulation issue. More important, by so doing, FERC undermines its own authority.

The previously discussed treatment of severance taxes in sales of intrastate gas is only one example of regulatory indecision and delay. Other basic questions remain. First, a rulemaking on the fundamental issue of the pass-through of gathering and production costs for all natural gas sales has been pending since December of 1980. Without a definite rule on the matter, FERC purports to be acting on a case-by-case basis. This situation is not unusual at FERC today. On at least five critical issues, FERC has had an opportunity to act but has not done so decisively. In each

\[\text{footnote text}\]

120 See text accompanying notes 70-77 supra for a discussion of severance taxes in sales of intrastate gas.

instance, prompt action by FERC could have clarified the major
gas pricing issues stated at the outset.

Second, in August of 1979, FERC issued a notice of proposed
rulemaking to provide special relief to encourage production of
interstate natural gas which could not be economically produced
under existing NGPA sections 104, 106 and 109 prices. A final
staff draft of these regulations was released in May of 1980. More
than two years later, the Commission has not acted on the
final draft. Thus interstate gas which could be in production is
lost to the market. Producers may justifiably be holding in abey-
ance plans for enhanced recovery of interstate gas pending an
action by FERC.

Third, Congress has provided producers a type of relief
through adjustment procedures in section 502(c) of the NGPA in
order to prevent special hardship, inequity or unfair distribution
of burdens. Under similar statutory language, the Department
of Energy has provided broad guidelines and processed hundreds
of cases through the Office of Hearings and Appeals providing
for special relief under the price regulations governing oil and
gas. But again, the Commission has required such severe show-
ings of hardship (much more stringent than the Department of
Energy) so as to render the section useless in all but the most egre-
gious circumstances.

Fourth, FERC's treatment of the application of "area rate
clauses" in interstate contracts existing under the NGPA is

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122 Procedures Governing Applications for Special Relief Under Sections 104, 106
(1979) (to be codified at 18 C.F.R. pts. 2 and 271).
123 Procedures Governing Applications for Special Relief Under Sections 104, 106
124 FERC recently issued two orders granting special relief on an individual basis,
Liberty Oil and Gas Corp., Docket No. RI78-78-000, 20 FERC ¶ 61,136 (1982) and Lib-
erty Oil and Gas Corp., Docket No. 82-3-000, 20 FERC ¶ 61,137 (1982). In these orders,
FERC acknowledged it has previously refused to grant such individual relief petitions
pending resolution of the rulemaking. FERC gave no indication whether it intended to
abandon the rulemaking. These orders specifically stated the cases required special, ex-
pedited treatment. Whether FERC will reverse its position and consider individual peti-
tions either in lieu of or in addition to the proposed rules is still an open question.
another example of hesitant regulation. Area rate clauses, contained in contracts executed under the NGA, are price escalator clauses which allow contract prices to rise to the regulated area rate ceiling price set for the type of gas covered by the contract. FERC maintained these clauses would not be effective contractual authority to permit collection of the prices allowed by the NGPA, even though the parties to interstate contracts could amend those contracts to allow for collection of the applicable NGPA wellhead prices. Commentators overwhelmingly disagreed with FERC’s position. Consequently, FERC reversed itself in Order No. 23, the first in a series of orders dealing with area rate clauses. FERC stated that “area rate clauses may be relied on by the parties to a contract as authority for an increase in rates to Natural Gas Policy Act statutory ceilings” and that, in the case of objections by third parties, “considerable weight will be given to the interpretation ascribed to the contract by its parties.” FERC concluded that because there was little evidence indicating Congress intended to preclude the operation of area rate clauses (and similar contractual provisions), such a result was not required by the statute.

Consequently, the Commission decided that the effectiveness of each clause was a matter of contract law and could not be dealt with by a blanket rulemaking determination. Great weight


was to be given to the intent of the parties and to the commercial context surrounding the clause. As a result of the approach adopted by FERC in Order No. 23, the details of guidelines to be followed in interpreting specific area rate clauses became a matter of continuing concern and, in many respects, the central issue in the area rate clause controversy.

In Order No. 23-A, FERC answered in the affirmative the question of whether amendments could be freely entered into by the parties, rejecting any requirement of additional specific consideration as an essential element of such an amendment. The Commission would consider protests as to the adequacy of consideration on a case-by-case basis while reviewing a pipeline's filing. The applicable standard for adequate consideration is the "fraud, abuse or similar grounds" test applied under NGPA section 601.

To answer the numerous questions regarding the protest procedures, FERC issued Order No. 23-B. Because of the limits of FERC's non-price regulatory control, the protest procedures only affect sections 104, 106(a), 108 and 109(a)(2) categories of gas. Under the order, evidence of agreement between the pipeline and the producer as to the collection of the NGPA price creates a rebuttable presumption that the parties to the contract did have an intent to make such a collection.

This series of orders satisfied neither producers nor consumers, all of whom challenged FERC's litany of orders in court. In Pennzoil v. FERC, the Fifth Circuit Court of Appeals basically upheld FERC's determinations. However, because FERC was not decisive as to the intent of the parties to the contracts in its case-by-case review of area rate clauses, protests abounded.

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129 Id. at 30,681; 30,632 (to be codified at 18 C.F.R. pts. 154 and 270). The Commission observed that "where the Commission must rule on the proper interpretation of a contracts clause, references will be made not only to the four corners of the contract, but also to the circumstances surrounding the execution of the contract." Id.

130 Id. at 34,472; 34,473.

131 Id. at 38,834.

132 Id. at 38,836.

133 645 F.2d 360 (5th Cir. 1981), cert. denied, 102 S. Ct. 1000 (1982).

134 FERC attempted once again to clarify its position on area rate clauses in Opinion No. 77, Independent Oil and Gas Ass'n of West Virginia, Opinion and Order Reversing
Literally hundreds of contracts remain in administrative litigation through third party protests, and FERC still has not adopted clear guidelines.

FERC's proposal to establish incentive rates for "near deep gas" illustrates a fifth problem area. It again demonstrates the agency's attempt to address regulatory pricing problems without an appreciation of the political or public relations problems involved. On December 30, 1981, the Commission proposed setting special incentive rates for gas produced from wells 10,000 to 15,000 feet deep which were spudded or drilled deeper into a new reservoir after that date. This so-called "intermediate deep gas" or "near deep gas" would be priced at 150% of the NGPA section 103 new onshore gas or the equivalent of approximately four dollars per MMBtu.

The Commission originally solicited comments on the petition to set these rates in July of 1980. From information derived from those comments, the Commission determined the cost of production at depths greater than 10,000 feet is three to six times greater than the cost of production of shallow gas. From this data, the Commission concluded that gas production from 10,000 to 15,000 feet presented extraordinary risks and costs for which the present applicable maximum lawful price did not compensate. The Commission noted that NGPA section 107(b)

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Initial Decision, Remanding and Consolidated Proceedings, Initiating Hearings, Established Procedures, and Granting Intervention, Docket Nos. RI74-188 and RI75-21, 45 Fed. Reg. 16541 (1980). As a general rule, FERC will give effect to the parties' interpretation of their contractual intent. The Commission reiterated that in a situation in which the parties to a gas sales contract agree as to the intent of an area rate clause within the contract, but their interpretation is contested by a third party, the contracting parties' mutual understanding is to control unless the third party can show that the contract language is clearly inconsistent with such an interpretation or can produce convincing extrinsic evidence contradicting the interpretation of the parties. But FERC was not satisfied with this approach and in Opinion No. 135, remanding protest dismissals to an administrative law judge for reconsideration, stated, "It was never the Commission's intention to present an insurmountable barrier to third party protestors . . . ." although such protestors were to have a greater burden than the contracting parties in showing the contract precluded the interpretation urged by its principals. Transcontinental Gas Pipe Line Corp., Opinion and Order Remanding for Limited Purposes, Docket No. GP80-24, 17 FERC ¶ 61,232 (1981) (issued Dec. 11, 1981).

allowed the Commission to establish ceiling prices which exceed the otherwise applicable maximum lawful price "to the extent necessary to provide reasonable incentives." The NGPA conference report and court decisions interpreting the NGPA have established that such incentive prices need not be cost-based.\(^\text{136}\)

As with other proposals to increase gas prices, Congress and consumer groups were most critical of the proposal. Commissioners Sheldon and Hughes expressed concern and disapproval regarding the type of general information which FERC had received from producers to bolster producers' assertions that higher prices are needed for intermediate deep gas. As FERC made clear in its proposed rulemaking, the Commission requested specific cost, production and reserve information.\(^\text{137}\)

Privately, FERC officials concede such criticism may have less bearing on the elements of this specific proposed rulemaking than on the fact that notice of this proposal was issued about the same time that proposals to raise the price of old flowing interstate gas were publicized. Given the extremely negative reaction of many members of Congress and consumer groups, coupled with the reluctance of most gas producers to provide cost justification data, adoption of the intermediate deep gas rule will be difficult. Nevertheless, the FERC recently reiterated its intention to issue the rule, but gave no indication as to a date for such an issuance.\(^\text{138}\)

However, without such a rule, the misallocation of exploratory and production funds might continue. The range between 10,000 and 15,000 feet might not be fully explored or produced because costs are too great. In areas where near deep gas is likely to be found, producers will be much more inclined to drill down

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\(^{137}\)Part of the problem with receiving such information is the public nature of a proposed rulemaking. A more generic problem is that the FERC has no statutory authority to preserve the confidentiality of material submitted to it. Thus, under the Freedom of Information Act, 5 U.S.C. § 552 (1976), such data is available to all parties. Obviously, in the area of deep gas drilling where seismographic and reserve data are scarce and expensive, a competitor would be most eager to obtain such data from FERC's Office of Public Information at no expense other than the photocopying charge.

to 15,000 feet and below to receive the decontrolled price for deep gas. Yet once again, in part because of FERC's politically inept timing of this proposal, it is now politically impossible to adopt the measure.

In sum, the FERC persistently refuses to allow its own orders to take effect and stand as final. In the case of severance tax treatment, guaranteed cost pass-through, Btu content measurement of gas, blanket pipeline certification authority and others, FERC issues final "orders" and then almost immediately stays the effect of those orders pending a petition for rehearing on the matter. As a result, regulated parties are at jeopardy in taking immediate action based upon FERC "final" orders because these orders are likely to be changed within days. FERC appears to be strangling itself in its failure to promulgate needed regulations and the constant re-examinations and classifications of those regulations it does promulgate. If more of the Commission's statutory authority under the NGPA were actually exercised, the market problems discussed previously might well be mitigated to some degree. At least the natural supply and demand factors could function more reasonably.

B. *Disparity Between the Interstate and Intrastate Markets*

Both houses of the 97th Congress held extensive hearings on the NGPA, its effectiveness and its weaknesses.139 These hearings focused on the macroeconomic issue of gas regulation and the overall impact of the NGPA. As might be expected, consumer groups (representing individuals, homeowners, the elderly, persons on fixed incomes and others) and state regulatory agencies in major gas consuming states favored retaining the NGPA or extending indefinitely NGPA price control authority. On the other side, most gas producers and state regulatory agencies in states producing more than their consumption urged more rapid gas deregulation. Interstate pipelines have generally skirted the de-

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regulation issue, but have sought to retain old gas at the lower rates.

The debate during these hearings focused upon this fundamental issue of regulation versus free market. Few, if any, specific legal criticisms of NGPA’s actual operation were lodged. In discussing this basic policy issue of regulation, certain themes recur. Market bidding disparities between the interstate and intrastate markets and the natural gas price spike or “fly-up” expected in 1985 received wide discussion, along with corollary contract clause problems and the loss of energy markets to alternative fuels.

1. The Perceived Problem of Market Disparities

One of the primary problems, both actual and potential, cited as requiring amendment of the NGPA is the alleged disparity between intrastate and interstate pipelines in bidding for additional supplies of new gas. The argument is that interstate pipelines, which have a long history of enjoying lower prices for natural gas because of the FPC regulation of wellhead prices under the NGA continue to benefit from that cushion of cheap old flowing gas.

The NGPA purported to eliminate the dual market system of regulated interstate and unregulated intrastate pipelines which existed prior to its enactment. But NGPA’s practical effect was not to eliminate the disparity; instead, it froze into existence the price controls for flowing interstate gas and flowing intrastate gas (with some allowance for inflation), and created a third pricing distinction for gas discovered after enactment of the NGPA.

140 NGPA provisions have been challenged many times in the courts. The NGPA withstood challenges to Title I dealing with producer prices, Oklahoma v. FERC, 661 F.2d at 832, but Title II, dealing with incremental pricing, remains under attack on constitutional as well as other grounds before the Supreme Court in Process Gas Consumers Group v. Consumer Energy Council, No. 81-2008 and Interstate Natural Gas Assn. v. Consumer Energy Council, No. 81-2020, 50 U.S.L.W. 3896 (May 1, 1982).

141 The problems of the dual market system of interstate and intrastate gas markets are not new. As one author put it, “The NGPA presents a Congressional response to the disparity of regulatory treatment created by Phillips in the same way the Natural Gas Act was a response to the disparity created by Missouri v. Kansas Natural Gas Company.” Nordhaus, supra note 34, at 857.
In this new pricing market, some gas, such as deep gas as defined in section 107 of the NGPA, is totally deregulated. Much of the gas, including NGPA section 102, new gas and section 103 new onshore production gas sells at very high prices compared to prices for old flowing gas. Current NGPA prices for old flowing interstate gas reflect the regulated prices, with an inflation adjustment allowed under the NGA. As a result, some interstate pipelines have a significant "cushion" of relatively low priced old gas. It is estimated that the cushion will increase after certain natural gas is deregulated beginning in 1985.142

Presumably this cushion allows interstate pipelines to outbid intrastate pipelines (whose higher average flowing gas prices reflect the previously unregulated prices of that market) for post-NGPA new gas, new onshore production gas, high cost gas and totally unregulated gas. For example, tax records from the State of Texas show that in January of 1981, the average cost of gas to interstate pipelines was $1.37 per Mcf while the cost to intrastate pipelines was $2.18 per Mcf; in August of 1981, the average cost to interstate pipelines was $1.67 per Mcf and to intrastate pipelines was $2.54 per Mcf.143

Such disparities arguably make it difficult for intrastate pipelines or purchasers to bid competitively on marginal supplies of gas coming into the market, nearly all of which fall within the higher prices permitted under the NGPA. To further bolster their argument for a free market for all gas pricing, proponents note the decline in reserve to production ratios since 1978.144 This situation is being felt, although only approximately three percent of the supply is deregulated. The real concern is the impact on the intrastate market and dual market system in 1985 and 1987 when

142 See R. Means, supra note 4, at 13 (stating that "the natural gas cushion will not be evenly distributed between interstate and intrastate pipelines. . . . [I]nterstate pipelines will have a substantially larger cushion than intrastate ones").
much of the natural gas, other than old flowing interstate gas, will be deregulated.

If NGPA gas prices remain unchanged at that time, a significant portion of the gas supply of certain interstate pipelines will be priced at the lower, old flowing gas rates still subject to price control, while prices for the new deregulated gas are expected to make a sharp "fly up." By comparison, the intrastate pipelines would have only their considerably higher priced gas which remains under contract to cushion their prices. Thus, intrastate pipelines not only will have considerably higher average costs for gas, but, because of this higher price, will also have difficulty competing with the interstate pipelines in bidding for the still more costly supplies of gas. At some point, if their average gas costs exceed the market clearing costs, customers of intrastate pipelines will simply switch to alternate fuels.

However, this argument presumes that each interstate pipeline has a significant cushion of old flowing gas priced at the lower rate and that each intrastate pipeline has no similar cushion of low priced gas controlled by its own contractual authorities. Such assumptions might not be wholly valid. In opposition to the argument, it should be noted that certain gas is currently being sold at well below NGPA ceiling prices based upon actual contracts, and some producers are having difficulty selling new gas supplies. Certainly, the percentage of old gas under contract for various interstate pipelines varies widely, from a low of twenty-nine percent to a high of seventy-nine percent. Thus, as might be expected, the average acquisition cost for interstate pipelines based upon those statistics varies widely from a low of $1.30 per Mcf to a high of $2.76 per Mcf. While statistics from intrastate pipelines are less readily available, it may well be that a similar disparity exists among those pipelines.

2. FERC’s Administrative Attempts to Address the Market Disparity Problem

To the extent the NGPA has vested discretion with FERC, FERC has proposed to address the market disparity through its
administrative procedures. Unfortunately, because of the extreme political conflict between competing interest groups involved in the issue of gas pricing, all administrative actions proposed by FERC have been subjected to substantial public and congressional criticism. As with all administrative agencies, public and political opinion, in addition to evidentiary submissions, influence the decision-making process in varying degrees.

Since the fall of 1981, discussions have ensued regarding the review of prices of old flowing interstate gas, as classified in NGPA sections 104(b)(2), 106(c) and 109(b)(2). Price increases were urged, in part, to deal with market disparities. Certain FERC officials referred to these discussions as "administrative decontrol,"146 a rather poor choice of words in terms of accuracy and publicity, and a phrase which drew the attention—and the ire—of important members of Congress and consumer groups.147

Use of this inaccurate phrase has tended to obscure the substantive discussion of the issues in the press, before the agency and within Congress. The NGPA specifically grants FERC authority to establish higher alternate prices for old flowing gas as defined in NGPA sections 104(b)(2), 106(c) and 109(b)(2) at a rate which is "just and reasonable within the meaning of the Natural Gas Act." The NGA meaning of just and reasonable has been amply interpreted by the courts. The courts have held that cost is not the only basis for just and reasonable rates.148 FERC can, in effect, establish higher rates for old flowing interstate gas through the authority granted it by Congress in the NPGA and

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147 Resolutions urging FERC not to take such action were introduced in the Senate by Senator Chafee (R-R.I.) and in the House by Representative John Dingell (D-Mi.), Chairman of FERC's jurisdictional committee, the Committee on Energy and Commerce. Both resolutions have a significant number of co-sponsors.
148 In American Pub. Gas Ass'n v. FPC, 567 F.2d 1016, 1058 (D.C. Cir. 1977) cert. denied, 435 U.S. 907 (1978), the Court observed: "In general vintaging is a method of pricing gas on the basis of cost at the time of production. However, the agency is not bound strictly to cost. The Commission 'must be free . . . to devise methods of regulation capable of equitably reconciling diverse and conflicting interests.'" Id. (citing Mobil Oil Corp. v. FPC, 417 U.S. at 331, which quoted Permian Basin Area Rate Cases, 390 U.S. at 767).
by relying upon NGA principles as interpreted by the courts.  

Courts also have noted specifically that the enactment of the NGPA signaled a definitive move away from cost based pricing.  

The establishment of such just and reasonable rates, even though not based upon cost factors, in no way constitutes “administrative decontrol” of gas prices. The rates must satisfy the well defined and specifically interpreted court concepts of “just and reasonable rates” developed during the years of NGA regulation. Basically, such rates would be subject to the same type of development and justification as rates established under the NGA which considered both cost and non-cost factors, including the replacement cost of gas.

After great internal debate over whether to propose a rulemaking and if so what it should contain, FERC compromised by releasing a notice of inquiry (NOI) in early 1982 addressing the question of the market disparities. The NOI was an attempt to gather information to determine the true extent of the market disparity. The NOI primarily sought public comments and data submissions to discover the exact nature of the economic distortions between the interstate and intrastate markets and the distortions likely to occur with decontrol of new gas in 1985. The NOI requested comments on appropriate Commission responses to such economic distortions. Also solicited were comments on the alternatives posed by the Commission in response to such problems: 1) elimination of vintaging and establishment of new just and reasonable rates pursuant to sections 104, 106 and 109; 2) restrictions on contract terms such as indefinite price escalation clauses and take-or-pay clauses, and 3) revisions of pipeline regulations to eliminate rolled-in pricing and to require marginal pricing for the purchase of decontrolled gas at the wellhead. The NOI also solicited comments on FERC’s legal authority to undertake actions necessary to apply such alternatives.

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150 See Pennzoil Co. v. FERC, 645 F.2d at 367.


152 See Notice of Inquiry, supra note 65. See text accompanying notes 141-45 supra for a discussion of market bidding disparities between the intrastate and interstate markets for natural gas.
Creating higher just and reasonable rates for old flowing interstate gas is one major solution urged by FERC to address the marketing bidding disparities between the interstate and intrastate markets for natural gas. The biggest question regarding raising flowing interstate gas prices is whether such a move would merely reverse the problem and shift the competitive advantage to the intrastate market, which in the pre-NGPA era traditionally enjoyed an advantage in gas acquisition. FERC has little, if any, data concerning the intrastate natural gas market, prices and controls. The NOI was in part an attempt to gather such information\(^\text{153}\) so that FERC could determine the price at which the interstate "cushion" of relatively low priced gas would reverse.

General Counsel Charles Moore has noted the wide disparity among the interstate pipeline prices shown in PGA filings, which reveal that some interstate pipelines have average gas costs almost twice the average costs of other pipelines.\(^\text{154}\) This discrepancy further complicates the task of raising flowing interstate gas rates to equalize gas costs for both interstate and intrastate pipelines, particularly given the historic role of pipelines as purchasers and resellers. Realistically, the economics of gas purchases are likely to fluctuate between the interstate and intrastate markets, and it may well be impossible to strike a balance through regulation.

A staff technical analysis,\(^\text{155}\) issued shortly after the NOI, addresses a revised and updated pricing structure using the Opinion No. 770\(^\text{156}\) rate-making methodology. The Opinion No. 770 methodology was the pricing structure last used under the NGA before the enactment of the NGPA. This pricing mechanism, with

\(^{153}\) Several commentators did present extensive data, including economic projections, in response to the Notice of Inquiry, supra note 65. See Joint Comments of Indicated Producers, presented before FERC, Washington, D.C. (Aug. 26, 1982).


\(^{155}\) Staff Technical Report, Impact of the NGPA on Current and Projected Natural Gas Markets, Docket No. RM 82-29-000, mimeo (June 3, 1982).

changes approved by the courts, employs some vintaging and takes into account the need for incentives in the gas industry as well as other public policy goals.\textsuperscript{157} This method deviates from the strict cost-based pricing method previously used.

The question with the application of this method is whether, given the price incentives of the NGPA, additional price incentives can still be justified or should be approved. Using this methodology with only slight modifications, prices for old gas in 1981 would range between $5.02 and $8.17 per Mcf.\textsuperscript{158} Political pressures would not permit such prices now, even if market conditions would. Also, given the change in the gas market brought about by the NGPA, one must question whether the Opinion No. 770 methodology would still be relevant.

Eliminating the vintaging concept, whether gradually or immediately, would also eliminate the unrealistically low prices for old flowing gas. The NGA seems to permit such an elimination of vintaging.\textsuperscript{159} In previous opinions, FERC announced its intention to eliminate vintaging.\textsuperscript{160} In \textit{Shell Oil Co. v. FPC}, the Fifth Circuit Court of Appeals specifically approved abandonment of the vintaging concept.\textsuperscript{161} However, it is unclear what will be substituted for the vintage price. Eliminating a current pricing scheme does not necessarily lead to a new and better scheme.

C. \textit{Price Fly-Up in 1985?}

The specter of substantial price increases for natural gas


\textsuperscript{158} Staff Technical Report, supra note 155, at 17, 20.

\textsuperscript{159} Prior to the issuance of the Notice of Inquiry, the FERC staff developed a comprehensive legal analysis of the Commission’s authority to eliminate vintaging and thus increase the prices for old flowing interstate gas. In a November 10, 1981, memorandum to Chairman Butler, Philip Marston of the Office of General Counsel concluded that such legal authority existed under the NGA and §§ 104(b)(2), 106(c), and 109(b)(2) of the NOPA. While disagreements will exist as to the wisdom of raising old gas rates and the specific methodology for doing so, the Commission does have the legal authority to address the issue.

\textsuperscript{160} Area Rates for the Appalachian and Illinois Basin Areas, 48 F.P.C. 1299 (1972).

\textsuperscript{161} 520 F.2d 1061, 1077-78 (5th Cir. 1975, cert. denied, 426 U.S. 941 (1976).
when decontrolled in 1985, commonly called the gas "fly-up" or the "price spike," is another area of debate in considering amendments to the NGPA. The spike or fly-up would occur because many natural gas purchase contracts contain price escalation clauses tied to the highest authorized price, the price of some other commodity such as No. 2 or No. 6 fuel oil, or the price paid for similar gas produced in the same or a specified area. These clauses would be triggered only when the price of gas is deregulated. Often the clauses are included to protect producers from discriminatory treatment by purchasers and/or from litigation instituted by royalty owners to collect their royalties based upon prices higher than those actually received by the producer.162

Whatever the logical and actual basis for such clauses, if allowed to operate following price deregulation, they could and probably would cause a domino effect. The overall price would increase and so would the cost of natural gas to ultimate consumers. A gas price spike could exacerbate any market disparities between the interstate and intrastate markets, result in customers turning to lower priced alternate fuels and generally be detrimental to the economy. In enacting the NGPA, Congress intended that escalating inflation factors would gradually move the price of gas up so that upon decontrol in 1985 gas prices theoretically would equal those for alternative fuels.163 At least as of 1982, the cost of alternate fuels has increased much more rapidly than projected in 1978 and the inflation rates for NGPA prices have not kept up with the prices of alternate fuels.

A basic assumption here is that the price of deregulated gas will fly up immediately. This assumption is taken for granted because of the strong history of price increases in gas shortages; however, evidence during the summer of 1982 suggests that the market clearing price for gas is not unlimited. Interstate pipelines began exercising "market out" clauses in existing contracts

162 In fact, the Department of the Interior, one of the nation's largest royalty interest owners by virtue of its management of federal lands, has proposed regulations which, if adopted, would "assume" a minimum price was received by the producer and collect royalties based upon that "assumed" price. Notice of Hearing on Fair Market Value of OCS Gas for Royalty Purposes, 47 Fed. Reg. 16,423 (1982).

163 Notice of Inquiry, supra note 65, at 19, 157-59.
for deregulated gas. Typically, these clauses permit the purchaser to terminate the contract or to reduce the price paid for gas if the contract price exceeds a level the purchaser deems to be the market price of alternate fuels. Also, when crude oil prices were deregulated the price of crude oil did not increase dramatically because of market factors. The actual level to which natural gas prices might climb after deregulation will be affected most by general economic conditions at the time. The current recessionary economy may favor immediate deregulation of gas prices because economic conditions would restrict the prices of natural gas; however, it is impossible to predict what the economic picture will be in 1985.

Regardless of market responses, some pipelines and consumers urge that, even with deregulation, free market forces will not be able to operate and producer prices will not respond to the market place because existing contract terms favor the producer. It is argued that indefinite price escalator clauses, such as most favored nation clauses and alternate fuel parity clauses coupled with take-or-pay clauses, insulate the producer from market forces. Since gas contracts typically tend to be for ten years or

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165 Of course, controls on crude oil and natural gas are not completely analogous. Crude oil had been price controlled for a relatively short time, compared with natural gas. Moreover, crude oil was gradually decontrolled so that an increasing amount each month was eligible for decontrol.

166 FERC's Notice of Inquiry includes the possibility of administrative revision of take-or-pay clauses in gas purchase contracts. Many opponents of gas deregulation attack the use of these clauses and of indefinite price escalator clauses on the same grounds and with the same argument. The two types of clauses are, however, substantially different. Take-or-pay clauses generally establish: 1) when the purchaser must begin taking gas or at least paying for gas if the purchaser chooses not to make actual takes; 2) how must gas the purchaser must pay for on a daily or monthly basis whether or not the gas is actually taken, and 3) that the purchaser must take from the well on an equal basis with other wells in the field and other wells from which gas is taken by the purchaser.

Take-or-pay clauses serve several important purposes other than insulating producers from market forces. Such clauses provide cash flow to offset the major capital investment which producers previously made. These clauses also protect the producers by keeping up well production to avoid drainage by other wells in which the producer owns no interest. Without such production, producers could be subject to royalty owner suits
more,\textsuperscript{167} these contracts will last well into deregulation. In congressional hearings and before FERC, many witnesses have urged legislative action to prohibit the operation of such producer price escalation clauses and take-or-pay clauses prior to NGPA’s 1985 decontrol date.

A number of pipelines already have protected themselves by including “market-out” clauses in more recently executed contracts. In fact, twenty-two percent of the old gas contracts containing indefinite price escalator clauses on file with FERC have purchaser recourse provisions to protect against high natural gas prices.\textsuperscript{168} Application of such contract clauses might tend to reduce any existing market disparities between interstate and intrastate pipelines because, as a general rule, interstate pipelines’ contracts are more likely to have indefinite escalation and take-or-pay clauses than intrastate pipelines’ contracts which are more likely to have “market-out” clauses.\textsuperscript{169}

Another issue in this area is the ambiguity of FERC’s legal authority over contracts and specific contract terms. FERC has no explicit general authority to modify gas purchase contracts or to prescribe standards for those contracts. NGPA sections 313-15 do enumerate certain specific limitations on contracts and, under section 5 of the NGA FERC has authority to modify contracts found to be unjust, unreasonable or unduly discriminatory or preferential.\textsuperscript{170} While the \textit{Sierra-Mobile-Memphis} doctrine discussed earlier purportedly limits FERC interference with contract terms, that doctrine itself is very fragile. For instance, the Commission’s current regulations prohibit the use of indefinite

\begin{footnotes}
\footnotetext[167]{Energy Information Administration, Natural Gas Producer/Purchaser Contracts and Their Potential Impacts on the Natural Gas Market: An Analysis of the Natural Gas Policy Act and Several Alternatives, Part II, at vii (June, 1982).}
\footnotetext[168]{\textit{NATURAL GAS REGULATION STUDY}, supra note 3, at 144-45.}
\footnotetext[169]{Energy Information Administration, \textit{supra} note 167, at xi.}
\footnotetext[170]{The NGA applies to all gas, including old flowing gas, not specifically exempted by the NGPA. Letter from Charles B. Curtis, Chairman of FERC, to Senator Henry Jackson, Chairman, Committee on Energy and Natural Resources, at 86 (Sept. 8, 1978) (accompanying section by section analysis of NGPA).}
\end{footnotes}
escalator clauses in pre-NGPA interstate sales contracts. The FERC adopted this prohibition prospectively in 1961, using its authority under the NGA, on the grounds that such clauses are "incompatible" with the public interest. The Supreme Court upheld this action. The Court later specifically upheld retroactive and prospective restrictions on price escalation clauses in area rate proceedings by limiting prices to those established by the Commission, not by the parties' contracts.

In adopting the NGPA, Congress believed it necessary to grant FERC specific statutory authority to restrict the operation of indefinite price escalator clauses as they might be applied in light of NGPA prices. Clearly, Congress did not believe that the NGA gave FERC the authority to restrict such clauses absent additional statutory authority. Given Congress' specific statutory action to allow certain discrete limitations on indefinite price escalators, one must conclude that Congress did not intend to grant broad authority to restrict contract clauses under any section of the NGPA, nor did Congress interpret the NGA as granting such authority.

The Commission's own precedent holds that FERC may not regulate contract clauses covering gas which is not subject to its jurisdiction. Once gas is deregulated under the NGPA, FERC has no direct authority over the price paid for that gas and thus, arguably, cannot act to prohibit or proscribe contract terms affecting that gas. There is simply no definitive resolution of the ex-

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174 Permian Basin Area Rate Cases, 390 U.S. at 783-84.
176 Cf. Columbia Gas Transmission Corp., Docket No. RP73-65, 19 FPS 5-356 (1979); and predecessor cases, 59 F.P.C. 1259 (1977) and 58 F.P.C. 331 (1977). In those cases, all involving the same factual situation, the Commission found it had no jurisdiction over the gas in question; therefore, it had no jurisdiction over the contracts covering that gas. The Commission overturned the administrative law judge's refusal to allow the pipeline cost passthrough on the grounds the contract contained escalator clauses which were illegal under FERC regulations. The Commission noted it had no role in regulating those contracts and the administrative law judge's attempt to base his refusal of the passthrough on the illegality of those contracts was invalid. The Commission did review the reasonableness of the pipeline's actions, including its entry into the questioned contracts, as part of the Commission's jurisdiction over the pipeline.
tent of FERC's authority over contracts and specific contract terms. Clearly, any effort by FERC to abrogate contracts or specific contract terms will be tested in court.

The price fly-up debate has heretofore ignored the fact section 122, under which the President or Congress may re-impose controls at any time between July 1, 1985, and June 30, 1987, provides a significant mechanism to address the problem of the "price spike" if it occurs. This authority also may operate as a moderating influence on producer prices. The threat of possible reimposition of controls in light of radically increased gas prices may serve to restrict price increases or encourage contract renegotiation to limit the effect of price escalators by the private parties to the contract. Given this significant stand-by authority, the price spike issue becomes somewhat less urgent.

IV. Future Outlook for Changes to The NGPA

At this point, whether changes in the NGPA will be made and whether they will come from FERC's exercise of its administrative discretion or from Congress itself can only be speculation. FERC, after proposing several rulemakings and notices of inquiries which would provide incentive prices for gas, appears not to intend to take any further action to move the proposals along. In Congress, hearings on NGPA's general status are being conducted. A variety of bills to amend the NGPA have been introduced, ranging from Representative Young's bill which would place further regulations on natural gas and eliminate the 1985 date for natural gas decontrol, to Representative Gramm's and Senator Johnston's bills which would accelerate deregulation.177 Most of the bills probably will be reintroduced in the 98th Congress. Certainly, additional bills with yet more innovative approaches also will be submitted.

A. Future Administrative Action by FERC

FERC has received extensive comments on its notice of in-

quiry regarding old flowing gas and on its other proposed rulemakings for incentive pricing. These comments urge widely different solutions to the perceived problems. These radically different approaches reflect the wide political divergence within the nation. FERC has taken little action to date in response to these comments. If, in fact, the Administration plans to introduce a deregulation bill in the 98th Congress, it seems unlikely FERC would confuse the issue by taking steps on its own to make administrative changes in natural gas pricing pursuant to its authorities under the NGPA. Although FERC is an independent agency, the majority of its commissioners were appointed by the current Administration and presumably are not inclined to compete with the Administration on changes in gas pricing. Moreover, the storm of publicity caused by the FERC's past proposals for administrative action and its consequent deliberate action on those proposals suggest that this collegial body is only too happy to allow the Administration to step forward to propose new solutions to the gas pricing problems.

Many of the gas producer groups which were expected to submit detailed comments on the old flowing gas notice of inquiry, apparently anticipating little if any action on the NOI by FERC, filed limited, if any, comments. This paucity of information makes it difficult for FERC to build a case to support administrative changes to the NGPA even if FERC were so inclined. Further, these limited responses give FERC an equally limited data base upon which to support arguments to the Congress for changes in the NGPA.

B. Action Within the Congress

With the extensive hearings held during 1982 by both the Senate and House of Representatives, the 98th Congress has an

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178 Extensive comments were submitted by a group of 28 producers. See Joint Comments of Indicated Producers, supra note 153. However, such traditional gas producer groups as the Natural Gas Supply Association, the American Petroleum Institute, the Independent Petroleum Association of America and various regional gas producer associations submitted no comments.

179 See note 139 supra.
initial basis for discussing some problems within the NGPA. However, given the volatile nature of the economy, and hence the energy markets, many of the facts presented during these hearings might have changed significantly. Also, the structure of the 98th Congress is somewhat different than that of the 97th. Thus, in spite of the hearings held in 1982, those seeking to work changes in the NGPA still have an uphill fight.

The leadership of the 97th Congress expressed doubts about the willingness of the 98th Congress to address the NGPA issue again.\textsuperscript{180} If it does, the starting point for congressional consideration of amendments to the NGPA undoubtedly will be the \textit{Natural Gas Regulation Study} prepared by the Congressional Research Service and the National Regulatory Research Institute.\textsuperscript{181} The report quite properly points out that the current system of regulation and the inflexibility of the gas transportation system have several institutional impacts, the most important of which may be a tendency toward long term agreements. By contract provisions, such as take-or-pay clauses and price escalator clauses, the producers attempt to protect themselves.\textsuperscript{182} By regulation and rolled-in pricing, the consumer is protected. But the results of these protections are that producers are, to some extent, insulated by their contracts from market signals and consumers are insulated by regulation from specific price negotiations and the full economic cost of gas. These protections make impossible any reasonable and effective negotiation for sale prices and conditions between producers and pipelines because the negotiations do not reflect current market status. Therefore, as the study con-

\textsuperscript{180} Representative Philip Sharp (D.-Ind.), Chair of the relevant Subcommittee on Fossil and Synthetic Fuels, in a June of 1982 speech before the Gas Men's Roundtable, cautioned the membership that regardless of his own point of view, his informal feeling of the rest of Congress was that there was no real need to open up the issue. He noted that those wishing to make changes in the NGPA will have to convince a number of members of the House in order to get the issue moving.

\textsuperscript{181} \textit{Natural Gas Regulation Study, supra} note 3.

\textsuperscript{182} If price escalator clauses were not a factor or the impact of such clauses were mitigated, the take-or-pay clauses would probably not be subject to this criticism because such clauses not only provide market protection for the producer, but also serve a non-market function regulating cash flow and gas storage to compensate for the cyclical demand for natural gas.
cludes, wellhead prices have little or no responsiveness to actual market supply and demand.\(^\text{183}\)

In comparing regulatory alternatives, the study not only considers wellhead pricing deregulation but also goes a step further; it examines the changes needed in regulation of the pipeline industry, given deregulation at the wellhead. The study lists as goals for regulatory changes: 1) adequate and reliable natural gas service; 2) economic efficiency; 3) equity among producers, pipelines and consumers; 4) assurance of financial stability of the pipeline, and 5) adequate response to market and price signals affecting the regulated system.\(^\text{184}\) The study outlines four basic options:

Remaining with conventional public utility regulation essentially the same as now in place; operating natural gas transmission systems without regulation; adopting a common carrier status for the line; or devising a hybrid regulatory system possessing characteristics of both utility and common carrier regulation.\(^\text{185}\)

Interestingly, the study itself contains relatively little discussion of the impact of gas price increases on consumers or the national economy. This fact will obviously be seen as a serious flaw by consumer interests and as a substantial attribute by producers. However, the absence of discussion may simply reflect a steadily growing belief that the issue of natural gas pricing and its impact on natural gas production reserves, and indeed the energy needs of the country, can most profitably be discussed by separating the issues of energy policy from those of domestic welfare policy, at least in attempting to draw rational pricing policies for energy development.\(^\text{186}\) Certainly no one can deny that the impact of gas prices on that segment of society which simply cannot afford increases in home heating or power prices must be

\(^{183}\) Natural Gas Regulation Study, supra note 3, at 5.

\(^{184}\) Id. at 9.

\(^{185}\) Id. The study constructs an abstract of the goals and compares the various types of regulation as to their ability to achieve such goals in table form. Id. at 11.

\(^{186}\) In one sense the economic impact of gas pricing on consumers is the basic issue in the entire regulation of natural gas. Obviously, if price were no consideration whatsoever, there would be no issue to discuss.
addressed. However, there is a growing sentiment even among consumers that it is inappropriate to base the overall pricing policy for natural gas upon the limited number of consumers who cannot afford increased energy prices.¹⁸⁷

Bills introduced in the 98th Congress will cover the range of options from price freezes and continued controls to immediate deregulation. Proponents of expanded or continued regulation argue that current gas prices are unaffordable. However, such proponents are opposing a growing trend toward deregulation in all areas. Conversely, parties agree it will be impossible to move any accelerated decontrol legislation through Congress without the vigorous support of the Administration. Given the Administration's past history on its support of such advance deregulation and its failure to work actively for such legislation, the necessary support may not be forthcoming.

Bills oriented toward accelerated deregulation will no doubt be drafted to decontrol gradually increasing amounts of natural gas. Deregulation bills may be drawn which in quick succession release all gas in a given NGPA category from controls. Such bills can emerge in a myriad of ways. Nonetheless, bills promoting deregulation will probably impose an ultimate price cap for natural gas tied to some commodity such as crude oil.

Along with the introduction of any accelerated decontrol legislation, a bill proposing a so-called “windfall profit” tax also should be expected. Even deregulation proponents have acknowledged such a tax may well be a quid pro quo. With the prospect of large federal deficits, the revenue from such a tax must be most appealing to both Congress and the Administration. Basically, such a tax would take the form of a straight excise or severance tax or a “windfall profit tax” such as is applied to

¹⁸⁷ For a lengthy discussion of this idea, see COMMITTEE FOR ECONOMIC DEVELOPMENT, ENERGY PRICES AND PUBLIC POLICY (July 1982), which argues that while the poor need protection against the effects of higher energy prices, energy pricing cannot be bound to welfare issues. It also argues that the government needs to address both income assistance and efficient energy pricing issues without attempting to mix the policy instruments appropriate to each of those issues. In these days of reductions in government spending on all fronts, but particularly for welfare assistance, it is unrealistic to argue that government assistance will come forward to insulate the poor against the increase in energy costs.
crude oil. Such a windfall profit tax applies a certain percentage tax to the difference between a set base price, usually escalated for inflation, and the actual sale price of the commodity. Different percentage rates are applied to different commodity categories; thus, the new gas category difference might be taxed at the rate of twenty percent, old gas at the rate of forty percent, etc.

Bills limiting the operation of contract clauses also can be expected. Such legislation would probably grant FERC the authority to proscribe take-or-pay clauses and price escalators in contracts applying to "deregulated" gas in order to make gas prices more responsive to market demand. Again, such bills may well be viewed as a quid pro quo for accelerated deregulation. Congressional hearings and public comments to FERC have revealed increasing sentiment for such bills among pipelines and consumers. Such bills may be adopted regardless of actions on price controls.

Unfortunately, commentators tend to group the indefinite price escalators and take-or-pay clauses in the same discussion. Such clauses must be considered separately because take-or-pay clauses, while serving the economic purpose of producer protection, also serve critical non-economic interests of both the pipeline and the producer. Take-or-pay clauses are an attempt to regulate cash flow and deliveries in light of the cyclical demand for natural gas. Any restriction on their legality must recognize this non-economic function as well as the producer's exposure to legal challenge.

In any action taken to address the problems of gas pricing and distribution, Congress must continually consider the impact of its actions on all parts of society. Congress does not enjoy the luxury of the interest groups which need consider only the single interest of their members. Therefore, Congress, in taking action, must consider not only the impact on gas production, gas reserves and all energy needs, but also the ultimate impact on an already shaky economy. Considering these competing interests, it is easy to see why Congress becomes embroiled in such lengthy, complex

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and bitter disputes when it begins to address the issue of gas pricing.

C. Action Within the Private Sector

Given the uncertainty in the treatment of gas pricing, the industry (both producers and pipelines or other purchasers) appears to be remarkably innovative in its attempts to deal with uncertainty. Pipelines particularly have been innovative in providing "market out" triggers to make the prices they pay for natural gas more responsive to their markets. New gas contracts increasingly contain such market out clauses. For instance, fifty-four percent of the contracts written in 1980 containing deregulation clauses also included "market out" clauses and forty-six percent of those contracts included maximum price provisions.\(^{189}\) These clauses have various triggers, some of which are based upon the cost of alternate fuels in different market areas. Thus, at least in new contracts, purchasers appear to be taking steps to protect themselves absent regulations. The typical free market response already is beginning to be felt in contracts for that section 107 gas which is now deregulated. These contracts contain market out clauses which are now being exercised.

Producers also are considering ways to protect their interests through use of stepped price clauses which begin at a somewhat lower contract price. In addition, producers are using sliding take-or-pay clauses. Other clauses provide if a purchaser exercises a market out clause, the producer can lawfully terminate the contract and require the purchaser to transport the gas if the producer can locate an alternate purchaser. Producers also are seeking indemnification clauses if they are challenged by interest owners for actions taken by the purchaser.

For those supplies of gas subject to existing contracts, the options are more limited. These contracts are subject to renegotiation, which, at this stage, is fraught with uncertainties. Yet it is possible that both purchaser and seller might be able to undertake a more mutually beneficial renegotiation in the calmer times

\(^{189}\) Energy Information Administration, supra note 167.
Before deregulation. Certain major pipelines are approaching their suppliers and requesting major renegotiations of contracts, especially regarding take-or-pay liabilities. Realistically, if the producer's price at the wellhead, plus the addition of the pipeline's costs, exceeds the market clearing prices at which the pipeline can resell the gas, the producer will have an incentive to renegotiate a lower price in return for greater sale quantities.\(^{100}\)

First, to the extent high prices threaten the economic viability of the pipeline, the producer has an interest in maintaining the pipeline as a purchaser. Second, the producer might have additional new supplies to sell to the same pipeline which could not otherwise be sold absent mutual agreement of the parties.\(^{101}\)

Most important, in some instances the pipeline itself has considerable retaliatory power based upon the state law calculation of allowable production. In Texas, for instance, production allowances for ratable takes by pipelines from producers are calculated not only on the basis of the producer's estimate of how much gas can be produced over the next month, but also upon the basis of estimates submitted by the purchaser of how much gas the purchaser will need.\(^{102}\) The pipeline can submit its estimates for only those purchases which it knows it can resell. Thus, the state can set the allowable production based upon the purchaser's estimate of need, rather than upon the producer's estimate of production. This will establish the lawfully permissible production rate from the producer's well.

The pipeline then may rely upon the "take-or-pay clause," which requires it to take or pay for only that quantity of production "lawfully produced" from the well. Since the amount that can be lawfully produced is determined by estimates made by the pipeline, any amount of gas produced in excess of that amount is

\(^{100}\) Some market out clauses may be triggered by a pipeline if the pipeline's total gas cost, including the pipeline's costs, exceeds certain prices in the pipeline's marketing areas. Thus, the price paid to one producer may not be as high as the price paid by the pipeline to other producers or its own affiliates, but the pipeline could exercise at its sole discretion the market out clause in the contract with the producer who was paid less.

\(^{101}\) Pierce, Natural Gas Regulation, Deregulation, and Contracts, 68 Va. L. Rev. 63, 103 (1982).

\(^{102}\) Texas Railroad Commission Rule 051.01.99.001, adopted by Special Order File No. 20-68,382.
unlawfully produced and the pipeline is not obligated to take or pay for that amount. Most state conservation laws are based upon conservation and efficient production of the gas.\textsuperscript{183} If the pipelines estimate they cannot resell the gas, then the well's production in spite of the lack of market would violate the state agency's mandates to conserve resources. If the state agency chooses to set production allowables based upon the purchasers estimates, the impact of take-or-pay clauses could be considerably reduced.

Assuming deregulation occurs as scheduled by the NGPA, disputes regarding gas sales will be bound by state laws governing private contracts. With the demise of regulation, contractual provisions will become more and more important. It is imperative for producers and pipelines to renegotiate carefully old contracts and to give thorough deliberation to new gas contracts. The days of relying upon a standard form gas contract, safe in the knowledge that for all practical purposes the contractual provisions are often superseded by regulations, are long past. Wise legal counsel suggests review of existing contracts and possible renegotiation, if necessary, now rather than in 1985. Likewise, new contracts should be drawn with contingencies for scheduled deregulation, as well as accelerated or no deregulation and re-regulation.

V. CONCLUSION

The next two years will be times of great uncertainty in the natural gas industry. It is likely that legislative changes will be made during that time, but specific legislation cannot be anticipated now. However, certain basic problems which will surface in some form have been identified. It is imperative that all interested parties participate in the entire process and that careful analysis be provided to Congress and FERC, as well as the industry.

Even if the NGPA is not changed, the effect of the scheduled deregulation of new gas categories is largely unknown. Adminis-\textsuperscript{183} See LA. REV. STAT. ANN. § 30:41 (West 1975); OKLA. STAT. ANN. tit. 52, § 238 (West 1969); TEX. NAT. RES. CODE ANN. § 85055 (Vernon 1978 & Supp. 1981).
trative action may accelerate slightly under those circumstances, but the bulk of effort will fall on the entire industry. Creativity in considering the problems faced by each segment of the industry will be mandatory. Some pipelines are, even today, working better with producers than they have in the past. But producer-pipeline cooperation alone will be insufficient to resolve the major potential and actual issues of disparity in gas acquisition, price spike or fly-up, and market disorder. Each of these issues has its own complications and a plethora of related issues, all affected by external variables such as the economy and foreign policy. The resolution of these issues inevitably will be gradual and painful.