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H.R. 4277: HOW TO KEEP NATURAL GAS SUPPLIES SHORT AND PRICES HIGH

INTRODUCTION

Congress has been embroiled for three decades in a bitter controversy over federal price controls on natural gas. Lawmakers believed in 1978 that they had resolved the gas dilemma with enactment of the Natural Gas Policy Act (NGPA). They were wrong. The NGPA has proven to be fatally flawed. Congress had intended the Act to allow gas prices to rise gradually until, in 1985, they reached a rough parity with the world price for an energy-equivalent amount of oil. In designing the mechanism by which market prices for gas would be phased in, Congress used an artificial "target price" of $15 per barrel to represent the world market price of oil in 1985. The problem has been that there was no way to adjust the mechanism when oil prices skyrocketed in the aftermath of Iran's 1979 revolution. Instead of bringing oil and gas prices closer, the NGPA is keeping them further apart.

To make matters worse, the NGPA threw a monkey wrench into the operation of the domestic gas market by extending the scope of federal price controls to previously unregulated gas supplies, and by greatly increasing the complexity of the federal price ceilings. At one point there were more than 30 price classifications for gas wells, with the federal ceilings ranging from 21 cents per thousand cubic feet (mcf) to $11 per mcf. The morass of regulation created enormous confusion and apprehension. Few gas customers understood how the rules applied to them, and no one was certain what would happen when the ceilings on so-called new gas (gas discovered after April 1977) were lifted in 1985. Rather than ending the gas debate, therefore, the NGPA merely fueled it.

Because federal regulations created substantial economic advantages for some firms and consumers, at the expense of others, powerful lobbies now oppose the partial elimination of controls,

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set for January 1, 1985. Comprising a few large interstate pipelines, some independent gas producers, and a number of self-styled "consumer advocates," this pro-regulation coalition seems to have convinced the House Energy and Commerce Committee to extend, and make permanent, the NGPA controls. A bill doing this, H.R. 4277, was approved in the full Committee in April, and is expected to go to the House Rules Committee this month.

The primary argument for re-control was that prices would increase sharply or "fly-up" when the NGPA ceilings expired on January 1, 1985. This is a baseless myth. Scare stories about huge potential price increases were widely circulated, especially in the home districts of key House Members. Volumes of studies were also prepared, in an attempt to give a cloak of academic credibility to such claims. However, on close examination, even the studies of the pro-regulation lobbies do not support the allegations they have put forward.

What the studies do indicate is the need for accelerated removal of all natural gas price controls. The overwhelming weight of economic evidence demonstrates that gas prices are likely to come down and supplies increase if the market is allowed to function. Decontrol also would sweep away the artificial price distinctions between gas from different types of wells; this would spur efficiency. Since decontrol would probably spark greater gas production, moreover, the consumer would benefit from the associated oil production from gas wells that are currently uneconomic, and so not operating, because of gas price controls.

WHY PRICE FLY-UP IS A MYTH

If controls expire in 1985, a number of factors will prevent gas prices from soaring. Among the most important is the surplus of supplies, which far outstrips demand. This surplus has created a buyer's market for gas, leading to a number of contract re-negotiations by major pipelines. Under reasonable decontrol, this surplus not only will continue, but will increase. As a consequence, producers would not be able to raise prices under decontrol to the levels asserted by advocates of continued price controls: no one would buy gas at higher prices. The surplus has already caused a decline in gas prices at the wellhead of about 2 percent over the past year. Market pressure clearly is helping consumers and would continue to do so after controls expire in January 1985.

A second factor that will influence gas prices is the continued moderation of oil prices. One of the reasons some control advocates claim that decontrolled gas prices would rise is that some contracts require re-negotiation of the price customers pay, on the basis of existing fuel oil prices. When oil prices were rising rapidly, this meant that the so-called indefinite price escalator clauses mandated gas price rises as well. However, oil prices have fallen from the record levels of a few years ago and

so the mandated prices have fallen as well. There is little reason to suppose any signficant change in this trend.

A final reason that decontrolled gas prices will not "fly up) is the major effort by large gas customers to find energy alternatives. If the price of gas were to rise steeply, these customers would use some other fuel. The producers know this, as do the large pipelines. This cold, hard fact gives them a considerable incentive to reach a reasonable accommodation on prices. Studies show that a number already have.

WHAT THE STUDIES SHOW

A recent study by the American Petroleum Institute (API) examined a number of cases of contract renegotiations between major gas suppliers and large pipelines.[1] According to the API study, many of the major oil companies, including AMOCO, Exxon, and Shell Oil, have given relief to their customers under so-called take or pay contracts. Among the pipelines benefitting from such moves are Columbia, Transco, and Northern Natural. This is important because these pipelines have been among the most ardent advocates of continued controls--no doubt on the mistaken assumption that decontrol would push up their costs.

The API study also cites instances in which major pipelines have evoked what are termed "force majeure" provisions of their contracts, claiming that circumstances beyond their control prevent them from honoring agreements. Among the reasons cited is that conditions in the market have changed so radically since the contracts were signed in the 1970s that the prices they mandate the pipelines to pay are no longer warranted. At present, "force majeure" actions remain under court challenge, but it is significant that some pipelines chose to cite changed market conditions as a basis for evoking them.

A particularly important study on the likely impact of decontrol recently has been produced by the Interstate Natural Gas Association (INGA).[2] Ironically, the intention of the study was to find support for continued controls. It shows, however, that only about 14 percent of all natural gas would be subject to "fly-up" in the event of decontrol. More important, the study found that the average increase in the wellhead price of natural gas under its scenario amounted only to around 9 percent. Since wellhead prices constitute just one part of the price the customer pays (the rest is for transportation and distribution), this means that the actual increase in prices--assuming the analysis

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1 "Draft Working Paper Indefinite Pricing Provisions in Natural Gas Contracts," American Petroleum Institute, March 29, 1983.

2 "Analysis of Price Fly-Up Under the Natural Gas Policy Act" (Washington, D.C.: Interstate Natural Gas Association, April 1984).

is correct--would amount to between 4 percent and 6 percent for most gas consumers. Even in the case of gas customers served by pipelines with higher than average proportions of gas subject to so-called fly-up increases, the price hike would only be from 9 percent to 12 percent, rather than the 51 percent increases some critics have claimed.

The INGA study, moreover, ignores substitution effects that might soon occur if prices initially should rise sharply. Overlooked are the many large gas users which have the capability to use alternative fuels. Should they do so in numbers, gas producers almost surely would respond by lowering prices, offsetting the modest "fly-up" effect. This substitution effect has already had an impact on the gas market, and should continue doing so.

The American Gas Association (AGA), another advocate of continued controls, recently has released data concerning the magnitude of a potential "fly-up."[3] In this study, the wellhead increase is placed at around 13 percent and the increase to consumers at around 10.6 percent. Even assuming these figures to be correct, they would hardly justify the permanent continuaton of as onerous a regulatory burden as currently afflicts the natural gas industry. Moreover, the AGA study acknowledges that the "fly-up" would be temporary, even if it does occur, and would moderate within two years as the market adjusted by bringing forth more supplies. This suggests strongly that it would be both unnecessary and counterproductive to meddle in the marketplace to the extent envisioned in the legislation now before Congress.

H.R. 4277

Under the provisions of H.R. 4277, sponsored by Representatives Philip Sharp (D-Ind.) and Thomas Tauke (R-Iowa), gas prices would be frozen for two years, so contracts covering the gas scheduled to be decontrolled would effectively be abrogated. The measure would also impose binding arbitration on firms unable to reach an agreement over contract renegotiations. And it would make future negotiations of gas contracts subject to review by the Federal Energy Regulatory Commission, giving the agency a veto over proposed gas prices. This is a thinly veiled device to make controls permanent.

CONCLUSION

The recent studies of the potential fly-up of natural gas prices likely to follow partial decontrol reveal that delaying

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3 "Historical and Projected Natural Gas Prices: 1983 Update" (Washington, D.C.: American Gas Association, November 1983).

decontrol would be unwise. Even if the predicted price increases did occur, they would be modest--certainly not sufficient to warrant continuing controls and thus discouraging new exploration and the more efficient use of existing reserves. In any case, the existence of a gas surplus, and the capability of large natural gas consumers to switch to alternative fuels, makes the prospect of any significant increase small indeed. More likely is a price decline after a short period of adjustment.

On the other hand, one thing is certain: the continuation of price controls would eventually lead to shortages, and shortages could only be removed through future price increases. Should Congress act to gain a short-term advantage, therefore, Americans may end up paying a high price in long-term gas costs. Congress would do better to halt its rush to re-control gas before it creates yet another avoidable energy problem.

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