The Heritage Foundation Backgrounder

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NATURAL GAS DEREGULATION: TIME TO FINISH THE JOB

INTRODUCTION

Energy policy has been one of the brightest spots in Ronald Reagan's domestic agenda. As one of his first acts of office, the President ordered the removal of the last vestiges of controls from crude oil and refined petroleum products, which for years had driven up prices by impeding the free operation of the energy market. In such areas as federal leasing, nuclear regulation, and energy conservation, the Reagan Administration also has followed a strongly market-oriented approach, which has led to lower prices and greater supplies.

Yet there is one aspect of energy policy in which the federal regulatory presence continues to impose a strong and disrupting burden: the natural gas market. While a significant portion of the nation's natural gas supplies were decontrolled on January 1, 1985, under the provisions of the 1978 Natural Gas Policy Act, large quantities of so-called "old gas" are still subject to federal price ceilings. In addition, remaining on the books are the Carter Administration's ill-advised and counterproductive restrictions on gas use, such as the Fuel Use Act and the Incremental Pricing Policy Program. Although these controls and restrictions were never justifiable, only recently have political and economic conditions allowed serious discussion of their removal.

With energy prices declining across the board and with the clear evidence that the elimination of price controls will lead to lower, not higher, prices, now is the time to finish the job begun in 1978 with the Natural Gas Policy Act and to eliminate the last major federal interference in the energy market.

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WHY CONTROLS WERE INSTITUTED

Natural gas has been used in the United States since the latter part of the nineteenth century. Throughout the middle 1920s, the federal government paid little attention to natural gas markets, primarily because they were essentially local in nature. Toward the end of that decade, however, improvements in pipeline technology made it possible to send gas from one state to another. Demand for it surged, and thus natural gas came to Washington's attention.

As the market for natural gas increased, so too did marketing competition. In some cases, overexpansion in building pipelines led to bankruptcies and a loss of service. Elsewhere some large pipelines squeezed out smaller ones by heavy price discounting, only to institute huge price increases once competition was eliminated. After dismayed local officials complained to Congress, the Federal Trade Commission was charged with studying the problem. In 1935, an FTC report, characterizing the natural gas market as "cutthroat," urged federal regulation. Congress responded with the Natural Gas Act of 1938, which extended the jurisdiction of the Federal Power Commission (a body originally created to regulate the interstate sale of hydroelectric power) to include regulation of the interstate sale of natural gas. Congress, however, limited the Commission's authority by specifically stating in the bill that the act "...shall not apply...to the production or gathering of natural gas."

Despite this clear prohibition on regulating the wellhead price of natural gas, the courts repeatedly tried to extend the Federal Power Commission's mandate to include an ever broadening spectrum of the natural gas market. The courts even went so far as to instruct the FPC that the pricing of gas from wells should be set on a so-called cost-of-service basis, an approach traditionally used in regulating public utilities.

The trend toward ever wider jurisdiction for the FPC culminated in the landmark 1954 Supreme Court decision _Phillips v. Wisconsin_, which effectively placed all natural gas flowing in interstate commerce under the Commission's control. By this action, the Court established a _de facto_ two-tiered market. Natural gas sold to intrastate pipelines (where business was confined to a single state) was free of federal interference; interstate pipelines were subject to stringent federal price rules. Tens of thousands of wells producing gas for the interstate market, moreover, were to have their sales price determined on a case-by-case basis. This created an impossible task for the Commission. Their solution was to adopt a system that would limit sharply the appeals which generated that paperwork.

The imposition of wellhead price controls turned the interstate sale of natural gas into a gigantic political and economic lottery with hundreds of millions of dollars at stake for the respective winners and losers. This gave rise to powerful interests who either

favored or opposed keeping the price ceilings in place, and it assured from the outset that no change in the system could even be proposed without setting off a fire storm of controversy. Worse, this politicization of natural gas pricing assured that the problems it created could not be addressed until they reached crisis proportions.

THE CONSEQUENCES OF WELLHEAD CONTROLS

One immediate problem, which arose from the two-tiered system of regulation, was a decline in natural gas supplies dedicated to interstate pipelines. After 1964, the ratio of proved reserves to production steadily declined. In that year, for example, there were sufficient proved U.S. natural gas reserves for 18.9 years of U.S. consumption. By 1977, the reserve base had eroded to an 8.5 year supply. At the very same time, supplies dedicated to the intrastate market were increasing.

The Federal Power Commission failed to read the implicit message of this: where controls did not impede the market, supplies were increasing; but where controls were in place supplies were declining. Instead, the FPC saw the dwindling interstate supplies as a "crisis," which required regulatory action to "share the shortage" by forcing large natural gas users to reduce their consumption.

A crisis was not long in coming. The winter of 1976-1977 was one of the harshest on record, and with it came a huge increase in the demand for natural gas from customers on the interstate market. Since price-controlled interstate supplies could not meet this demand, widespread shortages developed. Factories and businesses closed because of a lack of fuel, as did schools. Residents of the affected areas were soon barraging Congress with demands that the legislators "do something" about the crisis.

RESPONDING TO THE CRISIS: THE NGPA

The congressional response was two-fold. First, it passed emergency legislation that allowed gas earmarked for intrastate pipelines to be sold to those involved in interstate commerce. Companies on the intrastate market had a large surplus of natural gas they were more than willing to get rid of. Congress' second response was a year-long examination of the natural gas problem.

The result was the Natural Gas Policy Act (NGPA), passed in 1978, which called for the decontrol of a majority of the nation's natural gas supplies on January 1, 1985. To forge the congressional majority for this, however, backers of decontrol had to agree to retain controls on so-called "old" natural gas--gas discovered prior to

1978--and to bring previously uncontrolled supplies from the intrastate market under the aegis of federal price ceilings.

By the time the partial decontrol of natural gas went into effect on January 1, 1985, the prospects for total decontrol had changed dramatically. The cumulative effects of a surge in oil exploration that brought huge new supplies into the market, significant new gas discoveries, price-induced energy conservation, and the Reagan Administration's dismantling of much of the energy regulation apparatus resulted in not just a stabilization, but a sharp decline in energy prices. The partial decontrol of natural gas prices on January 1, 1985, for example, prompted a drop in prices. Opponents of decontrol long had warned that prices would surge--"spike" was the term widely used--as soon as controls were lifted.

Still, significant regional price disparities exist in natural gas prices. The reason, ironically, is that federal restrictions on price movements, intended to limit the degree to which natural gas prices can rise, actually limit the degree to which they can fall. Therefore, rather than helping keep the consumer's gas bills low, the controls have kept them higher than otherwise would be the case.

IDENTIFYING THE PROBLEMS

There are actually four issues to be addressed if the natural gas market is to be freed of its current impediments. Three of these are rooted in the legislative actions that have hindered the market's ability to operate: 1) the remaining price ceilings on certain categories of natural gas; 2) the Fuel Use Act, passed by Congress as part of President Carter's 1978 National Energy Act, which prohibits the use of natural gas in large industrial and utility boilers; and 3) the so-called "Incremental Pricing Program," which requires large users to pay above-market prices for the natural gas they use. A fourth issue involves the provisions in some of the contracts signed after the Natural Gas Policy Act was enacted, which call for the imposition of above-market prices in the event of decontrol.

Repealing the remaining controls on natural gas would be a long overdue return to a market-based energy economy. Natural gas is the only primary fuel whose price still is largely determined by government fiat. Continued federal rules, moreover, have kept large quantities of gas from the market, because the gas is in areas where the permissible price is less than the cost of developing the resource. As a consequence, many natural gas reserves that are far more expensive to develop have been brought to market because the price ceilings that determine what its producers can charge have made it economically possible to do so. The result: the price controls intended to keep prices low have raised them to levels higher than otherwise would be the case.

The Fuel Use Act and the closely related Incremental Pricing Program, which were enacted as part of the Carter Administration's National Energy Plan, also raise costs to the consumer. They do so in two ways. First, the outright prohibition on natural gas use contained in the Fuel Use Act and the requirement that large users pay above-market prices limit the use of natural gas by industry, even where it otherwise would be the optimum economic choice. This creates inefficiencies in the manufacturing sector of the economy. Second, by limiting the market for gas, these two provisions reduce pipeline volumes. Since the prices that pipeline companies charge to transport a given volume of gas vary in accordance with the degree to which the pipeline is being utilized, lower volumes mean higher transportation costs to the consumer, since costs are spread over fewer customers. Therefore, by eliminating the constraints on gas use by industrial customers, and thereby increasing pipeline utilization, repeal of the Fuel Use Act and Incremental Pricing Program will give consumers lower transportation charges on the natural gas they use.

A final area of concern relates to the "dumbbell" clauses--so called because they are triggered automatically if certain legal or market conditions occur. These clauses, included in many natural gas contracts, and more properly referred to as "indefinite price escalators," raise the price of gas sold under the contract to above-market levels in the event controls are lifted. Although a very small proportion (according to one internal review at the Energy Information Administration, maybe as low as 3 percent) of all natural gas contracts contain such provisions, their regional impact could be severe. There already has been a considerable movement to renegotiate these clauses by producers and pipelines, who recognize that they inevitably will be challenged in court. The process of litigating these provisions, however, could be lengthy and would complicate the decontrol process. Therefore, some administrative mechanism to resolve differences concerning indefinite escalators would provide considerable assistance in eliminating the legacy of controls.

ELIMINATING THE BARRIERS: THE MECHANISM FOR DECONTROL

Repealing the federal controls impeding the natural gas market could be accomplished in two steps. The first would be the immediate repeal of the Fuel Use Act and Incremental Pricing Program. This action would be far less controversial than the removal of federal rules concerning price, and thus there is already widespread support for this in Congress. Eliminating these demand restraints would bring the added benefit of helping to generate cash flow for many struggling independent oil companies, because independents frequently have retained ownership of natural gas supplies they discovered in conjunction with oil.

The second step would be to repeal the remaining federal price ceilings on wellhead natural gas prices. To provide for an orderly transition to the decontrol environment, the enabling legislation should provide for a period prior to decontrol during which contract issues could be resolved. If, at the end of the period--say six months--parties could not come to agreement as to the post-control price, then either should have the option of seeking to sell or purchase gas elsewhere. Once this period expired, all controls would be lifted, and the price of gas would be allowed to seek a market level.

CONCLUSION

The evidence supporting full decontrol of natural gas prices has been available for at least a decade. The disparity between the available interstate and intrastate market supplies during the winter of 1976-1977 alone stands in silent testimony to the negative effects such market impediments ultimately have on consumers. Despite the evidence, the political will has been lacking.

Today, however, the emptiness of the arguments of those who warned of the dangers of decontrol is obvious. Prices did not jump after partial decontrol--they dropped. Supplies have not run out--they have increased steadily. Most important, since oil and natural gas prices tend to move in tandem, the recent oil price collapse virtually ensures that, once controls are removed, natural gas prices will drop as well. Therefore, the consumer will reap a windfall once the federal rules are eliminated, allowing the market to adjust. All that remains is for Congress to take advantage of this window of opportunity.

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