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THE CONTROVERSY OVER FEDERAL REGULATION OF INDEPENDENT PRODUCERS OF NATURAL GAS

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INTRODUCTION

The Natural Gas Act,[1] enacted in 1938, gives to the Federal Power Commission the power of comprehensive regulation over the transportation of natural gas in interstate commerce and over the sale in interstate commerce of natural gas for resale. Under this statute the Commission has regulated the activities of the interstate pipelines which link the distant market points with the producing fields. One of the most controversial questions arising in the administration of the Act has been whether the producers and processors which sell the natural gas to the interstate transmission lines are subject to the Act. The question remained open until the opinion of the Supreme Court on June 7, 1954, in *Phillips Petroleum Company v. Wisconsin*,[2] resolved the issue in the affirmative.

The problem was one of statutory construction. The legislative grant of jurisdiction to the Federal Power Commission reads as follows:

> "The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or *to the production or gathering of natural gas*."[3] (Emphasis supplied)

The litigation was initiated in 1948 by an investigation ordered by the Commission to determine whether Phillips is a natural gas company.[4] Although Phillips sold and delivered gas to interstate pipelines, which then transported the gas through several states and sold the gas for resale in many states, the Commission held that such sales were within the exemption granted to "production or gathering."[5] The Court of Appeals, one judge dissenting, reversed the Commission.[6] The Supreme Court held that the sales by Phillips were sales for resale

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1. 52 STAT. 821-33 (1938); 15 U.S.C.A. § 717-717w (1946).
2. 347 U.S. 672 (1954).
3. Natural Gas Act § 1(b), 52 STAT. 821 (1938), 15 U.S.C.A. § 717 (1946).
4. The statutory definition is as follows: "Sec. 2(6) 'Natural-gas company' means a person engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale." 52 STAT. 822 (1938), 15 U.S.C.A. § 717a (1946).
5. *In re* Phillips Petroleum Co., 10 F.P.C. 246, 90 P.U.R. (N.S.) 325 (1951).
6. 205 F.2d 706 (D.C. Cir. 1953).

in interstate commerce and that the statutory exemption for "production or gathering" was not intended to encompass such sales, stating that exceptions to the primary grant of jurisdiction are to be strictly construed. In the concluding paragraph of the majority opinion it was stated:

> "Regulation of the sales in interstate commerce for resale made by a so-called independent natural-gas producer is not essentially different from regulation of such sales when made by an affiliate of an interstate pipeline company. In both cases, the rates charged may have a direct and substantial effect on the price paid by the ultimate consumers. Protection of consumers against exploitation at the hands of natural-gas companies was the primary aim of the Natural Gas Act. *Federal Power Commission* v. *Hope Natural Gas Co., supra,* at 610."[7]

The enactment was based on the Congressional finding that federal regulation of the interstate transportation and sale of natural gas is in the public interest.[8] As the Supreme Court points out, the states may regulate the local distribution of gas at retail but the wholesales of gas in interstate commerce are constitutionally not subject to state regulation. The Federal Power Commission under the Natural Gas Act was to fill this jurisdictional gap and supplement the regulation by the states.

Natural gas has grown in importance as a fuel since the enactment of the Act in 1938. At that time there were relatively few major interstate pipelines and the markets served by them were mostly in the western producing states and adjoining areas of the midwest. The gas transmission systems now reach and serve practically every state in the Union, except the Pacific northwest, and the Commission has recently approved a proposal to serve that area.[9] In 1936 natural gas represented only ten percent of the energy consumed in the country, whereas in 1953 it accounted for approximately twenty-three percent. During this period residential customers have increased from 8 million to 24.2 million. This period has also witnessed great increases in the field price of gas. Back in the middle 1930's gas was sold in the field in the neighborhood of 2¢-3¢ per thousand cubic feet, (MCF), whereas in 1954 large volumes have been contracted for as high as 16¢-20¢ per thousand cubic feet. The aggregate value at the well of marketed production has increased from $119,000,000 in 1936 to $775,000,000 in 1953, and the total gas bill paid by consumers in 1953 aggregated $2,250,000,000. This is to be compared with a total gas bill in 1945 of $681,000,000.[10]

The articulation of jurisdiction over independent producers sixteen years after the enactment of the Natural Gas Act has created difficult

7. 347 U.S. 672, 685 (1954).
8. Natural Gas Act § 1(a), 52 STAT. 821 (1938), 15 U.S.C.A. § 717 (1946).
9. Pacific Northwest Gas Company, FPC Opinion No. 271, June 16, 1954.
10. AMERICAN GAS ASSOCIATION, GAS FACTS (1953 Data Ed.)

problems of integrating the new regulation into the existing pattern of regulation. Moreover, the *Phillips* case has reactivated the political issue over regulation of producers. This article will attempt a rather general discussion of the problems and considerations involved in producer regulation with the hope of affording a degree of orientation in both the regulatory and political aspects for members of the bar not directly concerned with the issues.[10a]

Scope of the Regulation of the Natural Gas Act

The Natural Gas Act gives the Federal Power Commission comprehensive jurisdiction over the activities of natural gas companies. The Act gives the Commission jurisdiction over the rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and a natural-gas company is required to obtain a certificate of public convenience and necessity from the Commission before any service can be undertaken or any existing service abandoned. These key provisions are supported by other provisions giving the Commission jurisdiction over accounts and records, rates of depreciation and amortization, and jurisdiction to require natural-gas companies to file such annual or other periodic and special reports as the Commission may prescribe covering full information as to assets and liabilities, capitalization, investment, cost of facilities, cost of maintenance and operation of facilities for the production, transportation or sale of natural gas, and inventories of properties. Other provisions give the Commission jurisdiction over the exportation and importation of natural gas, power to regulate the activities of officers and directors in connection with the issuance and sale of securities and the payment of dividends, to conduct investigations and compel the attendance of witnesses.

The Act does not give the Commission any jurisdiction over the production, gathering, or processing activities of the independent producers, or over the operation by them of gasoline plants.

In order to bring the independent producers under regulation in accordance with the mandate of the Supreme Court, the Commission, on July 16, 1954, issued Order No. 174, consisting of rules and regulations governing independent producers.[11] On August 6, 1954, the Commission issued its Order No. 174-A,[12] amending Order No. 174 in certain minor respects, and on December 17, 1954, the Commission issued its Order No. 174-B,[13] making further revisions of a clarifying nature. These regulations were issued as amendments to the existing

10a. This article was written for earlier publication and speaks as of the early part of March, 1955, unless otherwise specifically noted.
11. 19 FED. REG. 4534 (1954).
12. 19 FED. REG. 5081 (1954).
13. 19 FED. REG. 8807 (1954).

regulations of the Commission which were directed principally to interstate pipeline companies.[14] Special rules of a reasonably simple nature for the independent producers were felt necessary in order to bring them quickly under the jurisdiction of the Commission.

The rules are essentially procedural in nature, and provide procedures and forms for invoking the Commission's rate and certificate jurisdiction. The rules expressly exempt the independent producers from keeping and maintaining their accounts in accordance with the Commission's Uniform System of Accounts for Natural Gas Companies.[15]

The rules require every independent producer to file rate schedules setting forth the terms and conditions of service and all rates and charges for jurisdictional sales and transportation effective on June 7, 1954. Proposed changes in schedules can be effected only by filing new schedules setting forth the proposed changes. The rules also require independent producers to file an application for a certificate of public convenience and necessity pursuant to Section 7 of the Act with respect to all interstate transportation or interstate sales for resale of natural gas being rendered as of June 7, 1954, and to file an application for and obtain a certificate of public convenience and necessity before engaging in any new service subsequent to the issuance of the rules. It was expressly provided that, pending action by the Commission on any application for a certificate covering a service being rendered on June 7, 1954, such service shall be continued.

Scope of the Term "Independent Producer"

The rules define an independent producer as:

> ". . . any person as defined in the Natural Gas Act who is engaged in the production or gathering of natural gas and who transports natural gas in interstate commerce or sells natural gas in interstate commerce for resale, but who is not primarily engaged in the operation of an interstate pipeline."[16]

The term "independent" is generally and loosely used in the oil industry. Although it has a variety of meanings, it is most commonly used to distinguish the large, integrated oil companies (majors) from the smaller and unintegrated companies. As used in these rules, however, the term distinguishes between producers who operate pipeline facilities and those who do not.

One of the chief issues raised by the rules is whether the Commission's definition of an independent producer is broader than is warranted by the Supreme Court's decision in the *Phillips* case. As the opinion of the Court discloses, Phillips sold natural gas directly to

14. 18 CODE FED. REGS. c. 1, Subc. E, pts. 154, 157 (1949).
15. 18 CODE FED. REGS. c. 1, Subc. F (1949).
16. 18 CODE FED. REGS. § 154.91 (Cum. Supp. 1955).

interstate pipeline companies, which transported and resold the gas to consumers and local distributing companies in many states. Approximately 50% of the gas involved in the case was produced by Phillips and the remainder was purchased from other producers. The sales were made by Phillips and delivered to the interstate pipeline companies at the discharge side of processing plants, where extractable products and impurities were removed. All transactions, including delivery to the interstate pipelines, occurred in a single state. The gas was brought from the producing wells to the processing plants through a network of converging pipelines of progressively larger size.

In its opinion, the Supreme Court did not limit itself to the particular Phillips' situation. Although it set forth the facts with particularity, it is difficult to determine whether the decision was limited to those facts or was intended to dispose of the jurisdictional issue on a broad and comprehensive basis. The latter interpretation would seem to be indicated by the Court's statement that Congress intended "to give the Commission jurisdiction over the rates of all wholesales of natural gas in interstate commerce, whether by a pipeline company or not and whether occurring before, during, or after transmission by an interstate pipeline company."[17] The Court, however, also stated "that production and gathering, in the sense that those terms are used in § 1 (b), [*sic.* of the Act] end before the sales by Phillips occur."[18]

Under the definition in the rules, any sale in interstate commerce for resale or any transportation in interstate commerce by a producer is considered jurisdictional, regardless of whether the sale is made at the well-mouth or at some other stage before gathering is completed. Although a great portion of the gas sold by producers to interstate pipeline companies fits the factual pattern of the *Phillips* case, much of it does not. Sales are made under a variety of circumstances, in many instances before gathering and processing are completed. Moreover, there is also the question of whether jurisdiction should extend to producer sales where one or more intermediaries intervene before delivery to the interstate pipeline company.

The jurisdictional question is now before the Commission. Deep South Oil Company,[19] Shell Oil Company,[20] and Humble Oil & Refining Company[21] have filed applications for declaratory orders declaring that they are not independent producers. These proceedings have been consolidated, and several other producers have been granted intervention. This case has been fully presented and it is expected that the Commission's opinion will go a long way towards resolving

17. Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672, 682 (1954).
18. *Id.* at 678.
19. F.P.C. Docket No. G-2952.
20. F.P.C. Docket No. G-4671.
21. F.P.C. Docket No. G-5261.

the jurisdictional uncertainties.[21a] This proceeding is of interest because of the factual differences between the operations of these companies and Phillips with respect to sales to interstate distribution companies. Unlike the *Phillips* case, where the sales to the interstate pipeline companies occurred at the discharge side of the processing plant, the sales by the applicants in these proceedings are made, in some instances, at the well-mouth, and in other instances before the gas is delivered to processing plants for extraction of liquid hydrocarbons and impurities.

The jurisdiction of the Commission has also been challenged in several court proceedings. In *Magnolia Petroleum Co. v. F.P.C.*[22] and *Ohio Oil Co. v. F.P.C.*[23] Judge Borah issued orders in November, 1954, staying Order No. 174-A, pending final hearing of the petitions for review. Such hearings have not yet been held.

Union Producing Co. v. F.P.C.,[24] *Stanolind Oil and Gas Co. v. United States*[25] and *Gulf Oil Corp. v. F.P.C.*[26] cases are original actions in the District Court for injunctions against the enforcement by the Commission of Order No. 174-A. In the *Union Producing* case, it was contended that the complainant is engaged solely in producing natural gas and selling it at the well-head, but performs no gathering service or transportation. It therefore contends that it is not properly subject to the Natural Gas Act, even under the broader definition enunciated in the *Phillips* case. This complaint also challenges the validity of Order No. 174-A on the ground that it was promulgated without a hearing. In an opinion issued on December 20, 1954, the court denied the Commission's motion to dismiss. The motion was based on the grounds that the only available form of judicial review of an action by the Commission is by a petition directed to the United States Courts of Appeal under Section 19 of the Act, and that the complainant has not exhausted its administrative remedy by applying to the Commission for a declaratory order.

In the *Gulf Oil* case, which raises similar issues, the court, in an opinion from the bench on February 18, 1955, denied plaintiff's motion for a temporary injunction. In doing so, the court ruled "that in a proper case where irreparable damage is shown, a federal court is not ousted of jurisdiction to enjoin the improper, capricious and arbitrary action of an administrative hearing." The court's order,

21a. On April 4, 1955, the Presiding Examiner issued his recommended decision, holding that the sales involved are subject to regulation under the act. On June 13, 1955, the Presiding Examiner in Dixie Pipe Line Company, et al, Docket No. G-2401, issued a recommended decision, holding on generally similar facts that the sales therein involved were non-jurisdictional. Both cases are before the Commission on Exceptions to the Examiner's Decision.

22. No. 15320 (5th Cir.)

23. No. 15321 (5th Cir.)

24. Civil No. 4949-154 (D.D.C. 1954).

25. Civil No. 3624 (D.N.D. 1954).

26. Civil No. 515-55 (D.D.C. 1955).

however, was based on its finding that the same issue is pending before the Commission[27] and has not been finally adjudicated. The court therefore reasoned that the plaintiffs have not exhausted their administrative remedies. The court also found that there was a failure to show irreparable damage.

Certificate Regulation

Under the Commission's rules independent producers are required to file applications for certificates of convenience and necessity covering all services being rendered on June 7, 1954, and for new service to be instituted thereafter. Pursuant to these rules between 5,000 and 6,000 such applications have been filed. To date no major issues have developed in connection with such filings, and, in the absence of public objection to the granting of the certificates, the proceedings are being administratively processed under the shortened form procedure.[28]

Under the *Phillips* case and other Supreme Court decisions, the phrase "production or gathering of natural gas" is restricted to the physical activities, facilities, and properties used in the production and gathering of natural gas. Thus, the drilling of wells and the construction, extension, or acquisition of production and gathering facilities, including gasoline plants, and the operation of such facilities, are nonjurisdictional matters. It is apparent that the Commission has sought to conform its rules to this jurisdictional construction. They are related to "service" rather than facilities.[29] In this connection it is interesting to observe that in the orders granting certificates the Commission has followed the practice of authorizing the transportation or sale, as the case may be, and the construction and/or operations of any facilities used for such transportation. Commissioner Seaborn L. Digby uniformly has objected to any reference in such orders to the producers' facilities on the grounds that the Commission has no jurisdiction over such facilities.

The contracts between the producers and the pipeline purchasers covering the sales of gas are required to be filed in support of certificate applications. This has raised the question of whether the issuance of a certificate based on such contracts constitutes an approval of the rate provisions contained therein. In many instances local distributing companies and local regulatory authorities have conditionally objected to the issuance of certificates unless the right of the purchasers later to object to the rate provisions is preserved. The Commission has adopted the practice of including a provision in its certificate orders expressly stating that the grant of the certificate

27. Undoubtedly the court was referring to the *Deep South Oil Company* and related cases mentioned above.
28. 18 CODE FED. REGS. § 1.32 (1949).
29. 18 CODE FED. REGS. § 157.23 (Cum. Supp. 1955).

shall not constitute a waiver of the rate-making requirements of the Act and the rules.

Such objections are directed to the various automatic escalation clauses contained in the producer gas sales contracts. In May of 1954 the Commission instituted a proposed rule-making procedure on consideration of the desirability of rules concerning automatic escalation and favored nation clauses in contracts by interstate natural-gas companies with producing companies.[30] In its Order No. 174-B the Commission found that clauses providing for adjustment of the price of the seller by reason of changes in the prices received by the purchaser upon resale, or clauses providing for adjustment of the price of the seller by reason of the payment of higher prices by other purchasers in the same or other producing areas, are not in the public interest, and that such clauses will not be considered as evidence in support of any application for a certificate of public convenience and necessity in contracts submitted on or after *May 1, 1955.* No adverse finding was made with respect to other types of escalation clauses, such as those providing for periodic increases or for first-party favored-nation escalation. By delaying the effectiveness of the operation of the policy with respect to the escalation clauses found to be objectionable, the Commission, of course, is accepting as valid such clauses in all existing contracts and in contracts currently entered into. In several cases distributing companies and state regulatory agencies have objected to the certification of producer sales based on contracts containing certain types of escalation clauses. In recent orders rejecting such conditions the Commission stated that issues directed to escalation clauses more appropriately should be raised in rate proceedings. Although the Commission terminated its proceedings in Docket No. R-137 by its Order No. 174-B, it has failed to take a definite position with respect to the treatment to be accorded the various kinds of escalation clauses for rate-making purposes.

Under Section 7(b) of the Act, a natural gas company may not abandon any service without the permission and approval of the Commission. This statutory provision has been implemented in the rules.[31] In the 174 and 174-A rules, it was provided that the jurisdiction over abandonments applied to any service being rendered on or since June 7, 1954. However, in 174-B, the reference to this date is omitted.

This provision on abandonment promises to be a troublesome problem. It is not known whether the omission of the June 7, 1954 date in the 174-B order reflects a change in Commission policy. In any event, the producers contend that they should have the right to determine for themselves whether they want to become subject to

30. Docket No. R-137, 19 Fed. Reg. 2768 (1954).
31. 18 Code Fed. Regs. § 157.28 (Cum. Supp. 1955).

federal regulation. The difficulty is, however, that large investments have been made in transmission, distributing and consumer facilities based on the availability of supplies under the producer contracts, and, if any substantial portion of such supplies is terminated, the results would be very unfortunate.

The issue is further complicated by the fact that in recent years many contracts between producers and pipeline purchasers have included a clause permitting the producer to terminate the contract in the event the jurisdiction of the Federal Power Commission is extended to independent producers. A suit was instituted by Magnolia Petroleum Company to test the validity of this contract provision and the Commission's rules on abandonment.[32] The action sought injunctive relief against the application of the 174 orders, a declaration of the rights of the parties under the contract and money damages. In a memorandum decision of November 13, 1954, the court held it was without jurisdiction to entertain the action for declaratory relief and denied the request for injunctive relief. It retained jurisdiction to consider the request for a money judgment.

There are also several proceedings before the Commission involving the abandonment issue.[33] These proceedings have arisen upon orders of the Commission rejecting proposed notices of termination of rate schedules and services filed by the producers. All of these cases are still in the administrative stage and no definitive orders have been issued as yet with respect thereto.

The rules on abandonment cover both a complete and partial abandonment of service. Concern was expressed in many quarters that this rule would conflict with the jurisdiction of state conservation commissions over rates of production. In order to minimize the possibility of conflict on this issue, the Commission added a proviso to Section 157.28 of its rules in Order 174-B to the effect:

> "That nothing herein shall be construed as interfering or as intended to interfere with or to prevent compliance by a natural gas company with valid conservation orders of a state agency relating to the production or gathering of natural gas."

Rate Regulation

From the standpoint of both the producers and the consuming public, the question of rate regulation presents an immediate and pressing problem. Since the cost of purchased gas by the transmission

32. Magnolia Petroleum Company v. Texas Illinois Natural Gas Company, Civil No. 5803, D.C., S.D. Texas.

33. Argo Oil Corporation, Docket No. G-6810; Argo Oil Corporation and Magnolia Petroleum Company, Docket No. G-6811; Texas Illinois Natural Gas Pipeline Company v. Argo Oil Corporation, Docket No. G-2951; Texas Illinois Natural Gas Pipeline Company v. Argo Oil Corporation and Magnolia Petroleum Company, Docket No. G-2950. These cases have been consolidated for hearing; also Skelly Oil Company, Docket No. G-5380.

companies and the local distributing companies is an operating expense which must be taken into account in their own rate structures and levels, rate increases by producers are quickly passed along to the consumer. The producers, of course, desire to avoid any interference with their contractual rate provisions.

Under the statute, rates must be just and reasonable and not preferential or discriminatory. The contractual prices may not in any way limit or impinge on the duty of the Commission to see that rates are just and reasonable, since the existence of private contracts can in no way thwart the federal jurisdiction.[34] The contractual rates can be accepted as lawful rates only if they meet the statutory standards. In recognition of this well-established principle, the Commission held, in an order issued October 1, 1954, that the fact that the proposed rate filing is based upon a contract between the parties is not in itself substantive support for such rates.[35]

Statutory Provisions Governing Rates

A look at the statutory provisions governing rates will be helpful in understanding the rate regulation problems presented. At the outset a distinction must be made between initial rates or new rates and a change in existing rates. Under Section 4(c) of the Act, every natural gas company was required upon the passage of the Act to file with the Commission "schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices and regulations affecting such rates and charges. . . ." These are called initial rates. Any rate by a new company or by an existing company for an entirely new service is similarly covered by the provisions of Section 4(c). Such rates are lawful rates until different rates are prescribed by the Commission after hearings in a complaint action brought under Section 5(a).

Although the Commission has no power to prevent the effectiveness of initial or new rates, it does have such power over any change in a rate, charge, classification, or service. Any natural gas company proposing a change[36] in an existing schedule must file, pursuant to Section 4(d), a new schedule with the Commission, stating plainly the change or changes to be made and the time when such changes will go into effect. Subject to the Commission's power, for good cause shown, to shorten the period, a change in schedule may not become effective until the expiration of thirty days after filing. During such

34. Colorado Interstate Gas Co. v. F.P.C., 142 F.2d 943 (10th Cir. 1944), *aff'd* 324 U.S. 581 (1945); Mississippi River Fuel Corp. v. F.P.C., 121 F.2d 159 (8th Cir. 1941).

35. Phillips Petroleum Company, Docket No. G-3175.

36. 18 CODE FED. REGS. § 154.94 (Cum. Supp. 1955) of the producer rules provide: "(c) The operation of any provision of the rate schedule providing for future or periodic changes in the rate, charge, classification, or service after June 7, 1954, or the operation of any like provision in any initial rate schedule filed after June 7, 1954, shall constitute a change in rate schedule."

thirty day notice period, which is designed to give notice to the Commission and to the public of the proposed change, the Commission, under Section 4(e), shall have authority, upon its own initiative or upon complaint of any state, municipality, or state commission, to enter upon a hearing to determine the lawfulness of the proposed change. Pending such hearing and decision thereon, the Commission may suspend the operation of the proposed change for a five months' period beyond the time when the change would have otherwise become effective.

If the Commission has not concluded its hearings prior to the expiration of the suspension period, the proposed rate change shall go into effect on motion of the natural gas company. Increased rates thus made effective are subject to refund to the extent of any portion of such increase ultimately found by the Commission not to be justified. The Commission is empowered to require the execution by the utility of a bond securing the refund, and to require the company to keep accurate account of all payments received under the increased rates. Section 4(e) provides that the burden of proof to show that the increased rate or charge is just and reasonable is upon the natural gas company.

Once a rate is legally effective, the Commission cannot change or alter such rate except through a complaint action initiated under Section 5(a). If, after such hearings, the Commission finds that any rate or charge or any terms and conditions of service is unlawful, the Commission must determine the just and reasonable rate, charge, or terms and conditions of service thereafter to be observed. The Commission, however, has no power to increase any rate, but may order a decrease where existing rates are unlawful or are not the lowest reasonable rates.

Under Section 4(a), it is declared that all rates and charges and all rules and regulations affecting or pertaining to such rates and charges shall be just and reasonable, and any rates or charges which are not just and reasonable are declared to be unlawful. Section 4(b) adds the additional standards that rates must not be unduly preferential or discriminatory, either as between localities or between classes of service. These standards, although of a general nature, have achieved the status of words of art through judicial proceedings and it has been generally accepted that Congress intended to engraft these standards into this legislation. The use of general standards affords the administrative flexibility required to administer effectively the complex issues involved in rate levels and forms.

The Commission's Policy on Suspension of Rate Changes

As of March 1, 1955 producers had filed approximately 2200 rate increases aggregating approximately $28,500,000 per annum. Of this group, 61 increases aggregating approximately $10,500,000 have been suspended and the remainder aggregating approximately $18,000,000 have been permitted to become effective without suspension. Of the unsuspended increases approximately 1700 of them aggregating approximately $6,250,000 are increases passing on state taxes. The period of suspension has varied from a few days to five months. There has been a lifting of suspension on 17 of the 61 suspensions involving rate increases of approximately $750,000 per year.

The Commission's action on suspension promises to be a very controversial subject. It has been generally accepted that under the statutory scheme of regulation, rate changes should be suspended unless their lawfulness is patent. In line with this accepted doctrine the Commission's practice in the pipeline cases uniformly has been to suspend proposed pipeline rate increases. If the action of the Commission is not to constitute abuse of discretion, the failure to suspend must reflect the Commission's conviction that the increase involved, as well as the effective rate upon which it is superimposed, is just and reasonable. Under regulation prices determined by preexisting contracts are not evidence of their reasonableness.[37] The Commission has expressly recognized this rule in its producer regulation.[38]

Under these circumstances the failure of the Commission uniformly to suspend the producer increases was rather unexpected. The Commission has not issued any statement setting forth the standards governing suspensions so that as of this time—more than nine months after the decision in the *Phillips* case—nothing is known about the Commission's policy on this essential aspect of regulation.

A good example of the confusion in the Commission's suspension actions may be observed from the fact that on October 29, 1954 the Commission suspended five producer rate increases totalling approximately $2,859,000 but did not suspend 238 other proposed increases totalling approximately $8,121,000. The suspensions covered sales to Transcontinental Gas Pipe Line Company and the unsuspended increases largely covered sales to Tennessee Gas Transmission Company. Among the rates suspended was a $2,465,000 increase by Union Oil Company of California; among the unsuspended rate increases was an increase of approximately $2,186,000 by the Chicago Corporation and an increase of $1,163,000 by A. C. Glassell, Jr., et al., large independent producers. No explanation has been forthcoming from the Commission explaining its apparently contradictory actions in these and other cases. It is an understatement to say that the industry

37. Colorado Interstate Gas Co. v. F.P.C., 142 F.2d 943 (10th Cir. 1944), *aff'd* 324 U.S. 581 (1945); Mississippi River Fuel Corporation v. F.P.C., 121 F.2d 159 (8th Cir. 1941).

38. Phillips Petroleum Company, Docket G-3175.

is in something of a quandary regarding the Commission's policy on suspensions.

The failure of the Commission to suspend on the sales to Tennessee and in the other instances is made more perplexing, even than would appear from the above, by virtue of the fact that the public actually had no knowledge of the filing of the producer rate increases. The flood of producer filings after the enactment of the 174 rules was so great that the Commission was unable to process applications filed with it, with the result that the filings were not available for public inspection. The purpose of the statutory requirement that a rate increase shall be filed with the Commission for thirty days before it may become effective is to give the public, particularly state regulatory commissions, the right to examine the filings and to request suspension and hearing as provided in Section 4(e) of the Act. In this respect the Natural Gas Act is patterned after the Interstate Commerce Act, which preserved to the utility the right initially to prescribe its own rates which may become effective in the absence of public or regulatory objection. Although the producer applications were filed for thirty days, the public was necessarily unaware of the filings and was, therefore, effectively precluded from exercising its right to protest.

The Contracts Between Producers and Pipeline Companies

A discussion of the existing contractual pricing pattern covering sales to pipeline companies is essential to an understanding of producer rate regulation. The business of transporting gas from the producing areas to the consuming markets requires the installation of long and expensive transmission facilities. Therefore, the economic feasibility of the interstate transportation of gas depends on an assurance of supplies for sufficiently long terms to permit the amortization of the cost of the transportation facilities. Moreover, consumers can be induced to purchase natural gas burning equipment only if they are assured of adequate supplies for a long period of time. In order to meet these conditions, a great portion of the gas sold by producers is under long-term contracts, generally about twenty years. Under these contracts, the producers agree to deliver specified volumes of gas from designated wells or from designated fields.

Practically all contracts entered into since the middle 1940's contain provisions for increasing the price of gas periodically, or upon the occurrence of certain designated extraneous causes. A common provision provides for periodic price increases. Another type of automatic escalation is known as the favored nations clause. This derives its name from the practice in international trade of granting other countries the same tariff advantages granted to a favored nation. Under this type of provision, the seller agrees to pay the independent producer the same price such seller pays any other producer in the field, or to match the highest price paid by any other purchaser to any other seller in the field. The first of these arrangements is known as the first-party favored nations clause, and the second is known as the third-party favored nations clause. In addition, many contracts contain so-called redetermination provisions under which the price is periodically redetermined and adjusted to an average of the highest prices paid by other purchasers in the field. There are also provisions which pass on to the pipeline purchasers all or designated portions of production and gathering taxes levied by the producing states.

Such provisions obviously constitute a constant pressure for higher rate levels. As might be expected under this kind of rate structure, the producer price levels have accelerated rapidly and sharply with the extension of interstate transmission facilities to all areas of the country, and with the intensification of consumption in both old and new markets. An indication of the extent of increases in producer rate levels may be gained from the following. As late as 1945, the estimated value at the well-mouth of marketed production in Texas was 2.6 cents per thousand cubic feet.[39] By 1953, the average price at the well-mouth for Texas production had increased to 7.6 cents per thousand cubic feet.[40]

Although this represents an increase in average prices of over 300% in an eight-year period, these averages do not reflect the prices on which current contracts are based, nor do they fully indicate the further sharp increases portended by the various automatic escalation provisions, in the producer contracts. Many old contracts in Louisiana, Texas, and other producing areas are today being renegotiated in a price area between 10 and 15 cents per thousand cubic feet, and new contracts are being entered into in this price range and even higher. The trend of prices may be observed from contracts entered into by United Fuel Gas Company for large quantities of gas to be transported by the newly formed Gulf Interstate Gas Company. In order to obtain the large volumes required, United had to pay initial prices of 16 and 20 cents per thousand cubic feet, with provisions for periodic escalation, depending on the fields which are the source of the production.[41] American Louisiana Pipeline Company, which is a projected new transmission line between the producing areas in the southwest and Michigan and Wisconsin markets, was required to pay approximately 20 cents per thousand cubic feet for its supplies.[42]

The changes in price levels over the past few years reflect the

39. FPC Natural Gas Investigation, Docket No. G-580 (1948), Report of Commissioners Smith and Wimberly, p. 180.
40. U.S. Bureau of Mines, Mineral Market Report No. MMS 2341.
41. Gulf Interstate Gas Co., FPC Opinion No. 251 (May 20, 1953).
42. American Louisiana Pipe Line Co., FPC Opinion No. 276 (October 1, 1954).

increasing demands for natural gas and the change which has occurred in the bargaining positions of the producers and pipeline companies as a result thereof. Back in the 1920's and 1930's, when there were relatively few pipeline companies, the bargaining position of the producers was relatively weak. The situation was aggravated by the discovery of large oil and gas reserves in east Texas. In those days, because of the absence of markets, gas had relatively little value and was flared as being practically worthless. The bargaining position of the producers was further weakened by the fact that most of the pipeline companies themselves controlled substantial reserves. During this period, long-term contracts were entered into at prices varying between 1 and 3 cents per thousand cubic feet in many areas.

Inperceptibly at first, and quite markedly later, the entire picture has changed. Whereas natural gas represented only approximately 10% of the energy consumed in the United States in 1936 (on a b.t.u. equivalent basis), it accounted for approximately 23% in 1953. Not only has natural gas taken over a larger share of the total energy market, but that energy market is much larger. In 1936, the marketed production of natural gas was approximately 2168 million MCF, compared with 8397 million MCF in 1953. In the earlier year, interstate shipments of marketed natural gas production was approximately 26% of total marketed production, and by 1953 this had increased to approximately 50% of marketed production. During this period, the value at the wells of marketed production increased from approximately $119 million to $775 million. Residential consumption has increased from 343 million MCF to 1686 million MCF, and the number of residential consumers from 8 million to 24.2 million.

It is fair to state that the public insistence on producer regulation stems primarily from the operation of the escalation clauses. They are justified by the producers on the ground that they are entitled to such protection under the long-term contracts they must enter into with the pipe line companies. They also contend such clauses are in the consumer interest because they encourage the producers to make supplies available. A major problem of the producers will be to demonstrate that the rates which result from the operation of the escalation clauses are just and reasonable.

Methods and Principles to be Applied in Fixing Producer Rates

The major problem in the regulation of producer rates is the selection of the principles and methods to be applied in determining whether such rates are just and reasonable and non-preferential and non-discriminatory, in accordance with the statutory requirements.

Historically, the Commission's rate regulation of pipelines has been based on original cost, allowing the utility a reasonable return on its original cost rate base. The rates allowed by the Commission under this method are designed to produce revenues sufficient to recover all costs of service, including depreciation, all taxes, including federal income taxes, and to provide a return of sufficient magnitude to attract the capital necessary to the operation and expansion of the enterprise.[43] There are obvious differences between the business of producing and gathering natural gas and the typical utility operation, and the question is whether such differences require the application of different rate-making standards.

Considerable doubt has been expressed in many quarters as to whether this traditional method of rate-making is adaptable to the regulation of producer rates. The business of producing natural gas has different economic and operational problems from those of companies typically considered to be utilities. One difference is that the production of natural gas involves a wasting asset which must first be found and captured. Another difference is that exploring for natural gas is a speculative venture and one in which there is not necessarily any relationship between the sums expended and the volume of gas discovered. It has also been pointed out that, since the cost experience of each operator may be different, the cost-of-service approach would result in wide price variations for gas depending on the seller.

The problem of pricing natural gas is not entirely new to the Commission. Many of the pipeline companies produce substantial quantities of gas. Until the Commission's decision in April of 1954 in the *Panhandle Eastern Pipe Line Company* case,[44] natural gas companies were required to include their own production on the basis of values arrived at under the cost-of-service method. Under this policy the pipeline company was allowed its costs of production, including taxes, and a return on the sums invested for leases and producing properties. In the *Panhandle* case, however, the Commission departed from this policy and permitted that company to include its own production on the basis of an average of the prices received by other producers in the field. This method is known as the fair field price method.

The *Panhandle* case was decided before the Supreme Court's decision in the *Phillips* case. Shortly after the *Phillips* decision the Commission issued its opinion in the rate case of *El Paso Natural Gas Company*,[44a] which case also involved the pricing of gas produced by a pipe line company. Significantly, the Commission expressly limited the *Panhandle* case as precedent, and indicated that the *Phillips* case may require consideration of other methods and principles for pricing gas produced by a pipe line company or independent producer.

43. Bluefield Water Works and Improvement Co. v. Public Service Comm'n, 262 U.S. 679 (1923).
44. Panhandle Eastern Pipe Line Company, Docket G-1116, Opinion No. 269 (April 15, 1954).
44a. El Paso Natural Gas Co., F.P.C. Opinion No. 278, November 26, 1954.

In view of the novelty and complexity of the problem of determining the reasonableness of independent producer rates, the Commission instituted a rule-making proceeding (Docket R-142) to consider the methods and principles to be applied in fixing producer rates and invited the comments and suggestions of interested parties. Views were expressed by producers, pipeline companies, local distributing companies and some state and local agencies. Public hearings were held in the early part of January but the Commission has not to date announced the rate policies it will follow.

The producers advanced the view that the Commission should accept the contract prices, including the effect of automatic escalation, as prima facie proof of the reasonableness of the rates, and, therefore, should permit the contract prices to become the lawful rates. Under this theory anyone desiring to test or challenge a rate change would be required to proceed by complaint action under Section 5(a). This theory is based on the contention that natural gas is a commodity and that as such its price should be regulated only by the operation of supply and demand. It was contended that the contracts between producers and pipeline companies are negotiated at arm's length and that the interplay of competitive forces should determine the producer prices. This approach to the problem would require that the Commission permit producer price changes to become effective without suspension. The rather active use by the Commission of its suspension powers, however, is rather clear indication that this proposal will not be accepted as a principle of general application.

Only a handful of distributing companies participated in the R-142 proceeding. By and large, their position was that producer prices should be designed to protect natural gas in the retail markets from price competition from other forms of fuel. They were concerned that natural gas may be priced out of the market, particularly along the eastern seaboard where fuel oil prices are most favorable and in coal producing areas, by the uncontrolled advance of producer prices. The distributors uniformly objected to the automatic escalation clauses, particularly those of the favored-nations type. Generally speaking, they also took the position that the cost-of-service approach was not suitable for the regulation of producer rates, primarily on the asserted grounds that it is not feasible and would tend to discourage an adequate rate of exploration.

The distributing companies are justly concerned about the effect on their business of continued increases in the price levels of natural gas. For the 1953 heating season the retail price of gas to residential customers in twenty-one cities throughout the country was equal to or greater than fuel oil or coal. Moreover, in thirteen additional cities the price of natural gas was within 15% of the nearest competitive price.[44b]

There is considerable doubt, however, about both the legality and feasibility of the regulatory criterion suggested by the distributing companies. The standard of the competitive ceiling does not necessarily have any relationship to the statutory standard that rates be just and reasonable and not preferential or discriminatory and does not assure compliance with the provisions of Section 5(a) of the Act that rates shall be the lowest reasonable rates. Moreover, this suggestion also has practical difficulties due to the fact that the interstate pipelines serve large geographical areas and there is no uniformity in the prices of the competing fuels throughout the territory served by any given pipeline company. Take, for example, the system of Tennessee Gas Transmission Company, which runs from the southwest producing fields through Mississippi, Tennessee, Kentucky, with one branch going through Ohio, Pennsylvania, and New York State to Buffalo, then east to Massachusetts, and with another branch going into West Virginia with service projected to the New York City area. In addition, Tennessee supplies large volumes of gas to other pipeline companies for resale by them in other areas. It is difficult to see how the standard of competitive prices in the retail markets can serve as a basis for fixing the producer rates to Tennessee.

The Public Service Commission of Wisconsin, which was the moving party in the *Phillips* case before the courts, the National Institute of Municipal Law Officers and several large cities urged that the producer rates should be regulated on the cost-of-service-rate base approach. The General Counsel of the Commission, while not urging this method as the sole standard of regulation, stated that it should be given serious consideration. In support of its use he stated that the validity of this method depends upon the importance of capital in the enterprise. He pointed out that in the electric and gas industries the ratio of total assets to sales is about 3.64 to 1 and for crude oil and natural gas production about 1.5 to 1.

A variety of other suggestions was made, including the setting of uniform field prices, producer prices based on uniform rates by retail areas and fair field prices along the lines of the *Panhandle* case. The Commission has not as yet issued any statement of policy indicating what methods and principles it may adopt, and to date no hearings have been held in any producer rate case and the Commission, therefore, has had no occasion to express its views in a formal opinion, since no rate cases have been concluded.

The broad public interest is concerned not only with rates but

44b. Based on data collected by Independent Natural Gas Association.

also with the maintenance of adequate supplies for the future. The principles of regulation must serve both of these objectives. The producer rate structure must provide an incentive for the higher level of exploration required to meet the large and growing public demands for natural gas. The heart of the problem is how the necessary incentive can be measured and translated into price. The incentive required to encourage a high rate of exploration is a problem in economics which can be resolved only on the basis of all relevant facts. The difficulty at the threshold of regulation is that such facts are not available.

The close relationship between the discovery and production of oil and gas has an important bearing on the question of gas supplies. Exploratory activity for natural gas is closely intertwined with the search for oil. Although some gas exploration is undertaken independently, gas discoveries are largely made incidental to exploration for oil. In the five years, 1949-53, gas wells accounted for about 12% of total oil and gas wells completed. As of January 1, 1954, there were about 68,000 producing gas wells as against over 500,000 producing oil wells. Although the volume of gas produced from gas wells has been increasing in the last few years at a somewhat faster rate than the volume of gas produced from oil wells, the later still comprises one-third of the total natural gas produced.

It appears from available data that oil companies and other large producers produce perhaps three-fourths of the total natural gas produced, other than that produced by pipeline companies. Despite the dominant position of the oil industry in the production of gas, published reports for thirty-five leading oil companies indicate that as of December 31, 1953 the gross investment of these companies in property, plant and equipment assigned to natural gas production totalled $240,000,000, or about 2% of the total of such investment in oil and gas production combined. For 1953 the sales revenue from natural gas for these companies totalled $459,000,000, or about two per cent of the total sales revenues of these companies. These thirty-five companies accounted for over 85% of United States crude oil production in 1953.

To the extent that gas is discovered as part of the exploration for oil, gas discoveries will continue to be made as long as there is exploration for oil. Although this basic fact tends to insure a high rate of exploration, it does not on the other hand justify a depressant public policy on natural gas prices. Natural gas prices must be reasonable, in light of all the circumstances.

With the passage of time since the hearings in the R-142 rule-making proceedings, it is becoming increasingly doubtful that the Commission will promulgate any general rate-making standards. Under these circumstances, the regulatory standards will evolve through the decisional process. At best this method is slow, particularly on such a frictional issue as rates, and several years may elapse before the governing body of law is fully developed. The problem is aggravated by the wide variety of interests and arrangements between producers which characterizes the oil and gas industry. This is troublesome, because, under the Natural Gas Act, the individual producer is the unit of regulation, and rates must therefore be just and reasonable with respect to each sale by each producer.

The scope and magnitude of the regulatory problem may be appreciated when it is recognized that the *Phillips* case may bring five to seven thousand producers under regulation. Although most of this great number are small operators and collectively do not account for a substantial portion of interstate sales, their transactions and activities must conform to the standards of the act. This situation emphasizes the need for a method of regulation, regardless of the standards applied, which would eliminate the necessity of considering the transactions of the small producers on a "case" basis. The administrative burden of dealing with such a large number of producers well may direct the course of regulation to a field-wide basis with adequate safeguards for both disaffected producers and consumers to challenge the field rate as it applies to individual producers. Such a method of regulation would recognize the basic fact that, even without regulation, the small producer is governed by the prices prevailing in his field.

LEGISLATIVE EFFORTS TO EXEMPT PRODUCERS FROM REGULATION

Federal regulation of any phase of the oil industry has always been a hot political issue. Federal regulation of independent producers of natural gas is no exception. The oil industry reacted quickly and sharply to the Supreme Court's decision in the *Phillips* case and has set as its goal the enactment of legislation expressly exempting the activities of producers from the Natural Gas Act. In the past, even before the *Phillips* case, strong efforts were made by the oil industry to obtain exemptive legislation to obviate the possibility that independent producers might be held subject to the Natural Gas Act by judicial interpretation. It will be remembered that the Kerr Bill, which followed several earlier unsuccessful legislative efforts, was passed by the 81st Congress only to be vetoed by President Truman.[45]

Now that regulation is a certainty and not a probability, the oil industry has renewed its legislative efforts.

The political climate would appear to be rather favorable for exemptive legislation. The issue is not one of party and finds both sides of the Congress divided on the question. However, the leader-

45. 96 CONG. REC. 5368 (April 18, 1950).

ship of both houses appears to be sympathetic. It also appears that the legislation may have substantial support in the administration.

There does not appear to be any comparable cohesion among those expected to oppose the legislation. General understanding has it that the large pipeline companies are supporting exemptive legislation. The position of most of the local distribution companies has not yet been made clear. There undoubtedly will be opposition to exemption from the large consuming states, but it does not appear that there will be any organized participation by these groups.

Proposed Legislation

Several bills have already been introduced in the 84th Congress to exempt independent producers from federal regulation.[46] Two bills have also been introduced in the House at this session expressly requiring the Commission to apply actual legitimate or original cost standards in fixing producer rates.[47] A similar bill has been introduced in the Senate.[48] All of these bills have been referred to the Committees on Interstate and Foreign Commerce.[48a]

It is understood that of the various measures proposing an exemption for independent producers, the Harris Bill is the one which has the organized backing of the oil industry.

This bill, a copy of which appears as Appendix "A" hereto, would achieve the exemption of independent producers from federal regulation by adding to Section 2 of the Natural Gas Act definitions covering "transportation of natural gas in interstate commerce" and "sale in interstate commerce of natural gas for resale." These terms would be limited to transportation and sales occurring after the gas has been received into the facilities of an interstate pipeline. Under these definitions the sales by processors, such as Phillips, to the interstate transmission companies, and all sales prior thereto, would be exempt, as would all transportation involved in moving the gas to the interstate transmission facilities.

Although the bill would remove all jurisdiction over independent producers, it would grant the Commission certain express powers with respect to the prices paid by pipeline companies to such unaffiliated producers. Under this provision, the Commission would be required to limit the cost a pipeline company could include as

46. H.R. 3703, 84th Cong. 1st Sess.; H.R. 3902, 84th Cong. 1st Sess.; H.R. 3940, 84th Cong. 1st Sess.; H.R. 3941, 84th Cong. 1st Sess.; H.R. 4214, 84th Cong. 1st Sess.; H.R. 4560, 84th Cong. 1st Sess.; H.R. 4675, 84th Cong. 1st Sess.

47. H.R. 3490, 84th Cong. 1st Sess.; H.R. 3616, 84th Cong. 1st Sess. (1955).

48. S. 1248, 84th Cong. 1st Sess. (1955).

48a. Subsequent to the writing of this article numerous other bills were introduced in both the House and the Senate. Among such bills were those sponsored by the coal interests which, generally speaking, provide for continuing regulation of the independent producers of natural gas and the adoption of rate standards and levels which would protect the coal industry from severe price competition by natural gas.

an expense in a rate case, where the rate increase is based in whole or in part upon any new or renegotiated contract, to the reasonable field market price. In determining such reasonable market price the Commission would be required to consider the effect of the contract upon the assurance of supply and the relationship of the contract price to existing or future market field prices. Although the full import as a regulatory standard of the reference to future prices and supplies is far from clear, it seems designed to give some measure of legislative recognition—albeit an uncertain measure—to the contractual escalation provisions.

Section 5 of the Act would also be amended expressly to provide that the Commission shall allow a pipeline company to include gas produced by it or purchased from an affiliate at the reasonable field market price. With respect to gas produced by pipelines or purchased from an affiliate, the amendment liberalizes and goes far beyond the policy of the Commission enunciated in the *Panhandle Eastern Pipe Line Company* case.[49] In that case, the Commission permitted Panhandle to include its own production and that purchased from affiliates on the basis of an *average* fair field price. This was a sharp departure from the principle of pricing such gas on the rate base-cost of service method, which had been followed since the earliest days of administration under the Act. In the proposed legislation, there is no mention of average field price and the use of the words "reasonable market price" would seem to refer to current market prices.

The Harris bill would also amend Section 7 of the Natural Gas Act, dealing with the issuance of certificates of public convenience and necessity. Under this amendment, the Commission shall not grant an application for a certificate in the event the prices to be paid for gas under the gas purchase contract supporting the application is greater than the reasonable field market price. It cannot be determined from this language whether the Commission would be limited to current market prices or would have to take into account probable future market prices as it would be under Section 2 (b) of the Harris bill.[50]

49. FPC Docket G-1116, Opinion No. 269 (April 15, 1954).

50. Since the writing of this article extensive hearings have been held on the various proposed measures by both the House and Senate committees and each committee has reported out substantially identical bills, which are amended versions of the original Harris Bill. The bill passed by the House Committee is H.R. 6645 and the Senate Committee version is S. 1853. The bills, as reported out of committee, retain the exemption of independent producers from the Natural Gas Act, but expand the provisions of the original Harris Bill giving the Commission jurisdiction over the prices paid by pipe line companies to producers. The jurisdiction of the Commission is extended to rate increases based on escalation clauses in contracts ante-dating the amended legislation. In its original version, the Harris Bill subjected to the Commission's jurisdiction only escalation provisions in contracts executed or renegotiated after the effectiveness of the amendatory legislation. Under the amended version, the Commission shall determine whether the price as increased by the contractual

The Cabinet Report on Energy Supplies and Resources Policy

As part of the legislative picture, reference must be made to the *Report of the Advisory Committee on Energy Supplies and Resources Policy.* A copy of that report as it relates to natural gas is included as Appendix "B" hereto. This Committee was established by the President on July 30, 1954, shortly after the Supreme Court's decision in the *Phillips* case. The director of the Office of Defense Mobilization was designated as chairman and the Secretaries of the Departments of State, Treasury, Defense, Justice, The Interior, Commerce, and Labor, were named as members. They were assisted in their work by a task force of members from industry.

The report of the committee is entirely disappointing. It reached extremely controversial conclusions unsupported by any presentation of the facts and data which presumably it considered. The significance and authority of the report suffer from this lack of documentation.

The report is all the more disappointing, because it held out the prospect that this high-level committee would serve the important function of bringing together a great amount of data scattered throughout the various Government departments and agencies and evaluating and synthesizing this mass of data into an objective and meaningful presentation. This would have been a contribution worthy of such a committee and helpful to the legislative process.

The official status of this report is equivocal. By virtue of its release by the White House the initial impression was that it was a report *by* the President, or that it at least had his sponsorship. In the face of Congressional and public protests which followed the release of the report, the White House indicated that this was a report *to* the President, that he had not as yet given it his support, and that the President would consider the matter from the standpoint of its effect on consumer interests.

The report stated that the problem of natural gas regulation was

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escalation provision is the reasonable market price of the gas at the delivery point and the pipe line company may charge as an operating expense only the reasonable market price as determined by the Commission.

Another provision in the amended bill creates a procedure for determining, with respect to new or renegotiated contracts, whether the price to be paid thereunder is the reasonable market price. After such determination is made by the Commission, the pipe line company shall thereafter be allowed to charge as an operating expense for rate purposes the reasonable market price of the purchased gas, as thus determined. This provision is designed to permit a pipe line company to ascertain whether prices proposed to be paid under new gas purchase contracts will be allowed by the Commission without actually waiting for the issue to arise in a rate proceeding.

These amendments, which constitute the principal changes in the original Harris Bill, have not quieted the controversy over the legislation, but on the contrary, have pointed up the basic question of whether producers should be exempt from direct regulation. As of mid-July, neither the House nor Senate bill had been brought to the floor. If Congress holds to its scheduled adjournment by August 1, it would appear doubtful that legislative action on this measure can be completed at this session of Congress.

"approached from the viewpoint of assuring adequate supplies and the discovery and development of additional reserves to support such supplies, in the interests of national defense, and expanding domestic economy, and reasonable prices to consumers." The report in its entirety, however, does not measure up to this objective premise.

In the single paragraph devoted to independent producer regulation, it expressed itself in favor of sound conservation practices and noted that the area of conservation management is under the jurisdiction of state conservation commissions. The further view was expressed that "the Federal Government should not control the production, gathering, processing or sale of natural gas prior to its entry into an interstate transmission line." This was said to be necessary "in the interest of a sound fuels policy and the protection of the national defense and consumer interests by assuring such continued exploration for and development of adequate reserves as to provide an adequate supply of natural gas."

The committee considered its natural gas policy as a segment of an overall national fuels policy. It stated that "The basic principle regarding the regulation of natural gas and the use of alternative energy sources should be as far as possible that of free choice by the consumer and free and fair competition among suppliers."

Although the Harris Bill and companion legislation substantially adopt the policies set forth in the Cabinet report, it is doubtful that the report will be of much assistance in the legislative process. In failing to support its policy conclusions with basic facts and considerations, it is unlikely to be found persuasive by those members of Congress not already committed to the views expressed therein. The chief significance of the report—and perhaps its purpose—is as an instrument of broad political strategy. The issuance of the report was immediately followed by the introduction of the Harris Bill and the announcement of the House Committee of hearings on the various proposals. It is generally recognized that legislative action, which is largely sponsored by Democrats from the producing states, is awaiting some form of public support from the administration. Apparently, the Cabinet report is the form in which this support is to be announced.

Conclusions

The issue before the Supreme Court in the *Phillips* case was whether the interstate sales and transportation by independent producers were comprehended within the Natural Gas Act. There is no doubt about the power of the Federal Government to regulate such interstate transactions, and the only question was whether it had done so under the Natural Gas Act.

The Harris Bill and the other measures proposing an exemption for independent producers from federal regulation poses the more significant question of whether the Federal Government should exercise its power to regulate the producers. This is a question of basic public policy affecting an industry important to the economy of the country and a major source of the nation's energy requirements. Large stakes are involved for both the industry and the public and in the normal course of events it can be expected that great pressure will be brought to bear on Congress from both sides. In view of the importance of the matter, it is to be hoped, however, that the decision ultimately made will not be a purely political one.

The controversy over whether there should be federal regulation over the prices and services of independent producers is a classic example of the recurring issue in our economic organization of how much governmental regulation of business there should be. The issue should be resolved not on the basis of inflexible doctrine but on the basis of the requirements of the broad public interest. The legislative objective should be to assure adequate supplies of natural gas at fair and reasonable prices. The real issue before the Congress is whether this objective may best be realized under or outside the scope of regulation. The contending considerations bearing on this issue may be stated as follows:

With the extension of pipelines to practically every nook and cranny of the country, the demands for natural gas have put, and will continue to put, a great pressure on prices. The contractual price structure of the industry has built-in price-increasing provisions (the automatic escalation clauses). In the post-war years the price of field gas has moved from around the 5 cents per MCF level to an area between 15 and 20 cents per MCF. No one knows how high the combination of these factors will raise the price of gas.

Against these facts must be set the contentions of the producers that the maintenance of adequate supplies for the future requires freedom from federal regulation; gas should be permitted to rise unrestricted, except by the limitation of competing fuels, in order that the producers may realize the full economic value of the product; the gas contracts between sellers and purchasers are arrived at through arm's length bargaining and reflect the operation of the law of supply and demand; the various automatic escalation clauses are needed to protect the sellers who must enter into long-term contracts for the disposition of their gas; and, the business of producing gas does not enjoy any monopolistic characteristics of a utility, is otherwise unlike a utility, and utility concepts are not applicable to it.

The problem before the Congress is to determine the merits of these contentions of the producers and to balance such contentions against the public interest in reasonable prices and adequate supplies.

It would seem that, basically, the question of adequacy of supplies turns on the question of price. The price allowed producers must compensate them for the unique risks of their business, and must provide a realistic incentive to engage in exploration and production activities. It is to be hoped that the Congress will inquire into the function played by price in bringing natural gas to market and will consider whether meaningful standards for determining the necessary amount of price incentive can be formulated.

The various automatic escalation clauses, which are the core of the industry contractual price structure, will certainly receive a major portion of attention from all sides. If a compromise is to be brought about it can be expected that it will involve the future of these various automatic escalation provisions.

In the meantime, little progress can be expected in the regulation by the Federal Power Commission of independent producers until Congress determines the threshold question of whether there should be regulation of independent producers.