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GAS PRODUCER RATE LAW – THE BABY BEATS THE NURSE

By Samuel Graff Miller *

THE natural gas industry, like Caesar's Gaul, is divided into three parts—one part long occupied by local distribution companies dealing directly with the public and subject to state regulatory control; another part including the operations of interstate pipelines which buy gas in the fields and transport it to the market areas as traditional wards of Federal Power Commission regulation; and a third area inhabited by gas producers, almost complete strangers to rate regulation, and as ruggedly individual as economic enterprisers can be.

Gas producers, in turn, are of two tribes, the less numerous including pipelines, pipeline subsidiaries, and utility companies; the other, numbering over 5,500 [1] and proudly bearing the descriptive name, *independent producers.* It is the latter tribe which is referred to hereinafter as *producers.* Legally speaking, only in the last five years [2] has the Federal Power Commission even gestured toward regulation of producers. As nurse to the producer industry, it has been so cozened by its charges as to make it appear that, in Shakespeare's words, "The baby beats the nurse and quite athwart goes all decorum." [3]

In the Southwest oil fields only twenty years ago, oil was making millionaires by the dozen, but no one became rich from gas which—if it was not flared [4]—was probably sold at 1 cent to 2 cents per Mcf (thousand cubic feet) to produce carbon black. Obviously, no regulatory control was needed at that time to keep down the field price of gas. Lack of markets more than

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[1] Estimates vary—and doubtless the actual number varies from time to time. The Federal Power Commission, in DIRECT SALES BY PRODUCERS TO REPORTING INTERSTATE NATURAL GAS PIPELINE COMPANIES (1958), listed 5,593 producers as suppliers of interstate pipelines. Since, generally speaking, oil producers also from time to time produce gas, it is interesting to note that DECHAZEAU AND KAHN, INTEGRATION AND COMPETITION IN THE PETROLEUM INDUSTRY, 2, (1959), estimate, on the basis of data supplied by the Bureau of Old Age and Survivors Insurance for 1949 that "Crude oil is produced in the United States by perhaps 7,000 companies. . . ."

[2] This has occurred since the Supreme Court opinion in Phillips Petroleum Co. v. State of Wisconsin, 347 U.S. 672 (1954), which dissipated the Commission's complacent illusion that it had no responsibility for producer doings.

[3] MEASURE FOR MEASURE, Act 1, Scene 3.

[4] In 1946, expert witnesses were testifying before the Federal Power Commission that the price of gas was so low that, although more than half of Texas' casinghead gas production was vented, the cost of saving it would be almost prohibitive. LARSON AND PORTER, HISTORY OF HUMBLE OIL AND REFINING COMPANY, 650 (1959).

took care of the price level.[5] True, Congress passed the Natural Gas Act in 1938, but this meant nothing to Southwest gas producers. As a matter of fact, there was neither widespread public demand for the bill nor real industry opposition.[6]

Nevertheless, the Natural Gas Act[7] carried as a banner the declaration of policy that the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest, and that federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is necessary in the public interest. Natural gas companies were defined as entities "engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale."[8] The regulatory arsenal of the Commission included the statutory power to "order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates,"[9] and this power was interpreted as leaving the courts without authority to set aside as too low any rate not confiscatory in the constitutional sense.[10] Guidance in arriving at the lowest reasonable rates was afforded by *Mississippi River Fuel Corp.* v. *Federal Power Comm'n*,[11] which held that "the value of the service to users is neither a reasonable rule nor supported by judicial decisions." The court also said, "A natural gas company fails to sustain the burden of proof as to reasonableness of rates, imposed upon it by the Act, when it produces no evidence to show the value of its property used and useful for serving customers . . . makes no proof of operating costs, and makes no proof as to what would constitute a reasonable rate of return on the property so used."

For ten years after the act became effective, the Commission confined its gas regulatory activities almost entirely to the care and nurture of gas pipeline companies, its quiescence troubled only infrequently by passing dreams of responsibility for producer behavior. However, the Commission found no difficulty in dissipating such dreams when they did occur. For example, *In re Columbian Fuel Corp.*,[12] the Commission flatly found that, "The companies to be subjected to regulation were conceived of as 'pipeline' companies. . . ."

[5] In 1939, the Average Value of Natural Gas at Point of Production was 4.9 cents per Mcf and the following year 1940, the average dropped to 4.5 cents: UNITED STATES DEPARTMENT OF THE INTERIOR, BUREAU OF MINES, MINERALS YEARBOOK AND MINERAL INDUSTRY SURVEYS.

[6] Producers were too busy exploring and drilling for oil to pay much, if any, attention to Congressional action relative to gas; furthermore, interstate gas sales were de minimis.

[7] 15 U.S.C. § 717a (1938).

[8] 15 U.S.C. § 717a(6) (1938).

[9] 15 U.S.C. § 717d (1938).

[10] Federal Power Commission v. Natural Gas Pipeline Co. of America, 315 U.S. 575 (1942).

[11] 121 F.2d 159 (1941), *affirming* 2 F.P.C. 170.

[12] 2 F.P.C. 200, 203 (1940).

And on August 7, 1947, the Commission announced that because of "misunderstanding" and "continuing expressions of fair and uncertainty" regarding its duty to supervise gas producers, it felt constrained to make this remarkable statement:

> The Commission gives its assurance to independent producers and gatherers of natural gas that they can sell at arm's length and deliver such gas to interstate pipelines and can enter into contracts for such sale without apprehension that in so doing they may become subject to assertions of jurisdiction by the Commission under the Natural Gas Act.
>
> The rule herein has this specific purpose and is issued at this time because the Congress has not yet reaffirmed such exemption by amending the act.[13]

Did ever any baby before have its nurse so bemused?[14]

As time passed, however, all exempting legislation was pigeonholed, defeated, or vetoed. Finally, the Commission in *In re Phillips Petroleum Co.*,[15] promulgated its last and most elaborate attempt to negate all independent producer jurisdiction. Over the protests of its staff, it volubly disclaimed such jurisdiction only to find itself in the Court of Appeals for the District of Columbia, defending its decision against the State of Wisconsin, the City of Milwaukee, Wayne County, Michigan, and the City of Kansas City, Missouri. The State of Texas and the Railroad Commission of that state, the State of New Mexico and its Oil Conservation Commission, and the Corporation Commission of Oklahoma, gallantly rushed to support of Phillips and the Commission, but to no avail.

On May 22, 1953, the Court of Appeals decided that the Commission must fix rates for producer sales to interstate pipelines,[16] and on June 7, 1954, the Supreme Court plainly and emphatically held that the rates charged by producers to pipelines may have a direct and substantial effect upon the price paid by ultimate consumers, and are therefore within the aim of the Natural Gas Act to protect consumers against exploitation.[17] The hour of truth had struck, and the Commission at last had no alternative but to acknowledge that the producers were confined to its salutary supervision.

The *Phillips* decision touched off an awe-inspiring display of emotional pyrotechnics. The baby cried havoc. It was ominously predicted that exploration for gas would cease, the supply would soon be exhausted and further,

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[13] Docket No. R-106 (1942).

[14] The executives of at least one large producer found the Commission disavowal "not sufficiently reassuring." LARSON AND PORTER, HISTORY OF HUMBLE OIL AND REFINING COMPANY, 651 (1959).

[15] 10 F.P.C. 246 (1951).

[16] 205 F.2d 706 (1953).

[17] Phillips Petroleum Co. v. State of Wisconsin, 347 U.S. 672, (1954).

what gas there was would be sold intrastate or simply held in the wells until the nation came to its senses. It is enough for present purposes to note that no such dire results have transpired.

On November 17, 1954, the Commission instituted a rule-making proceeding at R-142 with the resoundingly portentous title, "Consideration of Principles and Methods to Be Applied in the Fixing of Rates to Be Charged by Independent Producers for Natural Gas Sold in Interstate Commerce for Resale." The Commission invited "members of the industry, producers, gatherers, interstate pipe-line companies, distributors, consumers, groups and associations representative thereof, State commissions, municipalities, and any other interested persons" to submit by December 13th "information, data, views, comments or suggestions" and it set oral argument for December 15th. All this purported excitement about how to deal with producers was somewhat disingenuous, of course, because the Commission had long before evolved fully adequate rate disciplines for the remainder of its regulatory brood.

As might have been expected, the outcome of the gesture was further confusion. The producer chorus maintained the continuous chant that producer rates should not be regulated because, unless let alone, producers would no longer risk their funds in the search for gas and oil. The distributor companies and other consumer representatives, on the other hand, evinced imaginative concern with many and various rate-making schemes, but presented no common front on any specific issue. Commission General Counsel Gatchell, however, voiced some pithy truths, pointing out to the Commission that:

> To place a regulated company on economic equality with unregulated companies is one thing. To surrender your regulatory responsibility to the unregulated market place is something else again.
>
> In none of the cases which have been called to your attention has any regulatory agency charged with rate-fixing responsibility sought to regulate the rates for which it had responsibility by permitting all that the traffic will bear. Nor has any court said any such a surrender of public responsibility would be compatible with constitutional principles of regulation.
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> It is apparent from the rapid increase in producer prices over the past few years and from the observations in the last few days here that the demand for natural gas is in excess of the supplies which may be purchased and that the buyers are competing against each other upon the fairly safe assumption that whatever they honestly pay will be allowed as a part of their cost of service. Consequently, two, four, or even ten cents more than the market price may be of no economic concern to a company which sorely needs an additional supply to meet a need for increased service.[18]

[18] Docket No. R-142 (1954).

If the Commission had heeded these sane and forthright views, much of the later regulatory confusion might well have been avoided. Be that as it may, Docket No. R-142, after a brief few days in the sun, was relegated to the limbo of the Commission files never to reappear. On December 1, 1955, it was summarily interred by Commission order without any pretense of determination or discussion of principles or methods to be used in fixing producer prices.

Operation of the law of supply and demand—together with the increasing cost of finding and producing gas—naturally began to raise the field price level, but the price situation was intensified by fascinating little gimmicks in the standard gas purchase contract. These gimmicks were escalation clauses—for example, the "favored nation" clause, which provided that if the purchasing pipeline agreed with another producer for a higher price during the life of the contract, the price paid to the contracting producer would be equivalently increased. The practical result of the unnatural interrelation of purchases thus induced, was a single rate level for all purchasers in the area covered by the "favored nation" clause, which in turn could make the acquisition of additional reserves in the area prohibitively expensive. The pipelines, however, were not resistant to such escalation clauses so long as the increases were postponed until their loads were attached, because they would then be in a position to pass the increases on to their distributing company customers. At the time of the *Phillips* decision, most distributors had never seen a producer-pipeline contract and, even if they had, would probably not have worried much about the escalation clauses because the prevailing field prices were so low that escalations would have appeared a minor irritant at most.

Of course, any increases permitted by "favored nation" clauses must be filed with the Commission and supported by proof. They are subject to suspension and refund [19] so that, assuming established rules of rate regulation, they can theoretically be controlled. And for some time, control seemed not too far off.[20] But a realistic look in another direction was enough to stifle any burgeoning optimism. Initial rates, as distinct from increased rates, can be tested as to precise reasonableness only under section 5 of the Natural Gas Act,[21] which gives no powers of suspension or refund. Thus, when a pipe-

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[19] 15 U.S.C. § 717c(e) (1938).

[20] For example, the Commission was affirmed in holdings that absent "some financial evidence" to justify a producer rate increase, a showing of arm's length bargaining and comparability between the proposed rate and going field price fell short of such justification. Bel Oil Corp. v. Federal Power Commission, 255 F.2d 548 (5th Cir. 1958), *cert. denied*, 358 U.S. 804 (1958); Forest Oil Corp. v. Federal Power Commission, 263 F.2d 622 (5th Cir. 1959).

[21] 15 U.S.C. § 717d (1938).

line desires to carry out a large expansion program and contracts for correspondingly large supplies from producers, the contract prices are immediately payable and cannot be changed except upon completion of section 5 proceedings. Since all prices flow through the pipeline and the distribution company to the customers, this means that no matter how high the new contract prices may be, they must be borne by the customer without hope of refund—until a section 5 case is born and dies. Because of the length of section 5 proceedings—not one has been definitely disposed of in the more than five years since the *Phillips* decision—it has become evident that consumer protection, to be effective, must be given at the section 7 or certificate level.[22] In other words, the Commission must scrutinize the proposed price when considering certification of a new sale, and, if the price is out of line, it must appropriately condition the certificate. The seriousness of this situation is shown by the increases in the average price of interstate sales in Louisiana from 7 cents per Mcf (thousand cubic feet) in 1954 to 11.2 cents in 1955, to 12.4 cents in 1956, to 14.2 cents in 1957[23] and the jump in southern Louisiana from 17 cents to 21.3 cents in a six months' period[24] with a new proposed level being over 23 cents.[25] Reasonably, one would assume some substantial basis for this dizzy upward spiral, but one would be wrong. The truth appears from the following testimony:

> GENEAU [FPC Staff Counsel]: Is it your understanding that the highest price being paid for gas by any other pipeline company in the area is determinative of what price is asked?
>
> BARNETT [Vice President in Charge of Gas Supply of United Gas Pipe Line Company]: As far as I am concerned, yes, because that is what we have to meet if we want to buy the gas.[26]

This, of course, disposes of any justification of the spiral based upon alleged arm's length bargaining or the supposed restraining effect of competition.

So what did the nurse or the baby do about the matter? The baby was happy and did nothing, and the nurse only made vague noises to excuse its failure to use its power to grant certificates with price conditions under *Signal Oil and Gas Co. v. Federal Power Comm'n.*[27] However, in the past year, the law

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[22] 15 U.S.C. § 717f(c) and (e) (1938).
[23] DIRECT SALES BY PRODUCERS OF NATURAL GAS TO REPORTING INTERSTATE NATURAL GAS PIPELINE COMPANIES—1957 (undated pamphlet issued by Federal Power Commission).
[24] Superior Oil Co., 19 F.P.C. 637, 639 (1958).
[25] Transcontinental Gas Pipe Line Corp., 20 F.P.C. 262 (1958).
[26] Quoted in Superior Oil Co., 19 F.P.C. 637, 639 (1958).
[27] 238 F.2d 771 (1956), *cert. denied,* 353 U.S. 923 (1957).

has twice admonished the nurse to disciplinary duty, and the story of how this came about may appropriately bring this article to a close.

The first case involved proposed sales by CATCO[28] from offshore Louisiana fields to the Tennessee Gas Transmission Company at an initial price of 21.4 cents per Mcf (net of gathering and severance taxes), which was 25 per cent higher than the highest price paid by Tennessee for gas anywhere in the Southwest, 70 per cent higher than Tennessee's weighted average cost of gas, and more than 100 per cent greater than the price paid by Tennessee elsewhere in Southern Louisiana. Although the burden of proof of reasonableness and public interest is placed by section 7 of the Act upon applicants for certificates, CATCO made no attempt to justify or support the proposed price, except to say that it was reached by arm's length bargaining. *Translated,* this meant that the high price wave which would sweep in from the Gulf of Mexico to inundate Southern Louisiana had crested at the level of the Tennessee bid which topped all competitors. The Commission found, "The record contains insufficient evidence or testimony, however, on which to base a finding that the public convenience and necessity require the sale of these volumes of gas at the particular rate level here proposed," and remanded the proceedings to the hearing examiner to determine the rate required by the public convenience and necessity.

CATCO, supported by Tennessee, moved for modification of the order on the ground that it could not present evidence on the stated issue within any reasonable period and could not afford to commence construction until at least the initial rate question was resolved.

The Commission then issued a second order reiterating its finding that the record did not support the price but granting permanent certificates conditioned on CATCO's acceptance of an initial price of 17 cents (the highest price theretofore paid by Tennessee). It committeed itself to permit increase of the 17 cent price to 21.4 cents one day after the commencement of gas deliveries, the increased amount to be collected under bond subject to proof of its reasonableness in subsequent section 4 proceedings. One would think, as Commissioner Connole later said, that the Commission had, "made unprecedented efforts to ensure fair treatment," and had, "clearly evidenced our intention to cooperate in arriving at an initial price level that would be just and reasonable to all parties affected." But the efforts went unappreciated; on June 3, 1957, Tennessee—this time without CATCO—asked rehearing in a unique petition saying, "it is our purpose here to inform the Commission

[28] Continental Oil Company, The Atlantic Refining Company, Tidewater Oil Company, and Cities Service Production Company.

of recent developments." The recent developments were as follows: Tennessee has been definitely advised by the producer-applicants that they will not amend section 10 of the contract so as to change the initial rate from 21.4 cents per Mcf to 17 cents per Mcf. Tennessee has been further informed by the producer-applicants that the certificates issued by said order will not be accepted by them for that reason; and that, accordingly, the contracts will be terminated.

The Commission, without any further hearing, capitulated on June 24, 1957, and granted unconditioned certificates. As Commissioner Connole pointed out in dissent, "Nothing but threats by the producers supports the proposition that this gas would be barred forever from the interstate market. . . . In my opinion, the consequences of abandoning our position will be more serious than their effect on this particular sale." [29]

The New York Public Service Commission, Long Island Lighting Company, and Public Service Electric and Gas Company (a New Jersey distributor) had actively participated in the matter before the Commission and now petitioned the Third Circuit for review. The Third Circuit reversed, and CATCO and Tennessee sought certiorari from the Supreme Court. Granting certiorari, the Supreme Court remanded the case to the Commission holding strongly, in an opinion written by Mr. Justice Clark (a native Texan), that:

> The inordinate delay presently existing in the processing of Section 5 proceedings requires a most careful scrutiny and responsible reaction to initial price proposals of producers under Section 7. . . . Where the application on its fact or on presentation of evidence signals the existence of a situation that probably would not be in the public interest, a permanent certificate should not be issued.[30]

The second case involved proposed sales by 26 Louisiana producers to Transcontinental Gas Pipe Line Corporation at prices ranging from 22.4 cents per Mcf to 23.3 cents per Mcf.[31] The New York Commission, joined actively by Philadelphia Electric Company and the Philadelphia Gas Works Division of The United Gas Improvement Company, urged that the Commission prescribe appropriate price conditions. However, the Commission, again over

[29] Actually, the only intrastate markets having significantly large growth potentials are the industrial and manufacturing markets, and these are sensitively responsive to price increases. It is therefore of importance to note that even producer initiated studies indicate intrastate gas prices to be below those being paid in the interstate market. See JOHN W. BOATWRIGHT, REASONABLE MARKET PRICES, American Bar Association Section of Mineral and Natural Resources Law, Proceedings, 1957, p. 17.

[30] 360 U.S. 378 (1959).

[31] Opinion No. 315, p. 3.

Commissioner Connole's eloquent and spirited protest,[32] issued unconditioned certificates. The New York Commission and the Philadelphia companies appealed, but the Third Circuit affirmed the Commission,[33] even in the face of the Supreme Court CATCO decision. The Philadelphia companies and the New York Commission petitioned the Supreme Court for certiorari, and supporting briefs were filed by many state commissions, municipalities, et al. On December 14, 1959, the Supreme Court granted certiorari and by the same order, reversed the Third Circuit and directed remand to the Commission for reconsideration and redetermination.[34] This very unusual summary disposition indicated emphatically that the Court considered the Commission lax in performance of its regulatory task. Therefore, we may expect the Commission henceforward to pay more heed to the dictates of public interest and regulatory principle and less to the cries of the producers. We may now look to have rule by law rather than control of the regulators by the regulated. The baby, perchance, will cease to beat the nurse!

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[32] Although many briefs and several court and commission opinions have been written on the subject of initial rate conditions, Commissioner Connole's dissent in this case provides by far the most lucid and cogent treatment of the topic. It is a matter of wonder that he found heart to hold to his convictions in the face of repeated Commission majority rejection of his views while that majority was evincing "its manifest, protracted unwillingness to come to grips with the job of regulation," to borrow a phrase from "The Unnatural Problems of Natural Gas." (*Fortune Magazine*, September 1959, p. 122.)

[33] 269 F.2d 865 (3d Cir. 1959).

[34] Public Service Comm'n of the State of New York v. Federal Power Comm'n, 80 Sup. Ct. 292 (1959); United Gas Improvement Co. v. Federal Power Comm'n., 80 Sup. Ct. 292 (1959).