The Natural-Gas Glut of 1983: A Case for Congressional Inaction

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Advance Discussion Paper for an
Amercian Enterprise Institute conference on
Natural Gas In A More Competitive Market

This paper is a condensed version of the author's remarks at a McGraw-Hill ***Inside FERC*** conference on "Natural Gas: Making the Transition to Competitive Markets" in New Orleans on April 12, 1983.
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ADJUSTING TO COMPETITIVE MARKETS FOR NATURAL GAS:
The Case for Congressional Inaction

By Arlon R. Tussing

Welcome to the death spiral!

Within the past year, the pendulum of gas-industry concern has swung from anxiety over supply deficiencies to near-hysteria over shrinking demand. This condition, too, will pass. Markets will become less volatile and more self-regulating as institutions adapt to the responsibilities which go with greater freedom.

Gas prices in every corner of the United States have already exceeded what industrial consumers will pay for the volumes pipelines and distributors are offering them. On many if not most systems, residential and commercial prices have also reached levels at which shrinking sales can offset additional price increases, given a couple of years for people to change their appliances and their consumption habits.

In total, the wellhead gas prices and gas import prices sanctioned by existing contracts and law, the interstate transportation markups deemed "just and reasonable" by the Federal Energy Regulatory Commission, and the distribution markups deemed just and reasonable by state utility commissions, now exceed the burner-tip value of gas. Gas-producers, pipelines, and distribution companies can **try** to impose higher prices on consumers, according to the terms of their "lawful" contracts, tariffs and rates. But try as the companies may, consumers will not give them any more **revenue.** The attempt of each sector of the industry to recover its rising costs and also to obtain its allowed return on investment thus threatens to plunge all of them into a "death spiral" --- the self-perpetuating collapse of demand.

Is bankruptcy unthinkable?

The natural-gas industry in the United States is now on the first turn of this spiral. In this situation, each sector of the gas business has a powerful incentive to get its costs in line with market realities, and even the formidable "institutional barriers" in this regulated, balkanized industry are unlikely to keep it from adjusting quickly to reality. The industry **will adjust** because it **must adjust,** and **it is adjusting** --- far more quickly than FERC or Congress will even be able to reach a consensus about what is going on. The incentive to adjust is the most powerful one that exists in a private-enterprise economy --- the threat of massive financial losses and bankruptcy. FERC Chairman Butler said recently that the bankruptcy of a major gas-transmission company would be an "unthinkable disaster". Pipeline bankruptcy is **not** unthinkable; what is almost unthinkable, rather, is that there will be no gas-industry counterpart to Penn Central, Penn Square, or Braniff.

It isn't obvious, indeed, that one or more strategic bankruptcies would be disastrous to the industry or the nation. I can think of two, and maybe as many as four, gas-transmission companies whose customers and employees, suppliers and bondholders would be better off if they filed under Chapter 11 today than if they waited until there was no hope of recovery. For there is strength in admitted weakness. The example of a single bankruptcy would contribute far more than anything Congress could invent to speed up the contractual adjustments needed

to bring order into chaotic gas markets. "Gentlemen," a troubled gas distributor or pipeline might say to its suppliers, "we can't take, and we won't pay, and you won't even get a chance to sue us. For, if you and your colleagues don't help us work out our problem today, you can work it out with the bankruptcy judge next week."

No shortage of incentives.

FERC and Congress now seem determined to punish pipelines for their **past** purchasing practices --- practices intended by Congress in the Natural Gas Policy Act of 1978, recommended by the industry's consultants and commentators, approved by FERC and (in the case of imports) the Economic Regulatory Administration, and (with a few exceptions) endorsed or ignored by the state regulatory commissions. Gas pipelines are evidently now supplanting the hated oil majors in the role of U.S. economic scapegoat Number One.

There is no rule, however, which FERC or Congress can think up that will add anything to the incentive that consumer resistance has already given pipelines to keep their gas-purchase costs down and their load-factors up. Future cost-recovery and future profits are now totally hostage to the companies' present and future gas-purchase behavior. It is the market, not FERC, which will limit the net income of gas-pipeline companies and, in many cases, that income is bound to fall below a "just and reasonable" level because direct industrial customers will not, and distribution companies can not, pay the maximum prices that laws and regulators would permit.

In this situation, there is no need for FERC or Congress to put a new "cap" on pipeline cost-passthroughs, or to use high imputed load-factors in ratemaking, in order to spur pipelines into limiting their new-gas purchase costs or taking whatever action is available to reduce their flowing-gas prices. Nor is there much point in broadening the statutory definition of "abuse" in gas-purchasing decisions: The sins of Columbia Gas Transmission Company, for example, may be legion. But Columbia will suffer a far harsher chastisement for these sins at the hands of its customers and the securities market than any penalty FERC would dare to impose.

The Alternative to a Legislated Solution

There is no legislative solution, simple or complex, to the difficulties facing the natural-gas industry today. But there is an enormously complex solution involving an elegantly simple policy that I would like to recommend. The beauties of this solution are that it is almost infinitely flexible, it can handle whatever unforseen developments may crop up, and no single person needs to understand it completely. The solution is called the market and the policy it requires to work is for legislators to be patient, for gas-industry leaders to act like normal businessmen, and for FERC to be a bit creative in encouraging those Congressional and industry postures.

In essence I am suggesting that the gas industry be allowed to work out its problems on its own. And why not? By the time any Bill to

deal with the actual flyup reaches a Conference Committee, its proponents will likely be fighting a battle that has nearly ended. Recall the months of hearings Representative Sharp's subcommittee held in 1982 on the gas-price "fly-up" that was supposed to occur in 1985 --- but which was going on almost unnoticed right as the parties were debating.

Industry is adjusting to competition.

The gas industry is now adjusting with remarkable speed to its changed circumstances without the benefit of (or perhaps despite) oversight by FERC or Congress. Different parties are experimenting with literally dozens of approaches to "market ordering" and, in my judgment, the progress has been remarkable. First and most important, gas pipelines have stopped buying additional gas at above-market prices and are, in fact, buying little new gas at any price. Second, pipelines are exercising market-out, renegotiation, and arbitration clauses wherever they exist, and the most desperate of them are acting as if these terms existed even where they are absent.

Not only are buyers claiming force majeure on deficiency payments under take-or-pay terms, but many of those actions are not even being contested. Other pipelines have offered to pay suppliers only interest on the deficiency payment, with the matter left for another day. Some abrogations of take-or-pay commitments, moreover, won't show up for another six months, since the draw is calculated over an entire year.

There have been many recent examples of industrial statesmanship and entrepreneurial ingenuity in adapting to changed circumstances: Northern Natural has sponsored meetings between its gas producers and gas distributors so all of them understand what the others, as well as the pipeline middleman, are up against. Northwest Central and Valero have offered to reduce their own transportation markups as their suppliers reduce field prices. And Transco's proposal to create a two-tier market (contract and spot) points the way to the future configuration of the gas industry.

State and federal regulators and Congressional staff have belittled the progress toward contract renegotiation on the ground that the accomplishments thus far have mainly concerned take-or-pay and minimum-bill provisions rather than prices. But what, may I ask, did they expect? There is no consensus in any sector of the industry, or within government, about the degree to which the present gas "glut" stems from overpricing and how much it is a product of the general economic slump. More importantly, the major pipeline companies, INGAA, AGA, and the Department of Energy all assert that we still do not have a surplus of gas **reserves** in the United States at all, but only a surplus of **delivery obligations** under contract terms written in a price-regulated, supply-constrained market.

The majority wisdom thus implies that there will be a new supply crunch within a few years, and that wellhead prices for new gas will firm as existing old-gas reserves are depleted. I am not a party to this

consensus, but so long as it prevails, producers would be foolish to abandon their existing contractual price terms, especially with shareholders and royalty-owners (including federal and state governments) poised to sue them if they give up what is legally theirs. Forgiving, relaxing, or stretching out the take or minimum-bill obligations for high-priced gas thus seems **the most appropriate response** to a deliverability surplus that is perceived as temporary. Virtually every class of gas producers in every section of the country has been willing to negotiate in earnest over this kind of accomodation.

State Actions

Utility commissions in several gas-importing states, acting in behalf of distressed distributors or in response to popular pressure, are taking every plausibly legitimate measure to ensure that signals of consumer resistance are being transferred effectively upstream. Other state commissions, more cautious about their legal authority to influence city-gate prices, have begun acting as informal mediators among producers, pipelines, and distribution companies. Producing-state oil and gas conservation boards are trying to ensure more equitable apportionment of sales revenues between have- and have-not producers through market-demand prorationing and implementation of common-purchaser statutes. The state agencies are thus not only treating the local symptoms of the national market disorder, but are also establishing legal grounds for one or another of the private parties to force renegotiation of take and/or price terms in virtually every wellhead or city-gate contract that is truly unreasonable in today's environment.

Do no harm!

The first canon of the medical profession is "Do no harm." I would urge the same principle on Congress in its 1983 deliberations over natural-gas legislation. Overall, instead of trying to regulate this and prohibit that, FERC and Congress should take a hard look at the incentives that now prevail in natural-gas markets. Do these incentives on their own encourage the industry to change in the right direction? If they do, let well enough alone. If they do not, is there some way to change the incentives without cementing new barriers to the next needed market adjustment?

Amend the NGPA? So what if the Natural Gas Policy Act of 1978 freed certain categories of gas from price controls, and the prices for that gas soared to $8 or $10 per million btu during 1979-82? So what if even the ceiling prices for some regulated categories of gas are now too high by market standards. **Who**, after all, is still buying at those prices? Almost without exception, pipelines entering into new purchases are now too smart to be fooled. Let the NGPA price schedules stand; they can do no more harm one way or another.

Now that the market price of new gas is below its NGPA ceiling, it is hard to see how immediate new-gas deregulation could harm anyone. But it is also hard to see what point there is in taking up this issue at all in 1983, thereby aggravating consumer fears and reheating the near-religious passions that exist about wellhead price deregulation

generally, since price controls on new gas are scheduled to expire in less than two years anyway. The misnamed "incremental-pricing" provisions of NGPA have likewise served whatever useful purpose they may have had, and are now a gratuitous burden on the flexibility pipelines, distributors, and state commissions need to cope with the different problems of different classes of consumers. With average gas-acquisition costs exceeding boiler-fuel prices on most systems, however, it is not clear exactly what would be accomplished by stirring this political pot in 1983.

Decontrol old gas? Old-gas deregulation is the keystone of the Administration's legislative program, but immediate decontrol will not bring us any closer to workably competitive natural-gas markets except in some formalistic, ideological sense. With end-user gas prices already above market-clearing levels, the industry as a whole is incapable of extracting more revenues from consumers, and whatever additional income deregulation generated for old-gas producers would have to come instead out of the incomes of other classes of gas-producers, the pipeline companies, or the distributors. Old-gas deregulation would **not**, therefore, ease the present market disorder but only complicate and prolong it.

Those who advocate deregulating old-gas prices on the ground that doing so will get rid of the "cushion" that distorted market forces in the first place (giving rise to $8 or $10 deep-gas sales) are either foolish or disingenuous. There is no cushion left to kill. There is no room left for deep-gas producers, Canadians, or anyone else to walk away with windfalls. A handful of old supplemental-gas and high-cost import projects and proposals still limp along: the Alaska gas pipeline, Trunkline's LNG imports, and the Trans-Niagara and Boundary Gas import ventures, for example. But no one is likely to propose completing any old enterprises of this kind or breaking ground for any new ones, and certainly no one will lend money to them, **if their viability depends on a subsidy from underpriced old gas.**

The proper time to consider removing price controls on old gas (and for cleaning up a lot of other regulatory debris) will come **after** the transmission and distribution sectors have weathered the present crisis, and after new-gas deregulation has proved to the American people that market pricing does not necessarily mean higher prices: in 1985, perhaps, or 1986.

Abrogate all contracts? There will **never** be a proper time, however, for the universal "market-out" or abrogation of gas-supply contracts proposed by the Administration. Pipelines and producers need not rewrite every contract in order to right the balance between supply and demand. Yet that is what the Administration bill demands. Like the Fuels Use Act, this provision would likely turn out to be an obvious blunder as soon as the ink had time to dry. New-gas price flexibility plus renegotiation of the highest-price post-NGPA contracts ought to be sufficient, in any event, to make gas-markets effectively self-regulating well before 1986.

The most wretched rationalization that Secretary Hodel, Chairman Butler, and Congressional Republicans have offered for their arbitrary multi-billion dollar wealth-redistribution scheme is the one that rests on its alleged **fairness**. In my view, a universal "market-out" option would be monstrously inequitable. Every existing natural-gas sales contract was signed **voluntarily** under the regulatory and pricing expectations that prevailed at the particular time. Initial investment costs for old gas were, likewise, incurred voluntarily in the light of those expectations. Development costs were necessarly low by today's standards, because otherwise the producers would not have made the outlay, and those costs were written off long ago. Most old-gas properties have thus become "cash cows" --- nearly effortless sources of property income to operators and royalty-owners. No consideration of equity demands that the federal government abrogate tens of thousands of long-standing contracts to enhance the present value of such properties.

Higher old-gas prices would indeed make it possible to squeeze more gas out of many old fields by means of multiple completions, fracturing, and other new investments. But old-gas deregulation **without** abrogation of contracts would be sufficient to do the job, because it would free purchasers (as they are not free under current law) to offer producers the market value for **incremental** reserves or deliverability without any need to give them any more for their already-committed gas than contracts now require.

The deep-gas and tight-gas contracts of the NGPA era were also voluntary agreements on both sides. The high prices under these contracts frequently correspond to truly high development costs, which is just what Congress intended under Section 107 of NGPA. The contractual right to those prices often serves as loan collateral, and innocent third parties have bought working or royalty interests in Section-107 properties at prices reflecting the expectation that legally binding long-term contracts would indeed be legally binding. Granted, some exempt-gas contract provisions are now clearly unreasonable, but if they remain **too** unreasonable for **too** long, they are not likely to survive in any case. The rationalizations Administration spokesmen offer for confiscating the property rights incorporated in Section 107 contracts, in order to finance a windfall for old-gas producers and royalty owners, could just as well support a mandatory renegotiation of interest rates on all existing home-mortgages or municipal bonds.

Require common- or contract-carrier pipeline operation? Forcing pipelines to function as contract carriers or common carriers is an appealing program in today's market, where producers have unsaleable gas which they would be delighted to sell to distributors and industrial consumers for prices lower than the pipelines are offering to supply those same parties under their established rate schedules. The ability of producers to deal directly with gas distributors and large consumers can help to restrain consumer prices, maintain exploration and development incentives, and provide added flexibility in each future turn of the market. There will surely be a continuing role on the fringe of the gas

market, therefore, for a variety of "self-help" arrangements under which pipelines carry gas owned by others.

Over the long-run, there are few gas buyers who prefer to take gas under the delivery schedules that producers would regard as technically or financially optimum, or who want to accept the risk of depending for a large part of their supply on individual producing properties or producers. The majority of producers, likewise, will not elect to supply gas on schedules dictated by the cyclical or seasonal needs of individual industrial customers or gas-distribution companies. For most transactions, therefore, it will not be cost-effective for producers, industrial consumers, or distribution companies to purchase pipeline transportation services separately rather than continuing to use transmission companies as brokers, wholesalers, and custodians of natural-gas inventories. The innovations of Transco and others, to create a spot market parallel with its conventional long-term firm-gas business is probably a much closer approximation of the industry's future than is the currently fashionable notion that the main business of gas pipelines should be to carry gas owned by others.

Some pipelines have, of course, been less than eager to carry gas for their customers in competition with themselves, especially while they are unable to resell all the gas they are contractually obliged to buy. It is precisely the present kind of market, however, in which a pipeline's choice can boil down to moving gas on contract or not to move it at all --- which will, in almost every case, be the less attractive option. For most gas sold in the United States is produced in an area served by two or more pipelines, and most gas is consumed in regions served by two or more pipelines. If pipeline A doesn't want to carry gas on contract, therefore, pipeline B or a combination of C, D, and E will be delighted to move it, by displacement and exchange if not directly, if only to use their own plant more efficiently.

In my judgment, the main impediment to interstate gas pipelines serving as transportation companies is not the diffidence of the companies but some long-standing policies and attitudes of FERC. The present inferior status of the pipeline companies' transportation function reflects years of opposition to contract-carrier proposals on the part of the Commission and state utilities commissions, who have typically regarded them as subterfuges by which "low-priority" industrial consumers could bypass wellhead price controls, outbid distribution companies serving high-priority consumers for new gas supplies, and evade pipeline curtailment schedules.

These concerns are not germane in today's gas markets, and they will not be warranted at any time in the foreseeable future, yet FERC's anachronistic policies and attitudes on this issue (as on may others) live on, particularly in the middle levels of the Commission staff. Before Congress requires pipelines to function as common carriers or contract carriers, therefore, shouldn't FERC reexamine those of its own policies which actively or tacitly **discourage** pipelines from shipping gas owned by others? Before granting a statutory five-cent per thousand cubic foot bonus to pipelines that carry gas for other pipelines, why not first

simply raise the transportation of gas to a ratemaking par with the pipelines' existing private-carrier business?

Repeal the Fuels Use Act. The only major element in the Administration bill that is clearly warranted and clearly harmless is an end to the Fuels Use Act. So far as I can tell, this odious law has no remaining defenders (other than coal interests) except as a trading-point on other legislative issues.

Misinterpreting marginal phenomena.

Perhaps the most useful perspective to have in designing legislative, regulatory, or business responses to the present market disorder is to recognize that contractual or regulatory barriers to the movement of any good to those consumers who value it most will focus even a small excess of supply or demand on the fringes of the market and thereby magnify its impact substantially. The gasoline lines of 1974 and 1979, for example, were not caused by an overall shortage of product but by federal petroleum-allocation arrangements that concentrated whatever shortage occurred anywhere in the system on the general motorist (who lacked a favored position in the regulatory scheme) in a few areas of rapid population growth. Farmers, fleet owners, other preferred consumers and, indeed, most of the country were sitting on excess supplies which the rules would not allow to move to the areas of shortage.

During the natural-gas curtailment crises of the mid-1970s, likewise, there was only a slight overhang of firm demand over supply, and only in a few regions of the country. Absent regulatory barriers to the free flow of gas from those who had it to those who valued it more, and particularly from boilers in gas-exporting states to distributors in the gas-importing states, no symptoms of shortage would have appeared. The overreaction of Congress to the seemingly acute gas shortage of 1976-77, and the overreaction of gas-pipeline purchasing policies to a decade of chronic curtailments, have together propelled us into today's price fly-up a the seeming crisis of oversupply --- to which Congress is once more being urged to react excessively and largely in the wrong direction, setting the stage for still another natural-gas market crisis, perhaps in the late 1980s.

The need for inaction.

One of our biggest problems, I fear, is that most regulators and national officials, regardless of their offical economic philosophies, really don't like or trust competitive markets, or the decentralized decision-making that characterizes American federalism. Given the choice, they prefer a visible hand, however palsied, to an invisible one, and once in office many of them fall in love with the idea of playing God.

Perhaps the biggest challenge to FERC and Congress today is to recognize the opportunity afforded by mandating nothing or almost nothing. Instead of filing an *amicus* brief on behalf of Transco against Mississippi's invocation of its common-purchaser law, FERC should try

to distance itself from producer-buyer interactions in that state. A majority of the Commissioners profess to believe in wellhead-price deregulation and thus in letting the pipeline companies control their own gas-acquisition costs. Why, therefore, should they forbid the companies to sell off surplus commitments at a price that is lower, or higher, than their average gas-purchase costs? The two transactions are opposite sides of the same coin; off-system sales simply give pipelines the opportunity to undo any errors they might have made in their wellhead purchases. Why shouldn't the Commission automatically approve all off-system sales, whether they are intended to relieve a shortage on one pipeline system or a glut on another.

The Administration bill would further undermine the potential benefits of off-system sales and further impede the development of a competitive nationwide gas-transmission and distribution system, making a special point of ensuring that one pipeline with lower system costs cannot permanently capture customers from another pipeline. FERC members are concerned, in the Orwellian language of Chairman Butler, about the "anti-competitive" implications of "predatory pricing" when utilities seek to buy from one pipeline rather than another, in order to get a lower price. Are we still so hobbled by the the mercantilist philosophy of franchising monopolies (in which a market is treated as the monopolist's exclusive property right) that we can't see the goodness in allowing consumers and producers to benefit from the competition that is evolving naturally in the gas industry?

Conclusion

I have urged caution in legislating a solution to the current gas-market disorder, not out of a belief in laissez faire but from an even more conservative bias: skepticism about the ability of intelligent people, or government institutions led and staffed by intelligent people, to foresee or control gas-market developments, and particularly to foresee the consequences of frequent radical changes in the legal and regulatory environment. The Fuels Use Act was a stupid idea from the beginning, NGPA has done its constructive work and only its mischief remains, while the Natural Gas Act and the Public Utilities Holding Company Acts are largely useless anachronisms. But a repeated tinkering with the rules, an attempt to chase gas prices and supply conditions back and forth across the business cycle, and the attempt to fix transitory problems with grand structural reforms are likely to catapult the industry from one crisis to another. They can not hold consumer prices down, they can not guarantee supply additions to cope with a booming economy or a cold winter, and they will not even ward off pipeline and distribution-company bankruptcies.

In my judgment, Congress should resist the clamor of various factions and of Administration and FERC officials who should know better, to deal with the present disorder in ways that will make the system even less flexible than it is today. We must beware of the tendency to demand sweeping structural changes to deal with symptoms of market imbalance that are both marginal and ephemeral. We should not overlook the marvelous capacity for adjustment to changing condi-

tions that is inherent in the profit-seeking and loss-minimizing activity of thousands of producers, dozens of pipeline companies, and hundreds of gas-distribution companies, or belittle the remarkable adaptations this allegedly timid and hogtied industry has already made.

Finally, we "experts" should not quickly forget our demonstrated fallibilities as gas-market forecasters and policy planners. Errors of foresight or policy judgment can cause local or short-lived distress when they occur randomly within the gas production, transmission, or distribution sector, among the state regulatory commissions, or among consumers. Imposed by the federal government as national policy, however, bad forecasts and decisions readily metastasize into costly and painful nationwide economic disruptions.

If anything, the recent history of the gas industry and its regulatory institutions shows that we should proceed from a posture of great humility in the demands we make for federal action. If Congress acts at all this year, experience suggests that it should act only in small and tentative ways.

What I recommend for the gas-market crisis of 1983 is that Congress do nothing or next to nothing, that the states do whatever they can and must do to protect their own producer and consumer interests, that regulated gas companies act as if they were real business corporations rather than wards of the government, and that the FERC do its best to encourage the parties to assume these respective roles.

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