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ASSESSMENT OF INCREMENTAL PRICING UNDER THE NATURAL GAS POLICY ACT

*William A. Mogel**
*and William R. Mapes, Jr.***

I. INTRODUCTION

[We] greatly resent the idea that [we] are the primitive predecessors of other creatures.¹

Title II of the Natural Gas Policy Act of 1978 (NGPA)² mandates that the Federal Energy Regulatory Commission (FERC)³ establish by rulemaking proceedings⁴ a new rate design methodology for the sales price of natural gas sold by interstate pipeline companies subject to its jurisdiction.⁵ That new rate design is called "incremental pricing" by the NGPA.⁶

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1. Will, *Footprints Age*, Wash. Post, Apr. 5, 1979, § A, at 19, col. 1.

2. 15 U.S.C. §§ 3341-48 (Supp. II 1978).

3. The FERC, a five-member independent regulatory agency within the Department of Energy, succeeded to the functions of the Federal Power Commission (FPC). See Dep't of Energy Organization Act, 42 U.S.C. §§ 7101-7352 (Supp. I 1977); Exec. Order No. 12,009, 3 C.F.R. § 142 (1978). See generally Moody, *The FERC Inheritance — Unresolved Problems in Producer Regulation*, PROCEEDINGS OF THE 29TH ANN. INST. ON OIL AND GAS LAW AND TAX. 417 (1978); Williams, *Natural Gas and the Federal Energy Regulatory Commission*, 13 TULSA L.J. 761 (1978).

4. 15 U.S.C. § 3342 (Supp. II 1978). See generally Mogel, *The Federal Power Commission's Authority to Set Area Rates by Rulemaking*, 5 SETON HALL L. REV. 31, 43-61 (1973); Pierce, *The Choice Between Adjudicating and Rulemaking for Formulating and Implementing Energy Policy*, 31 HASTINGS L.J. 1, 47-66 (1979).

5. The FERC's jurisdiction is set forth in § 1(b) of the Natural Gas Act (NGA), 15 U.S.C. § 717(b) (1976), which provides:

The provisions of this chapter 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.

See *Panhandle E. Pipe Line Co. v. Public Serv. Comm'n*, 332 U.S. 507 (1947).

6. The incremental pricing provisions of the NGPA are set forth in Title II, 15 U.S.C. §§ 3341-3348 (Supp. II 1978).

The legislative objective of this form of incremental pricing is the subsidizing of a class of natural gas consumers determined to be "high priority,"⁷ from the price increases permitted by Title I of the NGPA,⁸ at the expense of another class of consumers composed primarily of boiler fuel users and industrial facilities.⁹ Thus, rather than adhering to established principles of public utility ratemaking, which have as their hallmark the axiom that rates must be cost-based,¹⁰ Title II of the NGPA sets the price to be paid by the subsidizing consumers at the ever increasing prices charged for another commodity, fuel oil. Consequently, the subsidized, high priority consumers pay for their natural gas service at rates reflecting less than true cost.

NGPA incremental pricing is bad politics, unsound economics, and an undesirable rate design. The ultimate effect of the statute and the FERC's rulemakings will be to increase the costs of natural gas service to the defined high priority market. Such a result is not only contrary to Congress' intended goal, but also conflicts with the three overriding national objectives of reducing both inflation¹¹ and our dependence on foreign oil,¹² and

7. Section 401(f)(2) of the NGPA defines high priority user as:

any person who —

(A) uses natural gas in a residence;

(B) uses natural gas in a commercial establishment in amounts of less than 50 Mcf on a peak day;

(C) uses natural gas in any school, hospital, or similar institution; or

(D) uses natural gas in any other use the curtailment of which the Secretary of Energy determines would endanger life, health or maintenance of physical property.

15 U.S.C. § 3391(f)(2) (Supp. II 1978).

8. *Id.* §§ 3301-3333 (Supp. II 1978). See generally Comment, *For Gas, Congress Spells Relief N-G-P-A: An Analysis of the Natural Gas Policy Act of 1978*, 40 U. PITT. L. REV. 429 (1979).

9. Under Title II of the NGPA the term "industrial boiler fuel facility" means any industrial facility using natural gas as a boiler fuel. 15 U.S.C. § 3341(c)(1) (Supp. II 1978). The FERC's regulations further define industrial facility as "any facility engaged primarily in the extraction or processing of raw materials, or in the processing or changing of raw or unfinished materials into another form or product." Order No. 49, Regulations Implementing the Incremental Pricing Provisions of the Natural Gas Policy Act of 1978, Doc. No. RM79-14 (Sept. 28, 1978) (to be codified in 18 C.F.R. § 282.103(d)).

The term "boiler fuel use" under Title II of the NGPA means "the use of any fuel for the generation of steam or electricity." 15 U.S.C. § 3341(c)(2) (Supp. II 1978).

10. See notes 19-42 and accompanying text *infra*.

11. President Carter's Address to the Nation, April 18, 1977, reprinted in SENATE COMM. ON ENERGY AND NATURAL RESOURCES, 95TH CONG., 1ST SESS., THE PRESIDENT'S ENERGY PROGRAM: A COMPILATION OF DOCUMENTS 1-5 (Comm. Print 1977).

12. *Id.*

conserving our nonrenewable energy resources.¹³ These undesirable consequences can be anticipated because the so-called incremental prices to be paid for natural gas service by the subsidizing industrial and large boiler fuel users will dramatically increase with ever escalating prices of oil.¹⁴ These users, therefore, will seek alternate sources of energy and switch from natural gas. Once this occurs, the fixed and increasing purchased gas costs of the interstate pipeline companies will be borne by the remaining consumers, the high priority consumers.

In order to avoid these adverse results, Title II of the NGPA should be repealed¹⁵ and the setting of natural gas rates should continue to be cost-based. There are other legislative tools available to Congress to shelter high priority consumers from the price increases of Title I of the NGPA. Drastic disruptions to the interstate pipelines' consumers and to national productivity are high prices to pay for a maverick rate design methodology.

This article will discuss, in a background section, general principles of public utility ratemaking, incremental pricing before the enactment of the NGPA, and a brief overview of the NGPA. The following section describes Title II of the NGPA. The next section is a critique of Title II incremental pricing.

II. BACKGROUND

"[O]ur only interest in the past is for the light it throws upon the present."¹⁶

13. Professor Commoner has stated that "[n]early all the energy now used comes from nonrenewable sources. As a nonrenewable source is depleted, it becomes progressively more costly to exploit, so continued reliance on it means an unending and exponential rise in price." Commoner, *Reflections, The Solar Transition — II*, THE NEW YORKER, Apr. 30, 1979, at 46.

14. The price of OPEC oil has increased from \$1.80 per barrel on January 1, 1970 to \$12.09 per barrel on January 1, 1977 and to \$30.00 per barrel on January 1, 1980. Wash. Post, Dec. 19, 1979, § A, at 22, col. 4. One observer has commented:

As recently as 1972, oil imports cost us less than \$5 billion. Seven Years later — 1979 — our tab for imported oil is \$65 billion. We are transferring that much wealth *annually* to the oil-exporting nations. How much is \$65 billion? It is, for one thing, \$295 for every one of us, or \$1,180 for a family of four.

Tobias, *The Only Article on Inflation You Need to Read*, ESQUIRE, Nov. 1979, at 49, 50.

15. Legislation (H.R. 5862) has been introduced in the House of Representatives to repeal Title II. Rep. Richardson Preyer, the cosponsor of H.R. 5862, has commented: Obviously, these increased operating costs for industry will not simply disappear. They will be borne, in the form of higher product prices, by all consumers — not only those who are theoretically protected by incremental pricing. . . . It is contemplated that the passthrough of industrial gas price increases could be 50% or more with even larger increases ahead as industrial gas prices follow the steep upward curve of fuel oil prices.

INSIDE F.E.R.C. (Dec. 24, 1979), at 12.

16. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 474 (1897).

A. General Principles of Public Utility Ratemaking

In enacting the NGPA, Congress intended the statute's pricing provisions to bridge the traditional cost-based ratemaking methodologies and the eventual price deregulation of natural gas in 1985.¹⁷ The NGPA attempts to achieve this by generally replacing the cost-based ratemaking methods with a multi-tiered system of pricing natural gas.¹⁸ To evaluate the wisdom of this congressional ratemaking, it is necessary to review public utility ratemaking principles that had evolved prior to passage of the NGPA.

It has long been accepted that public utility rates must be based on the utility's costs.¹⁹ In *Southwestern Bell Telephone Co. v. Public Service Commission of Missouri*,²⁰ Mr. Justice Brandeis stated:

17. Section 121 of the NGPA, 15 U.S.C. § 3331 (Supp. II 1978), provides, subject to reimposition of price controls pursuant to § 122, 15 U.S.C. § 3332 (Supp. II 1978), that the maximum lawful prices for first sales of natural gas established in Title I will cease to apply effective January 1, 1985, for the following categories of gas:

(1) NEW NATURAL GAS. — New Natural gas (as defined in section 102(c)).

(2) NEW, ONSHORE, PRODUCTION WELLS, — Natural gas produced from any new, onshore production well (as defined in section 103(c)), if such natural gas —

p (A) was not committed or dedicated to interstate commerce on April 20, 1977; and

p (B) is produced from a completion location which is located at a depth of more than 5,000 feet.

(3) INTRASTATE CONTRACTS IN EXCESS OF \$1.00. — Natural gas sold under an existing contract, any successor to an existing contract, or any rollover contract, if —

p (A) such natural gas was not committed or dedicated to interstate commerce on November 8, 1978; and

p (B) the price paid for the last deliveries of such natural gas occurring on December 31, 1984, or, if no deliveries occurred on such date, the price would have been paid had deliveries occurred on such date, is higher than \$1.00 per million Btu's.

15 U.S.C. § 3331(a) (Supp. II 1978). See MacAvoy, *The Natural Gas Policy Act of 1978*, 19 NAT. RES. L.J. 811, 819-23 (1979).

18. 15 U.S.C. §§ 3311-3319 (Supp. II 1978). See generally Cormie, *Incremental Pricing Under the Natural Gas Policy Act of 1978*, 57 DEN. L.J. 1, 3-7 (1979); Nordhaus, *Producer Regulation and the Natural Gas Policy Act of 1978*, 19 NAT. RES. L.J. 829, 848-56 (1979).

19. For comprehensive treatments of public utility economics, see J. BONBRIGHT, *PRINCIPLES OF PUBLIC UTILITY RATES* (1961); P. GARFIELD & W. LOVEJOY, *PUBLIC UTILITY ECONOMICS* (1964); E. NICHOLS, *RULING PRINCIPLES OF UTILITY REGULATION* (1955); A. PRIEST, *PRINCIPLES OF PUBLIC UTILITY REGULATION* (1969). See also I. A. KAHN, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS* 20-57 (1970).

20. 262 U.S. 276 (1923).

The compensation which the Constitution guarantees an opportunity to earn is the reasonable cost of conducting the business. Cost includes, not only operating expenses, but also capital charges.

. . . [A] rate is constitutionally compensatory, if it allows to the utility the opportunity to earn the cost of the service as thus defined.²¹

The second fundamental principle of ratemaking involves the concept of "rate of return," which is that amount of money a utility is allowed to earn over and above its operating expenses, depreciation expenses, and taxes.²² This amount is expressed as a percentage of the rate base, that is, the legally determined net valuation of utility property.²³ In the landmark case of *Smyth v. Ames*,²⁴ which established this concept of rate base,²⁵ the Court held that in determining the rate of return the Constitution required that: "[W]hat the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience."²⁶ Unfortunately, *Smyth's* description of "fair return" was ambiguous. However, in 1923, the Supreme Court in *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*,²⁷ held as follows:

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties. . . . [T]he return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.²⁸

21. *Id.* at 291 (Brandeis, J., dissenting).

22. See, e.g., J. BONBRIGHT, *supra* note 19, at 149; P. GARFIELD & W. LOVEJOY, *supra* note 19, at 116; E. NICHOLS, *supra* note 19, at 1-2.

23. See, e.g., J. BONBRIGHT, *supra* note 19, at 159-237.

24. 169 U.S. 466 (1898). See Note, *Natural Gas Rate Regulation: The Conflict in the Application of the Just and Reasonable Standard*, 12 TULSA L.J. 293, 297 (1976).

25. In Commission proceedings the rate base has generally been defined as the original cost of the plant which is used or useful in the natural gas business, less accrued depreciation plus working capital. See A. LEESTON, S. CRICHTON & V. JACOBS, *THE DYNAMIC NATURAL GAS INDUSTRY* 286 (1963). See also F. WELCH, *PREPARING FOR THE PUBLIC UTILITY RATE CASE* 179-94 (1954).

26. 169 U.S. at 547.

27. 262 U.S. 679 (1923).

28. *Id.* at 692-93.

Subsequently, in *Federal Power Commission v. Hope Natural Gas Co.*,²⁹ the Supreme Court further elaborated on *Bluefield*. The Court emphasized that the determination of a "fair" rate of return was not dependent on the particular regulatory method used, so long as the "end result" was reasonable to the consumer and investor.³⁰ The Court reiterated, however, that a regulatory agency rate order must result in the utility receiving earnings comparable to those of other enterprises with similar risks.³¹ Additionally, the rate of return must be sufficient to ensure the utility's financial integrity and its ability to attract new capital.³²

The Supreme Court, in *Phillips Petroleum Co. v. Wisconsin*,³³ held that independent producers which sell natural gas for resale in interstate commerce are "natural gas companies" within the meaning of section 1 of the Natural Gas Act.³⁴ Consequently, the FERC's predecessor, the FPC, applied the public utility ratemaking principles discussed above in determining a fair rate of return for this natural gas production.³⁵ The FPC initially determined each individual producer's cost of service and derived a "fair" rate of return for the sale of natural gas by each producer.³⁶ However, in 1960 the FPC initiated proceedings³⁷ to establish maximum pro-

29. 320 U.S. 591 (1944). In *Hope*, the Court endorsed the FPC's decision to permit only "actual legitimate costs" to be used in establishing the rate of return. See Hale, *Utility Regulation in the Light of the Hope Natural Gas Case*, 44 COLUM. L. REV. 488 (1944). See also Bonbright, *Contributions of the Federal Power Commission to the Establishment of the Prudent Investor Doctrine of Rate-making*, 14 GEO. WASH. L. REV. 136, 145-48 (1945).

30. 320 U.S. at 602-03.

31. *Id.* at 603.

32. The Court in *Hope* stated as follows with respect to the reasonableness of rate of return:

[I]t is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. . . . By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

Id. at 603.

33. 347 U.S. 672 (1954). See Harrison & Formby, *Regional Distortions in Natural Gas Allocations: A Legal & Economic Analysis*, 57 N.C.L. REV. 57, 63-65 (1978).

34. 15 U.S.C. § 717a (1976). For a critical analysis of the Court's use of the Natural Gas Act's legislative history in *Phillips*, see Note, *Legislative History of the Natural Gas Act*, 44 GEO. L.J. 695 (1956).

35. See generally Breyer & MacAvoy, *The Natural Gas Shortage and the Regulation of Natural Gas Producers* 86 HARV. L. REV. 941 (1973).

36. The methodology employed was similar to that used to regulate transportation rates charged by interstate pipeline companies. See *Phillips Petroleum Co.*, 24 F.P.C. 537 (1960).

37. See *Area Rate Proceedings*, 24 F.P.C. 1121 (1960). See generally Mosburg, *The Permian Decision — A Study in Group Regulation*, 19 OKLA. L. REV. 133 (1966).

ducer rates for each of the major producing areas, thereby attempting to avoid setting cost of service prices for each field sale by a producer.³⁸ Under this methodology, average industry-wide costs were computed for a particular region, with a fair rate of return established pursuant to the principles enunciated in *Hope*. The Supreme Court upheld the Commission's area rate methodology in *Permian Basin Area Rate Cases*,³⁹ which has been described as probably "the Supreme Court's most important opinion in the public utility field since *Hope Natural Gas*."⁴⁰ In the *Permian* case, the Court stated that the *Hope* criteria, "suitably modified to reflect the special circumstances of area regulation, remain pertinent, but they scarcely exhaust the relevant considerations."⁴¹ Thus, the Court emphasized that "the 'end result' of the Commission's orders must be measured as much by the success with which they protect . . . [the public] interests as by the effectiveness with which they maintain . . . credit and . . . attract capital."⁴²

The foregoing body of law evidences an established judicial sanctioning of cost-based ratemaking methodologies. However, as this article will discuss in section II(C), the NGPA departs significantly from these principles respecting the pricing of most natural gas production by establishing, in Title I, separate pricing categories based upon geological rather than actual or average cost considerations. Moreover, under the incremental pricing provisions of Title II, the price of natural gas is not based upon its cost plus a reasonable rate of return, but instead is generally set by reference to the price of oil.

B. Incremental Pricing Prior to the NGPA

Prior to the NGPA, the FERC's predecessor, the FPC, had addressed the issue of incremental pricing in several cases. But as used by the FPC incremental pricing meant something different from the way the term is used in Title II of the NGPA. Simply stated, the FPC's version of incre-

38. The application of this regulatory formula to thousands of individual producers proved to be impracticable. It has been estimated that there were 4500 natural gas producers in business when the FPC initiated area rate proceedings in 1960. C. HAWKINS, *THE FIELD PRICE REGULATION OF NATURAL GAS* 37 (1969).

39. 390 U.S. 747 (1968).

40. 2 A. PRIEST, *supra* note 19, at 575 (footnote omitted).

41. 390 U.S. at 791.

42. *Id.* One commentator has suggested that the Court's acceptance of group or area ratemaking for natural gas producers departs from the criteria established in *Hope* and other prior cases, since area-rate pricing is "not necessarily adjusted to the reasonableness of the resulting return to specific individual firms." J. Spengler, *A Critique of Administrative Regulation of Public Utilities* in *THE PUBLIC UTILITY PROBLEM VIEWED HISTORICALLY* 176 (W. Samuels & H. Trebing eds. 1972).

mental pricing referred to a method of rate design whereby the acquisition costs of new natural gas supplies are not averaged or "rolled in" with the utility's other gas acquisition costs but are charged solely to the customer or class of customers benefiting from the newly acquired gas.⁴³ NGPA incremental pricing differs from that practiced by the FPC; the former is not based on the cost of the natural gas actually sold while the latter is based upon costs.

The FPC generally employed the practice of "rolling in" the price of new increments or additions of natural gas supply in its regulation of the natural gas industry.⁴⁴ This methodology enabled the FPC to avoid the onerous administrative task of assigning a different portion of the cost to each of a large number of customers. It results, all other factors being equal, "in all customers paying the same price of gas taken from the pipeline at the same point, and recognizes that all customers enjoy the benefits of having the whole gas gathering and pipeline system."⁴⁵

There have been situations, however, in which the FPC recognized that incremental pricing of natural gas supplies was appropriate. In *Montana Power Co.*,⁴⁶ additional gas supplies were obtained from Canada and pipelines were constructed to meet the requirements of one customer. Although the new facilities fed into the existing distribution system, and the new and old gas was commingled, the FPC charged all the costs on an incremental basis to Anaconda Copper Mining Company. The FPC justified this exception to the general rule favoring rolled-in pricing because of the unique situation; all the gas was imported with the explicit limitation that it meet the needs of one particular customer.⁴⁷

Subsequent to *Montana Power*, the FPC applied incremental pricing to certain sources of an interstate pipeline's general system supply. Application of this rate design to the pricing of relatively expensive supplemental natural gas supplies⁴⁸ had grown with the increasing gap between the historic cost of gas and the cost of attaching new supplies to replace the

43. See, e.g., *Battle Creek Gas Co. v. FPC*, 281 F.2d 42 (D.C. Cir. 1960).

44. See, e.g., *Neueces Indus. Gas Co.*, 45 F.P.C. 1224 (1971); *Kansas-Nebraska Nat. Gas Co., Inc.*, 25 F.P.C. 448 (1961); *El Paso Nat. Gas Co.*, 22 F.P.C. 260 (1959); *Trunkline Gas Co.*, 21 F.P.C. 704 (1959); *American La. Pipe Line Co.*, 13 F.P.C. 380 (1954); *Panhandle E. Pipe Line Co.*, 10 F.P.C. 185 (1951); *Trunkline Gas Supply Co.*, 8 F.P.C. 250 (1949).

45. *Battle Creek Gas Co. v. FPC*, 281 F.2d 42, 46 (D.C. Cir. 1960).

46. 11 F.P.C. 1 (1952).

47. *Id.* at 9.

48. Supplemental gas is usually defined as gas acquired from unconventional sources and/or through unconventional techniques; for example, Alaskan and imported natural gas, liquefied natural gas, synthetic natural gas.

dwindling flow from conventional sources.⁴⁹

In *Columbia LNG Corp.*,⁵⁰ which involved liquefied natural gas (LNG) imported from Algeria as the incremental gas supply, the FPC conditioned certificates issued under section 7 of the Natural Gas Act⁵¹ upon the requirement that the applicants sell the LNG on an incrementally priced basis. It rejected the application of rolled-in pricing, reasoning that this rate design methodology would be contrary to the public interest since it disguises the economic cost of a relatively expensive natural gas supply.⁵² The FPC required the pipeline to condition sales to its distributor customers upon the individual distributor's agreement to sell the LNG to its customers under incrementally priced rate schedules. In this manner, the FPC attempted to insure that the economic cost of the LNG would be "flowed through" to the ultimate consumer.⁵³

On rehearing,⁵⁴ the FPC eliminated, as administratively impractical, the condition requiring distributors purchasing LNG to sell such gas at the burner tip under separate incremental rate schedules but stated that the policy of applying incremental pricing "is predicated upon considerations of economic principles, efficient allocation of resources, distributor flexibility, and consumer protection."⁵⁵ In a concurring statement, Commissioners Walker and Moody articulated their rationale for requiring incremental pricing of relatively high cost natural gas supplies: "[I]t is not economically rational to sell a product over an extended period of time for less than its full cost."⁵⁶ The concurring statement set forth the following policy reasons for applying incremental pricing to the certification of an energy project: (1) gas to be sold on an incrementally priced basis would provide a better test of the potential market for the new supply; (2) rolled-in pricing of the high cost gas would result in inequitable subsidization by high priority customers who would have to bear part of the cost of maintaining a supply for low priority users; and (3) incremental pricing affords distributors the freedom to choose whether it is in their best interest to

49. See generally OFFICE OF ECONOMICS, FEDERAL POWER COMMISSION, INCREMENTAL PRICING OF SUPPLEMENTAL GAS (Aug. 1976).

50. 47 F.P.C. 1624 (1972). See generally Pierce, *Natural Gas Rate Design: A Neglected Issue*, 31 VAND. L. REV. 1089, 1110-14 (1978).

51. 15 U.S.C. § 717f (1976).

52. 47 F.P.C. at 1639.

53. *Id.* at 1641. Section 1(b) of the NGA, 15 U.S.C. § 717a(b) (1976), precludes the Commission from asserting jurisdiction over sales made by distribution companies. Nevertheless, the effect of the Commission's opinion was to indirectly require incremental pricing to the burner tip.

54. *Columbia LNG Corp.*, 48 F.P.C. 723 (1972).

55. *Id.* at 730.

56. *Id.* at 736 (Comm'rs Walker & Moody, concurring).

contract for fully costed gas supply, or to seek alternative sources of supply which may be more economical.⁵⁷

On judicial review, the United States Court of Appeals for the Fifth Circuit in *Columbia LNG Corp. v. Federal Power Commission*,⁵⁸ although not disapproving of the FPC's application of incremental pricing, remanded the case to the Commission for a full evidentiary hearing.⁵⁹ On remand,⁶⁰ while not rejecting the concept of incremental pricing, the FPC reversed its position and authorized rolled-in pricing for the imported LNG.⁶¹ The FPC reasoned that "[t]he features of incremental pricing that were persuasive to the prior Commission are not predominant today,"⁶² particularly in light of the deteriorating supply situation⁶³ and the fact that the price of the proposed LNG imports was now competitive with that of domestic natural gas supplies.⁶⁴ The FPC stated, however, that although supplemental supplies such as LNG had become increasingly important in maintaining an adequate base load supply for high priority customers, its determination to employ rolled-in pricing in *Columbia LNG Corp.* was "not intended to signal a precedent to be applied in other supplemental supply projects which may come before us in the future."⁶⁵

Only a few months after its decision on remand in *Columbia LNG*, the

57. *Id.* at 736-37.

58. 491 F.2d 651 (5th Cir. 1974).

59. The court was concerned that the Commission had inadequately explored the inherent problems and ramifications of the new rate design. The court noted that "[n]o testimony was taken as to the administrative problems which might arise, what the cost of the implementation might be, or how the public interest could be best served." *Id.* at 654.

60. *Columbia LNG Corp.*, 18 PUB. U. REP. 4th, 359 (1977).

61. *See Pierce*, *supra* note 50, at 1114-15.

62. 18 PUB. U. REP. 4th at 369.

63. The shortage of natural gas has been judicially recognized. *See, e.g.*, *FPC v. Louisiana Power & Light Co.*, 406 U.S. 621, 626 (1972); *Public Serv. Comm'n v. FPC*, 467 F.2d 361, 362-63 & n.1 (D.C. Cir. 1972); *Monsanto Co. v. FPC*, 463 F.2d 799, 801 (D.C. Cir. 1972). *See also Breyer & MacAvoy*, *supra* note 35; *Mogel*, *supra* note 4.

64. The Commission declared:

A critical distinction in the current situation is the higher costs of domestic supply. The new national rate established in Opinion Nos. 770 and 770-A allows the producers to collect \$1.42 per Mcf for all new gas delivered to the interstate market. This supplemental LNG supply which will provide a substantial portion of these pipelines' supply cannot be viewed as an "expensive exotic supply." Its price is competitive with the new national rate. Estimates for the cost of deliveries of new gas from conventional sources are comparable to the cost of this LNG supply. Once in the pipeline, the characteristics of the supplemental supply are indistinguishable from those from conventional sources.

18 PUB. U. REP. 4th at 369 (footnote omitted). The price of the regasified LNG upon entering each of the three purchasing pipelines' system was \$1.66, \$1.71, and \$1.81 per MMBtu. *Id.* at 366-67.

65. 18 PUB. U. REP. 4th at 370.

FPC ruled in *Trunkline LNG Co.*,⁶⁶ that incremental rather than rolled-in pricing was the appropriate rate design method for that particular LNG import project. The Commission distinguished *Trunkline* from *Columbia LNG*, reasoning that the element of roughly competitive prices between new domestic production and the LNG imports present in *Columbia LNG* was lacking, since the proposed imports were more than twice as costly as new domestic production.⁶⁷ In addition to this significant price differential, the FPC based its determination to require incremental pricing on the following:

If the cost of LNG is rolled-in with cheaper old gas, consumers will be given "incorrect signals" regarding the scarcity and costliness of supplemental gas supplies. "Consumers will be able to purchase these supplies for less than their cost of production and transportation." Use of the incremental method discourages the inefficient use of the gas because the LNG will be subject to the market test of whether its users value the LNG enough to pay the true cost of supplying them with this expensive gas. . . . To allow the LNG to be marketed on a rolled-in basis would, in effect, create an artificial market for the imported gas. . . . [T]o the extent that the LNG is incrementally priced at each stage of its sale and resale, all customers, including retail customers, are given the appropriate economic incentive to consider its actual cost in relation to the cost of other options, including conservation.⁶⁸

Upon rehearing,⁶⁹ the FPC once again reversed itself, ruling that the costs of the LNG imports should be rolled-in rather than incrementally priced.⁷⁰ The Commission did not specifically address most of the policy reasons which had initially persuaded it to mandate incremental pricing, but instead asserted that requiring incremental rate design would "render the

66. Op. No. 796 (Apr. 29, 1977); [1977] UTIL. L. REP. (CCH) — 11,942 (reprinted in part).

67. *Id.* slip op. at 25.

68. *Id.* slip op. at 6. Commissioner Holloman, dissenting, harshly disagreed:

Admittedly, the idea of incremental pricing has a certain appeal as an abstract theory and is a proper subject for continued study as a philosophical concept of economic policy. However, absent special circumstances and an amendment to the Natural Gas Act extending this Commission's pricing jurisdiction past the city-gate to the burner tip, it remains not only unworkable and impractical, but contrary to the public interest as well. I agree with the majority that the price involved in these sales is an element to be considered. However, this distinction alone is far from sufficient to overcome the sound case against incremental pricing set forth in Op. No. 786.

Id. at 1.

69. *Trunkline LNG Co.* (Op. No. 796-A), 20 PUB. U. REP. (PUR) 4th 310 (1977).

70. *Id.* at 314. See also Pierce, *supra* note 50, at 1116-17.

project unfinanceable."⁷¹

The FPC's decisionmaking respecting the application of non-Title II incremental pricing versus rolled-in pricing was a precursor of the vigorous congressional debate accompanying the incremental pricing provisions of Title II of the NGPA. The significance of the FPC's decision as between rolled-in or incremental pricing is that the choice of rolled-in pricing — although based upon true costs — produces a subsidy. This occurs because under rolled-in pricing all utility consumers share the costs of the new energy supplies although they benefit only a limited class of the utility's consumers. In contrast, Title II incremental pricing subsidizes a majority of a utility's consumers at the expense of a limited number of consumers. Whether the NGPA choice is administratively feasible or wise policy requires the test of experience.

C. Overview of the Natural Gas Policy Act

After extended debate in the halls of Congress and elsewhere,⁷² the NGPA became law on November 9, 1978.⁷³ President Carter initiated

71. 20 PUB. U. REP. 4th at 314. In modifying the certificate to allow rolled-in rather than incremental pricing, the FPC acknowledged a statement filed by President Carter's Energy Resources Council (ERC):

[C]alling the Commission's attention to § 414 of the proposed National Energy Act transmitted by the President to the Congress on April 29, 1977. According to the ERC, the policies and positions considered in drafting § 414, which is entitled "Incremental Pricing of Natural Gas," are similar to those considered by the Commission in Opinion No. 796. The ERC explains, however, that whereas Opinion No. 796 provides for full marginal cost pricing of a specific source, § 414 provides that the costs of all above-average-cost gas supplies will be allocated to low-priority users until the burner-tip prices for such users reach the prices of substitute fuels.

Id. at 311. It is likely that the FPC's lack of jurisdiction under the Natural Gas Act to extend incremental pricing past the city-gate to the burner-tip was instrumental in disregarding the incremental pricing provisions proposed in the President's energy bill.

72. *See, e.g.*, 124 CONG. REC. S16245 (daily ed. Sept. 27, 1978) (remarks of Sen. Abourezk) ("[T]he natural gas bill . . . is a lousy, stinking bill."); *id.* at S14879 (daily ed. Sept. 11, 1978) (remarks of Sen. Hansen) ("[T]his proposed bill . . . is so full of nooks, crannies, gradations, splotches of color here and there that a visual representation would look like a Jackson Pollock painting. . . ."); *id.* at S16262 (daily ed. Sept. 27, 1978) (remarks of Sen. Byrd of W. Va.) (" . . . it is to the credit of this Senate that the . . . Conference Report . . . represents a legislative milestone and not a legislative tombstone. For months we have read about the imminent demise of this legislation [T]he chronicle of this conference report has wavered between the front pages and the obituary pages"). *See generally* MacAvoy, *supra* note 17, at 819-20; Comment, *supra* note 8, at 460-64.

73. The NGPA was only one part of the comprehensive National Energy Act, which is comprised of the following five statutes: the National Energy Conservation Policy Act of 1978, 92 Stat. 3206 (codified in scattered sections of 12, 15, 23, 42 U.S.C.); the Powerplant and Industrial Fuel Use Act of 1978, 92 Stat. 3289 (codified in scattered sections of 15, 42, 45, 49 U.S.C.); the Public Utility Regulatory Policies Act of 1973, 92 Stat. 3117 (codified in scattered sections of 15, 16 U.S.C.); the Energy Tax Act of 1978, 92 Stat. 3174 (codified in

consideration of the bill which became the NGPA by submitting draft legislation to Congress on April 29, 1977, proposing permanent price controls on all natural gas sales,⁷⁴ in place of the existing federal price controls on only the production of gas sold for resale in interstate commerce.⁷⁵

On August 5, 1977, the House passed the administration's natural gas legislation as H.R. 8444 with only minor modifications.⁷⁶ H.R. 8444 mandated permanent price controls on both intrastate and interstate sales of natural gas. The bill also defined "new natural gas" and established a federal price ceiling for this gas related to the average refiner acquisition cost of domestically produced crude oil. The initial price was established at \$1.75 per MMBtu, with increases tied to increases in crude oil costs.⁷⁷ H.R. 8444 also included an incremental pricing mechanism for passing through price increases by both interstate and intrastate pipelines to low-priority natural gas users, until the price of gas to these users reached the

scattered sections of 23, 26 U.S.C.), and the NGPA. In addition to the NGPA, the Public Utility Regulatory Policies Act of 1978, and the Powerplant and Industrial Fuel Act of 1978, are of significance to the natural gas industry.

By way of summary, the Public Utilities Regulatory Act of 1978 establishes 11 voluntary standards on rate design for consideration by state regulatory authorities, retail standards for activities by natural gas utilities, a policy favoring industrial cogeneration facilities, FERC jurisdiction to require interconnection of electric power transmission facilities, funding to assist state implementation and consumer intervention in proceedings, procedures applicable to natural gas conservation by local distribution companies, procedures to facilitate the voluntary conversion of facilities from natural gas to heavy fuel oil, authority for the President to declare a natural gas supply emergency, and an amendment to the NGA providing for the transportation of natural gas sold by a producer to a high priority user who consumes such gas.

The Powerplant and Industrial Fuel Use Act of 1978 provides for: (1) the prohibition against the use of oil or natural gas in new electric utility generation facilities or in new industrial boilers with a fuel heat input rate of 100 million Btu's per hour or greater, unless exemptions are granted; (2) requirement that existing coal capable facilities use coal and non-coal capable units to use coal-oil mixtures; (3) limitation of natural gas use by existing utility power plants to the proportion of total fuel used during 1974-1976, and the requirement that there be no switches from oil to gas; (4) an \$800 million loan program to assist utilities in raising necessary funds for pollution control; (5) supplemental authority to prohibit use of natural gas in small boilers for space heating and in decorative outdoor lighting and (6) the allocation of coal in emergencies.

74. See COMMUNICATION FROM THE PRESIDENT OF THE UNITED STATES, NATIONAL ENERGY ACT, H.R. DOC. NO. 138, 95th Cong., 1st Sess. (1977).

75. Prior to the passage of the NGPA there was no federal price regulation of natural gas sold for resale in intrastate commerce. Sales for resale in interstate commerce were regulated by the NGA, 15 U.S.C. § 717-717w (1976). See notes 19-71 and accompanying text *supra*.

76. H.R. 8444, 95th Cong., 1st Sess. (1977), which included the natural gas legislation, was approved by a vote of 244 to 177. 123 CONG. REC. H8826-27 (daily ed. Aug. 5, 1977). See Nordhaus, *supra* note 18, at 846.

77. H.R. REP. NO. 1752, 95th Cong., 2d Sess. 67 (1978) [hereinafter cited as CONFERENCE REPORT].

Btu equivalency of the cost of substitute fuels.⁷⁸

The Senate, however, significantly altered the administration and House-passed natural gas pricing proposals by adopting the Pearson-Bentson amendment.⁷⁹ The Senate bill, S. 2104, would not have extended price controls to flowing intrastate gas, and would have continued existing federal regulation of flowing interstate gas.⁸⁰ Deregulation of the price of new onshore gas would occur within two years and the price of new offshore federal domain gas within five years.⁸¹ Pending deregulation, the Senate bill established interim price ceilings at a level tied to the cost of imported fuel oil.⁸² Moreover, S. 2104's incremental pricing provision, which was limited to consumers served directly or indirectly by interstate pipelines, required the Commission to allocate costs of old natural gas for rate purposes to high priority users until the price of natural gas to low priority users equalled the reasonable cost of substitute fuel oil.⁸³

Due to the differences between the House and Senate bills, a Conference Committee was convened on October 18, 1977.⁸⁴ Following an effort to resolve the differences between the two bills, the Conference Committee adopted compromise legislation and issued its report on August 18, 1978.⁸⁵ After extensive debate in the Senate from September 11-27, 1978,⁸⁶ the Senate agreed to the Conference Report on September 27, 1978.⁸⁷ The House then considered the Conference Report on October 13-14, 1978, and adopted it by a vote of 231-168 on October 14, 1978.⁸⁸ Having passed Congress, the NGPA was signed by the President and became law on November 9, 1978.

Through the NGPA, Congress abandoned the regulatory approach of the Natural Gas Act, which applied traditional public utility regulatory

78. *Id.* at 67.

79. Amend. No. 1039, 123 CONG. REC. S16323-25 (daily ed. Oct. 4, 1977). The amendment was approved by a vote of 50-46. *Id.* at S16323. The Senate then adopted its own bill, S. 2104, as amended, by a voice vote. *Id.* at S16325.

80. CONFERENCE REPORT, *supra* note 77, at 68.

81. *Id.*

82. *Id.*

83. *Id.* at 68-69.

84. For a general overview of the legislative maneuvers, see Ligon, *Problems of Contractual Authorization to Collect NGPA Wellhead Prices*, 57 TEXAS L. REV. 551, 552-54 (1979).

85. S. REP. NO. 1126, 95th Cong., 2d Sess. (1978).

86. The debate included the defeat of a motion by a 57-42 vote to resubmit the bill to conference. 124 CONG. REC. S15420-21 (daily ed. Sept. 19, 1978).

87. The Senate agreed to the Conference Report by a vote of 57-42. 124 CONG. REC. S16265 (daily ed. Sept. 27, 1978).

88. 124 CONG. REC. H13427 (daily ed. Oct. 14, 1978).

principles to sales of natural gas.⁸⁹ The NGPA generally rejected the use of cost-based controls on the wellhead price of natural gas sold in interstate commerce,⁹⁰ substituting a statutory price control formula applicable to both intrastate and interstate natural gas sales. This formula relies upon a system of classifying and pricing gas based upon the circumstances of its production and sale. As a result, the FERC is generally no longer required to inquire into producer costs or establish permissible rates of return.⁹¹

According to a congressional report, the "central issue" during consideration of the pricing policy, generated by the perceived need to eliminate the "artificial" distinction between the interstate and intrastate markets, was "whether market equalization should occur through deregulation of the interstate market, as in the Senate bill, or through regulation of the intrastate market as in the House bill."⁹² The NGPA combined both approaches.

The uniform, national price policy for intrastate as well as interstate natural gas production, as provided in the House bill, was adopted.⁹³ Title I of the NGPA substituted a series of statutory maximum price levels⁹⁴ applicable to specifically defined categories of both interstate and intrastate "first sales"⁹⁵ of natural gas, for the former system of price regulation re-

89. See notes 19-71 and accompanying text *supra*. See generally Note, *Regulatory Opportunity and Ambiguity in the Search for High-Cost Natural Gas*, 57 TEXAS L. REV. 641, 641-43 (1979).

90. See SUBCOMM. ON ENERGY & POWER OF HOUSE INTERSTATE AND FOREIGN COMMERCE, 95TH CONG., 2D SESS., ECONOMIC ANALYSIS OF H.R. 5289, NATURAL GAS POLICY ACT OF 1978 I (Comm. Print, 1978) [hereinafter cited as ECONOMIC ANALYSIS].

91. See generally FERC, SECTION BY SECTION ANALYSIS S. REP. NO. 426, 95th Cong., 2d Sess. 12-13 (1978) (accompanying letter from Charles B. Curtis, Chairman of the FERC, to Sen. Henry Jackson, Chairman of the Senate Committee on Energy and Natural Resources, Sept. 8, 1978); Norhaus, *supra* note 18, at 854.

92. ECONOMIC ANALYSIS, *supra* note 90, at 2.

93. Representative Dingell commented as follows respecting the uniform pricing provisions:

The most important provisions of the bill are those which deal with wellhead pricing. These establish a schedule of price ceilings applicable to specifically defined categories of gas production. The result is the creation of a single, national market for natural gas and an end to the economic distortions which accompanied the outdated mode of regulation under the Natural Gas Act.

124 CONG. REC. H13114 (daily ed. Oct. 14, 1978). See generally Comment, *supra* note 8, at 437-39.

94. The NGPA established 8 new major categories and numerous subcategories of natural gas production. 15 U.S.C. §§ 3312-3319 (Supp. II 1978). See generally Ligon, *supra* note 84, at 554-55; Nordhaus, *supra* note 18, at 849-53.

95. Section 2(21) of the NGPA defines "first sale" as follows:

- (A) General rule. - The term "first sale" means any sale of any volume of natural gas —
 (i) to any interstate pipeline or intrastate pipeline;

specting only interstate sales. Under Title I, different pricing treatment is accorded production and sales of gas within the specific categories; the appropriate category being determined by reference to geological information, production history, field records, prior contractual arrangements, and information of a similar nature.⁹⁶ The prices are adjusted monthly for inflation,⁹⁷ but the prices of certain categories are allowed to increase faster than inflation to provide additional incentives for exploration and development.⁹⁸

Title I incorporated, in part, the approach taken in the Senate bill by providing wellhead price deregulation for most categories of gas in 1985.⁹⁹ This delay in deregulation was intended to provide "sufficient time for gradual interim pricing mechanisms to raise the price of new gas from

- (ii) to any local distribution company;
- (iii) to any person for use by such person;
- (iv) which precedes any sale described in clauses (i), (ii), or (iii); and
- (v) which precedes or follows any sale described in clauses (i), (ii), (iii), or (iv) and is defined by the Commission as a first sale in order to prevent circumvention of any maximum lawful price established under this chapter.

(B) Certain sales not included. — Clauses (i), (ii), (iii), or (iv) of subparagraph (A) shall not include the sale of any volume of natural gas by any interstate pipeline, intrastate pipeline, or local distribution company, or any affiliate thereof, unless such sale is attributable to volumes of natural gas produced by such interstate pipeline, intrastate pipeline, or local distribution company, or any affiliate thereof.

15 U.S.C. § 3301(21) (Supp. II 1978).

96. See Preamble to the Interim Regulations implementing the NGPA, 43 Fed. Reg. 56,448, 56,452, 56,453 (1978). See generally MacAvoy, *supra* note 17, at 821. By way of example, a "new, onshore production well" is defined by § 103 of the NPGA as:

Any new well (other than a well located on the Outer Continental Shelf) —

- (1) the surface drilling of which began on or after February 19, 1977;
- (2) which satisfies applicable Federal or State well-spacing requirements, if any;

and

- (3) which is not within a proration unit —
 - (A) which was in existence at the time the surface drilling of such well began;
 - (B) which was applicable to the reservoir from which such natural gas is produced; and
 - (C) which applied to a well (i) which produced natural gas in commercial quantities or (ii) the surface drilling of which was begun before February 19, 1977, and which was thereafter capable of producing natural gas in commercial quantities.

15 U.S.C. § 3313(c) (Supp. II 1978).

97. Section 101(a), 15 U.S.C. § 3311(a) (Supp. II 1978), prescribes the method for computing the annual inflation adjustment factor for NGPA ceiling prices.

98. See, e.g., 15 U.S.C. § 3312(b) (Supp. II 1978) (new natural gas and certain outer continental shelf wells); 15 U.S.C. § 3318(a) (stripper wells) (Supp. II 1978).

99. For the deregulation provisions established in § 121 of the NGPA, 15 U.S.C. § 3331 (Supp. II 1978), see note 17 *supra*.

historically underpriced levels to a point where the market can clear."¹⁰⁰ The price of gas from high-cost gas wells was to be deregulated after one year, while flowing gas, for which little additional economic incentive was necessary to encourage continued production, remains regulated indefinitely.¹⁰¹

As discussed in section III of this article, Title II of the NGPA¹⁰² requires the incremental pricing of portions of the acquisition cost of certain categories of gas, set forth in Title I, which exceed specified levels. Title III¹⁰³ authorizes the President to declare a natural gas supply emergency under certain circumstances,¹⁰⁴ and to permit interstate pipelines and distribution companies to purchase natural gas in order to alleviate the emergency upon such contract terms as the President may require.¹⁰⁵ If these purchases are insufficient to meet the needs of high priority customers, the President may allocate certain natural gas supplies.¹⁰⁶ Moreover, Title III allows the FERC to permit interstate pipelines to transport gas on behalf of any intrastate pipeline or local distribution company,¹⁰⁷ and to authorize intrastate pipelines to sell to,¹⁰⁸ or transport¹⁰⁹ gas on behalf of interstate pipelines or distribution companies served by interstate pipelines.

Title IV¹¹⁰ of the NGPA sets forth a federal natural gas curtailment policy. The purpose of this title is to assure that gas supplies for certain essential agricultural uses and essential industrial process or feedstock uses generally will not be curtailed unless curtailment is required to protect enumerated high priority users.¹¹¹

Title V¹¹² grants the FERC various rulemaking¹¹³ and enforcement

100. 124 CONG. REC. H13114 (daily ed. Oct. 14, 1978) (remarks of Rep. Dingell).

101. See ECONOMIC ANALYSIS, *supra* note 90, at 2. See generally MacAvoy, *supra* note 17, at 820-23; Comment, *supra* note 8, at 449-59.

102. 15 U.S.C. §§ 3341-3348 (Supp. II 1978). See notes 120-97 and accompanying text *infra*.

103. 15 U.S.C. §§ 3361-3375 (Supp. II 1978).

104. *Id.* § 3361.

105. *Id.* § 3362(a).

106. *Id.* § 3363.

107. *Id.* § 3371(a)(1).

108. *Id.* § 3371(b).

109. *Id.* § 3371(a)(2).

110. *Id.* §§ 3391-3394.

111. See Mogel, *Food, Fuel and Federal Curtailment Regulations*, 56 CHI.-KENT L. REV. 301 (1980). See also Harrison & Formby, *supra* note 33, at 72-76.

112. 15 U.S.C. §§ 3411-3417 (Supp. II 1978).

113. The FERC is authorized to "prescribe, issue, amend, and rescind such rules and orders as it may find necessary or appropriate to carry out its functions" under the NGPA. 15 U.S.C. § 3411(a) (Supp. II 1978).

powers.¹¹⁴ Additionally, the FERC is authorized to review determinations of eligibility for qualifying natural gas production and sales under the categories established in Title I.¹¹⁵ Title V also sets forth the procedure for obtaining judicial review of Commission action pursuant to the NGPA.¹¹⁶ Title VI,¹¹⁷ the final section of the NGPA, coordinates the provisions of the NGPA with the NGA, setting forth the areas where utility-type regulation pursuant to the NGA is still retained.

It is apparent that a fundamental purpose of the NGPA is to provide immediately higher incentive prices¹¹⁸ for natural gas pending deregulation, in order to encourage increased production of natural gas.¹¹⁹ The following section of this article will discuss Title II of the NGPA, which was intended in part to shield high priority users from the higher natural gas incentive prices resulting from this Act.

III. TITLE II OF THE NGPA

[T]his bill is nothing but a masterpiece of confusion. It is so

114. Section 504 of the NGPA, 15 U.S.C. § 3414 (Supp. II 1978), empowers the FERC to impose substantial civil and criminal penalties and other sanctions for violations of the NGPA.

115. Title V requires that before a producer collects the NGPA price for certain categories of gas (new natural gas under 15 U.S.C. § 3312(c); gas from the Outer Continental Shelf under 15 U.S.C. § 3312(d); new, onshore production wells under 15 U.S.C., § 3313(c); and stripper well gas under 15 U.S.C. § 3318(b)), it must first obtain a determination that such gas actually qualifies for that price. Determinations of eligibility are to be made by the state agency regulating gas production, if the gas involved is located on lands subject to state jurisdiction, or by a federal agency such as the U.S. Geological Survey, if the gas is located on lands under federal domain. These determinations are subject to the FERC's review and are appealable to the courts only if the FERC remands or reverses the determination of the state or federal agency. 15 U.S.C. § 3413(a)-(d) (Supp. II 1978).

Pending a final determination, producers may collect the maximum lawful price for which they believe the gas qualifies pursuant to the FERC's implementing regulations. Any amount collected in excess of the subsequently determined maximum lawful price must be refunded, with interest. *Id.* § 3413(e).

116. *Id.* § 3416.

117. *Id.* §§ 3431-3432.

118. Although it is difficult to assess accurately the economic impact of the NGPA, the Energy Information Administration of the Department of Energy has prepared an analysis which estimated that for the period 1977-1985, the NGPA would increase producer revenues by 13.7 to 23.5 billion dollars and would elicit an additional one trillion cubic feet of natural gas production. ENERGY INFORMATION ADMINISTRATION, AN EVALUATION OF NATURAL GAS PRICING PROPOSALS (June 14, 1978) (Analysis Mem. No. AM/IA-7802).

119. In floor debate just before the final Senate vote on the natural gas bill, Senator Jackson, the Senate manager of the bill, stated: "[T]he legislation that is before us for this final legislative act in the Senate will give us a better law than we have today in the field of natural gas pricing and delivery [I]t will provide the incentives for increased production." 124 CONG. REC. S16264 (daily ed. Sept. 27, 1978) (remarks of Sen. Jackson).

murky in its utter complexity, other than being a lawyers' and accountants' relief act, that it does nothing to advance the energy policy of this country.¹²⁰

A. Introduction

This commentary on the NGPA, spoken during the House debate, exemplifies congressional uncertainty as to both the efficacy and results that would arise from the NGPA. The conference report accompanying the NGPA recognized that the "implementation of [the Title II incremental pricing provisions] . . . will be complex."¹²¹ There are few who would quarrel with the observation that the incremental pricing provisions of Title II of the NGPA invoke "utter complexity"¹²² in an already rarefied field.

Generally, Title II mandates the incremental pricing of certain purchased gas costs incurred by interstate pipelines. This is effectuated by requiring amounts paid in excess of specified ceiling prices for certain categories of natural gas to be segregated into a special account by each pipeline, and then passed through as a surcharge to certain industrial and boiler fuel users until the gas cost to these users equals the cost of an alternative fuel. Such a surcharge, however, may not raise the gas cost to the industrial user above the cost of the fuel oil which could be used by the industrial customer as an alternative to natural gas.

This section will discuss the general intent of the incremental pricing provisions, including an analysis of the legislative history of Title II of the NGPA. The facilities or users subject to incremental pricing pursuant to sections 201,¹²³ 202,¹²⁴ and 206¹²⁵ will be discussed next. Finally, this section will address the acquisition costs subject to incremental pricing pursuant to section 203¹²⁶ and the manner of passing through these costs set forth in section 204 of the NGPA.¹²⁷

B. Intent of Incremental Pricing

The intent of Title II of the NGPA is two-fold. First, it is to serve as a market ordering device by inducing industrial users to exercise their

120. 124 CONG. REC. H13131 (daily ed. Oct. 14, 1978) (remarks of Rep. Anderson).

121. CONFERENCE REPORT, *supra* note 77, at 95.

122. 124 CONG. REC. H13131 (daily ed. Oct. 14, 1978) (remarks of Rep. Anderson).

123. 15 U.S.C. § 3341 (Supp. II 1978).

124. *Id.* § 3342.

125. *Id.* § 3346.

126. *Id.* § 3343.

127. *Id.* § 3344.

purchasing leverage to prevent interstate pipeline companies from bidding up the price of deregulated natural gas.¹²⁸ Second, Title II is intended to shift the immediate wellhead price increases resulting from Title I of the NGPA¹²⁹ primarily to industrial users, thereby protecting residential and other "high priority" users from rapid price increases which could otherwise result from the new wellhead prices.¹³⁰ According to Representative Dingell, the Chairman of the House Subcommittee on Energy and Power, upon deregulation of certain categories of natural gas, incremental pricing is to substitute for wellhead price controls as a "market ordering device."¹³¹ A further goal is to eliminate potential market distortions before such deregulation occurs.¹³²

Title II reflects a primary congressional concern: precluding interstate pipelines from averaging or rolling-in the expensive volumes of deregulated gas with the volumes of less expensive flowing regulated gas. In the legislative debate preceding enactment of the NGPA, it was contended that deregulation would drive new gas prices far above long-run market levels as a result of a bidding war between pipelines. This in turn would push the price of unregulated new gas to high levels.¹³³ In its report accompanying H.R. 8444,¹³⁴ a forerunner of the NGPA, the House *Ad Hoc* Committee on Energy stated that upon sudden deregulation:

an interstate pipeline will be able to bid extremely high prices for new supplies of natural gas, which even deregulation proponents concede will be relatively small as compared to the volumes of presently flowing natural gas. The interstate pipelines, unlike the intrastate pipelines, are not constrained by a limited demand for natural gas. Using rolled-in pricing, interstate pipelines can bid the price of new supplies of natural gas to unprecedented levels of \$5 per Mcf or more.¹³⁵

Title II incremental pricing was expected to eliminate this phenomenon by focusing price increases primarily upon a pipeline's industrial custom-

128. See 126 CONG. REC. H60 (daily ed. Jan. 23, 1980) (remarks of Rep. Dingell).

129. As of January 1, 1980, the NGPA ceiling prices for deliveries of natural gas in January 1980 falling within §§ 102-109, 15 U.S.C. §§ 3312-3319 (Supp. II 1978), excluding high cost gas as defined in § 107(c)(1)-(4), *id.* § 3317(c)(1)-(4), ranged from \$.220 to \$2.523 per million British thermal units (MMBtu). See 45 Fed. Reg. 7781-7782 (1980). Beginning on November 1, 1979, the price of natural gas finally determined to be eligible as high cost natural gas under § 107(c)(1)-(4), 15 U.S.C. § 3317(c)(1)-(4) (Supp. II 1978), is deregulated.

130. 124 CONG. REC. H13115 (daily ed. Oct. 14, 1978) (remarks of Rep. Dingell).

131. *Id.* at H13114.

132. *Id.*

133. *Id.* at H13113-14.

134. H.R. REP. NO. 543, 95th Cong. 1st Sess., Vol. II (1977).

135. *Id.* at 395.

ers. By allowing the price of gas delivered to industrial customers to rise to the level of alternative fuels, it was believed that the leverage of industrial customers would limit the ability of pipelines to pass through high prices for new gas.¹³⁶ Restrained by these passthrough limitations, Representative Dingell stated in floor debate that:

[P]ipelines will be forced to bid responsibly for deregulated supplies of gas or face a loss of customers and an associated reduction in throughput volumes and profits. . . . Incremental pricing is not intended to achieve conservation of natural gas through forced conversions of industrial users to other fuels. Instead, it is intended to apply the leverage industrial customers have over pipeline management in such a way that pipelines will be forced to bid responsibly for new supplies of gas. Residential natural gas consumers are thereby protected from sharp increases in gas prices which would otherwise accompany deregulation.¹³⁷

Thus, Congress intended that Title II incremental pricing would place industrial users in a position of constraining their pipeline suppliers from bidding up the price of deregulated natural gas.

Congress also recognized that it was necessary to employ a mechanism that would not compel industrial users to forego interstate pipeline systems and to convert to other fuels. Representative Dingell stated:

The [NGPA] will not drive industrial users off natural gas and onto other fuels. Such a result would be contrary to the very purpose of the bill's provisions. . . . If incremental pricing in fact drove industrial users to other fuels, the leverage these users have with pipeline managements would be lost and the consumer protection aspects of incremental pricing would be seriously impaired. The conferees have provided several statutory guarantees against such an unintended result.¹³⁸

Since it was assumed that the price to industrial users could at most rise to the level of alternative fuels, Representative Dingell believed that these customers would not be compelled to convert to other fuels.¹³⁹ Moreover, it was stated that "a broadening of incremental pricing to other industrial users will give added assurances against forced conversions" to other fuels, since "[w]ith more users sharing the load it is less likely that the price to any single user will get high enough to force conversions."¹⁴⁰ It was also

136. See 124 CONG. REC. H13114 (daily ed. Oct. 14, 1978) (remarks of Rep. Dingell).

137. *Id.*

138. *Id.*

139. *Id.* That belief apparently was formulated when the price of fuel oil was approximately \$12 per barrel. As of January 1, 1980, the price has increased to approximately \$30 per barrel. Wash. Post, Dec. 19, 1979, § A, at 22, col. 4.

140. 124 CONG. REC. H13115 (daily ed. Oct. 14, 1978) (remarks of Rep. Dingell).

assumed that conversion would not take place, since "incremental pricing is capped at the price of alternative fuels . . . [and thus] natural gas will remain an attractively priced fuel even for incrementally priced industrial users."¹⁴¹

Representative Dingell commented in the floor debate on the NGPA that a "highly beneficial side effect of the bill's incremental pricing provisions is that they will protect residential gas users from sharp price increases."¹⁴² Support of the NGPA by various congressmen was conditioned, in part, upon the bill's provisions that would partially shield residential consumers from the higher natural gas prices permitted by Title I. Of note is the following colloquy between Senator Stone and Senator Jackson, Chairman of the Senate Energy Committee, on the Senate floor during the final debate on the NGPA:

MR. STONE. [I]s this [incremental pricing] provision in any way intended to encourage industrial customers who are currently using natural gas to switch from natural gas to other fuels?

MR. JACKSON. The incremental pricing mechanism is in no way intended to encourage industrial customers to switch from using natural gas to other fuels. Instead, the incremental pricing provision is intended to provide some protection from higher natural gas prices to certain gas customers, in particular residential and small commercial customers.¹⁴³

The legislative history of the Title II incremental pricing provisions reveals Congress' two-fold objectives. First, it was believed that by placing the initial cost of deregulated natural gas price increases primarily on industrial users, these users would have sufficient purchasing leverage to restrain their supplying pipelines from bidding up the price of deregulated gas. Second, Title II incremental pricing was intended partially to shield high priority natural gas users from the immediate impact of wellhead price increases resulting from the natural gas pricing provisions established in Title I of the NGPA. Whether the accomplishment of such objectives is "naive" or "fanciful" awaits the test of application and time.¹⁴⁴

141. *Id.*

142. *Id.* at H13114.

143. 124 CONG. REC. S16236 (daily ed. Sept. 27, 1978) (remarks of Sen. Stone and Sen. Jackson). In the final floor debates it was stated that "[t]he Senate's intention with incremental pricing was to protect the consumer from higher prices." *Id.* at S16239 (remarks of Sen. Percy). Senator Glenn observed that incremental pricing "protects the individual residential user from drastic increases and places the major load onto industrial users for any higher priced new gas flowing through the interstate system." *Id.* at S16262.

144. *See* INSIDE F.E.R.C. (Nov. 26, 1979).

C. Facilities Subject to Incremental Pricing

Title II mandates that the incremental pricing provisions be implemented in two phases. Pursuant to section 201 of the NGPA,¹⁴⁵ the FERC was directed to promulgate and make effective within twelve months of November 9, 1978:

a rule designed to provide for the passthrough, in accordance with the provisions of this subchapter, of the costs of natural gas which are -

- (1) described in section 3343 of this title, [section 203] and
- (2) incurred by any interstate pipeline. . . .¹⁴⁶

The requirements of such a rule are to apply "with respect to the boiler fuel use of natural gas by any industrial boiler fuel facility."¹⁴⁷ Significantly, however, a statutory exemption from incremental pricing is provided in section 206 for electric utilities using natural gas as a boiler fuel in generating electricity.¹⁴⁸ The FERC issued its Phase I rule on September 28, 1979, which became effective on November 1, 1979.¹⁴⁹

Section 202 of the NGPA¹⁵⁰ directs the FERC to prescribe by May 9, 1980, a Phase II amendment to its Phase I rule. Under Phase II incremental pricing, the FERC may extend the incremental pricing program to other non-boiler industrial users and mandate that such users be subject to a surcharge to recover certain costs incurred by interstate pipelines¹⁵¹ as described in section 203.¹⁵² Specifically, the rule may expand the application of the incremental pricing program to: "any industrial facility which is within a category defined by the Commission in such amendment as subject thereunder to the requirements of such rule which is not exempt under [Section 206 of the NGPA]."¹⁵³ Unlike the Phase I regulations, the FERC's Phase II rule is subject to a congressional review mechanism; either house of Congress may disapprove the rule within thirty calendar days of continuous session after it has been submitted.¹⁵⁴ In this regard,

145. 15 U.S.C. § 3341 (Supp. II 1978).

146. *Id.* § 3341(a).

147. *Id.* § 3341(b). *See* note 9 *supra*.

148. 15 U.S.C. § 3346(c)(2) (Supp. II 1978).

149. 18 C.F.R. § 282 (1979).

150. 15 U.S.C. § 3342 (Supp. II 1978).

151. *Id.* § 3342(a)(1)(B).

152. *Id.* § 3343.

153. *Id.* § 3342(b)(2).

154. *Id.* § 3342(c). If either House adopts a resolution of disapproval, the FERC may submit a different proposal to each House no earlier than six months after the resolution of disapproval, and no later than two years after the date of adoption of any resolution of disapproval. *Id.*

Senator Jackson commented during the floor debate immediately preceding the enactment of the NGPA: "I would note that this bill does not compel incremental pricing with respect to any industrial use other than in large boilers. Extension of incremental pricing beyond boiler use could be prevented by a majority vote of either House of Congress 2 years from now."¹⁵⁵ On November 15, 1979, the FERC issued a notice of proposed rulemaking in Phase II to extend incremental pricing to other industrial facilities.¹⁵⁶

The scope of incremental pricing, however, is limited by the exemptions established in section 206 of the NGPA.¹⁵⁷ Subsection 206(a) provides an interim exemption for small industrial boiler fuel users in existence on the date of enactment of the NGPA, if gas use by the facility does not exceed "an average of 300 Mcf per day during any month of a base period determined appropriate by the Commission."¹⁵⁸ This interim exemption will last until the FERC prescribes and makes effective a permanent rule pursuant to subsection 206(a)(2).¹⁵⁹ The permanent exemption, required to be promulgated by May 9, 1980, will apply to certain small industrial boiler fuel facilities in existence as of November 9, 1978, whose boiler fuel use during the peak month of calendar year 1977 was the lesser of an average of 300 Mcf per day, or such average daily rate of use as the FERC deems necessary to ensure that the boiler fuel use permanently exempted by such rule does not exceed five percent of all natural gas that the FERC estimates was transported by interstate pipelines for boiler fuel use during the calendar year 1977.¹⁶⁰

Subsection 206(b) of the NGPA,¹⁶¹ grants a further statutory interim exemption rule for any agricultural use of natural gas. "Agricultural use" is defined as the use of natural gas:

(A) for agricultural production, natural fiber production, natural fiber processing, food processing, food quality maintenance, irrigation pumping, or crop drying; or

(B) as a process fuel or feedstock in the production of fertilizer, agricultural chemicals, animal feed, or food.¹⁶²

155. 124 CONG. REC. S16239 (daily ed. Sept. 27, 1978) (remarks of Sen. Jackson).

156. Rule Required Under § 202 of the Natural Gas Policy Act of 1978, Proposed Rulemaking and Public Hearings, Doc. No. RM80-10, 44 Fed. Reg. 67,170 (1979).

157. 15 U.S.C. § 3346 (Supp. II 1978).

158. *Id.* § 3346(a)(1).

159. *Id.* § 3346(a)(2)(A). Unlike the rule required by § 202, *id.* § 3342, the permanent exemption is not subject to congressional review.

160. *Id.* § 3346(a)(2)(B).

161. *Id.* § 3346(b).

162. *Id.* § 3346(b)(3).

This interim exemption continues until the FERC prescribes and makes effective on May 9, 1980, a permanent rule exempting agricultural users from incremental pricing. Agricultural uses will be exempt under the permanent rule only if the FERC determines that an alternative fuel or feedstock is not "economically practicable; or . . . reasonably available."¹⁶³

The final statutory exemption from incremental pricing is set forth in subsection 206(c).¹⁶⁴ This subsection provides a permanent exemption for schools, hospitals and similar institutions, qualifying cogeneration facilities, and electric utilities. The exemption of electric utilities,¹⁶⁵ which currently use a substantial amount of natural gas for generating electricity, is a further significant reduction in the pool of natural gas users that are subject to incremental pricing.

Subsection 206(d) further authorizes the FERC to provide, by rule or order, additional partial or complete exemptions for other nonexempt industrial facilities or categories.¹⁶⁶ The conference report explains that these other exemptions "may deal with either who is covered by the [incremental pricing] rule or at what level any particular class of users covered by the rule will be incrementally priced."¹⁶⁷ It also indicates that the FERC may grant partial exemptions lowering the substitute fuel level applicable to any particular class of nonexempt users below the level that would otherwise apply.¹⁶⁸ However, subsection 206(d)(2) provides that any rule which grants an exemption under this subsection is subject to con-

163. *Id.* § 3346(b)(2). Although the statute conditions the permanent exemption in the disjunctive (i.e. —"economically practicable" or "reasonably available"), the Conference Report uses the conjunctive, stating that the exemption applies only if the Commission determines that an alternative fuel or feedstock "is both economically practicable and reasonably available." CONFERENCE REPORT, *supra* note 77, at 102.

The potential limitations on the scope of incremental pricing because of the statutory agricultural use exemption is significant. American agriculture is energy intensive, as illustrated by a Department of Agriculture estimate that 22% of the nation's energy supply is used in the production of food and fiber, placing the agricultural sector as the third largest industrial user of energy after the steel manufacturing and petroleum refining industries. Approximately one-third of that energy use is derived from natural gas, and is used primarily for fertilizer, fuel, irrigation, pesticides and seed drying. *See* Mogel, *supra* note 111. It is likely that for many of these uses, there is no alternative fuel or feedstock that is economically practicable or reasonably available. Consequently, the statutory agricultural use exemption will significantly reduce the pool of available industrial users that will be subject to an incremental pricing surcharge.

164. 15 U.S.C. § 3346(c) (Supp. II 1978).

165. Subsection 2(28) of the NGPA defines an "electric utility" as: "any person to the extent such person is engaged in the business of the generation of electricity and sale, directly or indirectly, of electricity to the public." 15 U.S.C. § 3301(2)(28) (Supp. II 1978).

166. *Id.* § 3346(d).

167. CONFERENCE REPORT, *supra* note 77, at 102.

168. *Id.*

gressional review; either House of Congress may disapprove the rule within thirty calendar days of continuous session after it has been submitted.¹⁶⁹

D. *The Mechanics of Incremental Pricing*

Section 204¹⁷⁰ of the NGPA specifies the manner in which gas acquisition costs subject to incremental pricing are to be passed through to nonexempt industrial users. Interstate pipelines must establish an incremental pricing account and credit to it the costs subject to incremental pricing. The amounts so credited are then passed through as a surcharge on the total volumes of natural gas delivered, directly or indirectly,¹⁷¹ to incrementally priced industrial facilities¹⁷² for ultimate industrial use.¹⁷³ The surcharge allocates increases in natural gas prices to nonexempt facilities until the price paid by these facilities at the burnertip is equal to the appropriate Btu equivalent cost of alternative fuel.¹⁷⁴ A facility's surcharge is to be reduced if an unadjusted surcharge would result in rates to that facility which exceed the appropriate alternative fuel cost. This reduction is to be borne by other nonexempt facilities served by the pipeline. Any amount that a local distribution company does not recover from facilities it serves, because the price would then exceed the Btu equivalent cost, reverts back to the pipeline and is shared by all remaining nonexempt facilities served by the pipeline that pay less than the alternative fuel price. When all such nonexempt facilities reach the Btu-equivalency of the alternative fuel cost, then "the passthrough will operate only to the extent necessary to maintain rates and charges for industrial users at that equivalency,"¹⁷⁵ with any excess amounts "allocated in whatever manner by which the pipeline or local

169. 15 U.S.C. § 3346(d)(2) (Supp. II 1978). The statute specifically authorizes Congress to veto any rule promulgated under section 206(d)(1), *id.* § 3346(d)(2), but does not refer to any exemption order the FERC may issue pursuant to that section. However, the conference report states that "[a]ny proposed exemption is required to be submitted to Congress." CONFERENCE REPORT, *supra* note 77, at 102. This would appear to include exemption orders issued by the FERC.

170. 15 U.S.C. § 3344 (Supp. II 1978).

171. *Id.* § 3344(c)(2).

172. Subsection 204(g), 15 U.S.C. § 3344(g), defines the term "incrementally priced industrial facility" as: "any industrial facility subject to the requirements of the rule under section 201 (including any amendment under section 202 to such rule)."

173. Subsection 204(h), 15 U.S.C. § 3344(h), provides that: "For purposes of this section, the term 'industrial use,' when used with respect to natural gas, means the boiler fuel use of natural gas (as defined in section 201(c)(2)) and any other use defined, by rule, by the Commission as an industrial use."

174. *See* CONFERENCE REPORT, *supra* note 77, at 98.

175. *Id.* at 99.

distribution company is permitted to recover normal costs."¹⁷⁶

Section 204 of the NGPA¹⁷⁷ provides that the alternative fuel cost limit on the incremental pricing mechanism in a region, unless the FERC determines otherwise, shall be the average price paid by industrial users for No. 2 fuel oil in that region.¹⁷⁸ In certain cases the FERC may, by rule or order, reduce the appropriate alternative fuel cost to a level not lower than the price paid for No. 6 fuel oil by industrial users on a regional basis. However, FERC must determine that such a reduction is necessary to prevent rate increases for residential, small commercial, and other high priority natural gas users resulting from a reallocation of costs caused by conversion of an industrial facility from natural gas to other fuels. This determination may be made on a case-by-case basis, or regionally by category of user on a pipeline-by-pipeline basis.¹⁷⁹

Section 203¹⁸⁰ of the NGPA sets forth the "first sale acquisition cost"¹⁸¹ of natural gas that must be placed in a pipeline's incremental pricing account. This section further provides that the first sale acquisition cost of natural gas in certain enumerated categories¹⁸² which exceeds the incremental pricing threshold must be passed through.¹⁸³ The incremental pricing threshold for any month initially is defined in subsection 203(c) as \$1.48/MMBtu, for March, 1978, "and for each month thereafter, the amount determined for the preceding month multiplied by the monthly equivalent of the annual inflation adjustment factor [as defined in section

176. *Id.*

177. 15 U.S.C. § 3344 (Supp. II 1978).

178. *Id.* § 3344(e).

179. See CONFERENCE REPORT, *supra* note 77, at 100.

180. 15 U.S.C. § 3343 (Supp. II 1978).

181. The term "first sale acquisition cost" is defined in § 203(b)(1), 15 U.S.C. § 3343(b) (Supp. II 1978), as follows:

(A) the price paid, per million Btu's, in any first sale of such natural gas, in the case of any natural gas produced in the United States and acquired in such first sale; and

(B) the price paid for such natural gas, per million Btu's, at the point of entry to the United States, in the case of natural gas or liquefied natural gas imported into the United States.

182. The categories are as follows: (1) new natural gas [as defined in § 102(c), 15 U.S.C. § 3312(c)]; (2) gas delivered under rollovers into the interstate system of previously intrastate gas [as defined in § 106, 15 U.S.C. § 3316]; (3) gas produced from new, onshore production wells [as defined in § 103(c), 15 U.S.C. § 3313(c)]; (4) liquefied natural gas imported into the U.S. (subject to § 207, 15 U.S.C. § 3347); and (5) sales of gas pursuant to § 311, 15 U.S.C. § 3371 (which authorizes certain transportation arrangements between intrastate and interstate pipelines and certain sales by intrastate pipelines to interstate pipelines or local distribution systems).

183. 15 U.S.C. § 3343(a)(1), (2), (3), (4) & (10) (Supp. II 1978).

101(a)] applicable for such month."¹⁸⁴ Thus, any first sale acquisition cost in the five enumerated categories exceeding this incremental pricing threshold must be passed through to the nonexempt industrial facilities.

The remaining categories of gas defined by Title I generally are not controlled by the incremental pricing threshold for determining that portion of the cost to be passed through. Under subsection 203(a)(6)¹⁸⁵ any portion of the acquisition cost of stripper well gas¹⁸⁶ that exceeds the maximum price for new gas under section 102 must be placed in the incremental pricing account and passed through. The amount of incrementally priced high cost gas¹⁸⁷ is computed under a formula¹⁸⁸ presumably intended to maintain the incentive price and marketing requirements of increased production of this category of gas. Natural gas produced from the Prudhoe Bay Unit of Alaska and transported through the transportation system approved under the Alaskan Natural Gas Transportation Act of 1976¹⁸⁹ is also subject to treatment under a unique formula. Subsection 203(a)(8) of the NGPA¹⁹⁰ mandates incremental pricing of that portion paid for such Alaska natural gas which exceeds the cost computed under section 109 (\$1.45 per MMBtu as of April, 1977, plus inflation adjustment), plus any amount paid to any person other than the producer for gathering, process-

184. *Id.* § 3343(c).

185. *Id.* § 3343(a)(6).

186. Stripper well natural gas is defined in § 108(b), 15 U.S.C. § 3318(b) (Supp. II 1978), as nonassociated natural gas produced during any month from a well, if:

(A) during the preceding 90-day production period, such well produced nonassociated natural gas at a rate which did not exceed an average of 60 Mcf per production day during such period; and

(B) during such period such well produced at its maximum efficient rate of flow, determined in accordance with recognized conservation practices designed to maximize the ultimate recovery of natural gas.

187. High cost gas is defined in § 107(c), 15 U.S.C. § 3317(c) (Supp. II 1978), as natural gas:

(1) produced from any well the surface drilling of which began on or after February 19, 1977, if such production is from a completion location which is located at a depth of more than 15,000 feet;

(2) produced from geopressured brine;

(3) occluded natural gas produced from coal seams;

(4) produced from Devonian shale; and

(5) produced under such other conditions as the Commission determines to present extraordinary risks or costs.

188. Section 203(a)(7), 15 U.S.C. § 3343(a)(7) (Supp. II 1978), provides that the portion of the acquisition cost of high cost gas which exceeds 130% of the Btu-equivalent of the landed cost of No. 2 fuel oil in New York harbor "during an appropriate period preceding the month during which delivery of such natural gas occurs," is required to be passed through to nonexempt industrial facilities.

189. 90 Stat. 2903 (codified in scattered sections of 15, 42, 43 U.S.C.).

190. 15 U.S.C. § 3343(a)(8) (Supp. II 1978).

ing, treating, liquefying, transporting, or compressing the gas into the pipeline system.

The passthrough of the first sale acquisition costs of imported natural gas is also subject to unique treatment.¹⁹¹ With respect to liquefied natural gas, subsection 203(a)(4)¹⁹² requires that any portion of the first sale acquisition cost of new LNG imports exceeding the incremental pricing threshold (\$1.48 per MMBtu as of March, 1978, plus inflation adjustment) be incrementally priced. For natural gas imports other than LNG, subsection 203(a)(5) of the NGPA¹⁹³ provides that any portion of the first sale acquisition cost of new natural gas imports exceeding the maximum lawful price computed under section 102¹⁹⁴ for the month in which the gas enters the U.S. also be incrementally priced.¹⁹⁵ However, in connection with granting any authorization to import gas under the Natural Gas Act, the Secretary of the Department of Energy or the FERC has the discretion to require incremental pricing of LNG and non-LNG volumes in certain instances.¹⁹⁶

191. *Id.* § 3343(a)(4), (5).

192. *Id.* § 3343(a)(4). However, § 203(a)(4), is subject to § 207(a), *id.* § 3347, which exempts from incremental pricing LNG projects which (1) received a certificate under § 3 of the Natural Gas Act, 15 U.S.C. § 717b (1976), on or before May 1, 1978; (2) had a certificate application pending as of May 1, 1978; and (3) projects where the Secretary of Energy or the FERC determines that the importer had made substantial financial commitments or entered into a binding contract on or before May 1, 1978. 15 U.S.C. § 3347 (Supp II 1978). Section 207(c) is in turn subject to the provisions of § 207(c)(1), *id.* § 3347(c)(1). *See* note 196 *infra*.

193. *Id.* § 3343(a)(5).

194. *Id.* § 3312. For January, 1980, the maximum lawful price computed under § 102 was \$2.358 per million British thermal units (MMBtu). 45 Fed. Reg. 7782 (1980).

195. However, § 207(b), 15 U.S.C. § 3347(b) (Supp. II 1978), mandates that the pass-through provisions of § 203(a)(5) shall only apply to volumes of non-LNG imports which exceed both:

(1) the maximum delivery obligations, for the month in which such delivery of such natural gas occurs, which is specified in contracts entered into on or before May 1, 1978, and in effect when such delivery occurs; and

(2) the volume of natural gas imported into the United States by the interstate pipeline involved during any corresponding period (determined appropriate by the Commission) of calendar year 1977.

Section 207(b) is in turn subject to § 207(c), *id.* § 3347(c). *See* note 196 *infra*. Of note with respect to non-LNG imports is the FERC's recent authorization to import natural gas from Mexico issued in *Border Gas, Inc.*, Doc. No. CP80-93 (Dec. 21, 1979). The FERC required the purchasing interstate pipeline companies to price incrementally the imported volumes pursuant to § 203(a)(5) of the NGPA, 15 U.S.C. § 3343(a)(5) (Supp. II 1978).

196. As indicated in notes 191 and 194, the passthrough requirements of the first sale acquisition cost of LNG and non-LNG import volumes specified in § 207(a) and (b), 15 U.S.C. § 347(a), (b) (Supp. II 1978), are subject to § 207(c), 15 U.S.C. § 3347(c) (Supp. II 1978) which provides:

(c) Authority with respect to incremental pricing of natural gas or LNG imports.—

(1) LNG imports.— Subsection (a)(2) and (3) of this section shall not apply with

In sum, Title II is a labyrinth of inclusions, exemptions, pricing catego-

respect to any liquefied natural gas imports if, in connection with the granting of any authority under the Natural Gas Act to import such liquefied natural gas, the Secretary of the Department of Energy or the Commission . . . determines that the provisions of section 3343(a)(4) of this title shall apply with respect to such liquefied natural gas imports.

(2) Natural gas imports (other than LNG).— The provisions of section 3343(a)(5) of this title shall apply to the passthrough of the first sale acquisition costs of volumes of natural gas (other than liquefied natural gas) imported into the United States which exceed the volume of natural gas imported into the United States by the interstate pipeline involved during any corresponding period (determined appropriate by the Commission) of calendar year 1977 if, in connection with the granting of any authority under the Natural Gas Act to import such natural gas, the Secretary of the Department of Energy or the Commission . . . determines that the provisions of section 3343(a)(5) of this title shall apply with respect to such natural gas imports.

15 U.S.C. § 3347(c).

Section 502(d) of the NGPA, 15 U.S.C. § 3412(d) (Supp. II 1978), provides that any determination made under § 207(c) that incremental pricing will apply to certain imports, shall be made "in accordance with the procedures applicable to the granting of any authority under the Natural Gas Act," thus referring to § 3 of the NGA, 15 U.S.C. § 717b (1976). Section 3 of the NGA provides that the FERC, and now the Economic Regulatory Administration (ERA), pursuant to Delegation Order Nos. 0204-54 and 0204-55 of the Secretary of Energy, 44 Fed. Reg. 56,735-36 (1979), may by order grant an import application: "with such modifications and upon such terms and conditions as the Commission may find necessary or appropriate, and may from time to time, after opportunity for hearing, and for good cause shown, make such supplemental order in the premises as it may find necessary or appropriate." In this respect, § 3 of the NGPA has been interpreted to allow the FERC to revise existing authorizations and impose additional conditions on import authorizations previously issued. *See* *Distrigas Corp. v. FPC*, 495 F.2d 2057 (D.C. Cir. 1974). Consequently, if an import authorization has been issued and further authorization is not sought, the FERC or the ERA may decide that a supplemental order requiring incremental pricing is "necessary or appropriate," in exercising the discretion granted in § 207 (c), 15 U.S.C. § 3347(c) (Supp. II 1978).

Of note with respect to § 207(c) of the NGPA is the following colloquy between Senators Dominici and Jackson concerning the impact of this provision on LNG imports:

MR. DOMENICI. Section 207(c) recognizes the existing authority of the Department of Energy or the Commission under the Natural Gas Act to determine whether to incrementally price the LNG imports of these projects at the time that authority is granted.

It is my understanding that this provision is neutral as to whether incremental pricing is appropriate and in no way is a mandate to the Department of Energy or the Commission to impose incremental pricing.

MR. JACKSON. The Senator's understanding of the provision is correct.

MR. DOMENICI. One last question: In the event a determination is made under the Natural Gas Act to incrementally price the LNG imports of the pending projects, it is my understanding that the amount to be incrementally priced must be in accordance with section 203(a)(4) and that the incremental pricing has to be implemented under the legislation.

MR. JACKSON. The Senator's understanding is correct.

124 CONG. REC. S16236 (daily ed. Sept. 27, 1978) (remarks of Senators Domenici and Jackson).

ries, surcharges, rulemakings,¹⁹⁷ and congressional vetoes. The legislative

197. On September 28, 1979, the FERC issued Order No. 49 setting forth final rules implementing a portion of Phase I of incremental pricing. 44 Fed. Reg. 57,726-54 (1979). In brief, Order No. 49 established the regulatory framework for the calculation and billing of incremental pricing surcharges to non-exempt boiler fuel facilities. The FERC also adopted an incremental pricing passthrough mechanism based on a "reduced" purchased gas adjustment (PGA) charge to all nonexempt industrial boiler fuel users based on (1) actual gas usage; (2) the applicable alternative fuel cost ceiling; and (3) the customer's monthly maximum surcharge absorption capability (MSAC).

The MSAC is the key element of the surcharge passthrough mechanism. In simplest terms, it is the total difference between the cost of gas to a facility and the incremental pricing ceiling applicable to the facility; that is, the total incremental costs the facility can absorb before its price of gas rises above the applicable ceiling. The reduced PGA then forms the basis of the PGA rate for all customers on a pipeline's system, with non-exempt industrial customers billed on the basis of this reduced PGA rate, plus an incremental pricing surcharge. Order No. 49 required that natural gas suppliers commence booking incremental gas costs on January 1, 1980, and that billing for surcharges for nonexempt users begin during January 1980.

On September 28, 1979, the FERC also issued, as part of phase I, Order No. 50. 44 Fed. Reg. 57,754-77 (1979). This order established a three-tier system of alternative fuel cost ceilings for computing the capacity of nonexempt industrial boiler fuel users to absorb gas acquisition costs subject to incremental pricing. Under the three-tier rule, alternative fuel cost ceilings will be published monthly for No. 2 fuel oil, high sulfur No. 6 fuel oil and low sulfur No. 6 fuel oil in 31 large metropolitan areas and each of the lower 48 states. The ceiling applicable to a particular user will be determined by the fuel which that user has the installed capacity and legal authorization to burn. In the event an industrial facility cannot use an alternative fuel, the highest fuel cost ceiling will apply. The three-tier system is designed to maximize the passthrough of incrementally priced gas acquisition costs while minimizing the possibility of load shifts. However, as a result of uncertainty concerning the impact and administrative complexity of the three-tier system, the FERC concurrently issued Order No. 51, 44 Fed. Reg. 57,778-89 (1979), which proposed to exempt industrial boiler fuel users from the higher No. 2 and low sulfur No. 6 alternative fuel ceiling prices until November 1, 1980. Order No. 51 was transmitted for congressional review pursuant to § 206(d), 15 U.S.C. § 3346 (Supp. II 1978). The review period expired on November 10, 1979, and Order No. 51 became effective since a resolution of disapproval was not passed by either House of Congress.

On May 6, 1980, the FERC submitted its Phase II rule to Congress, 45 Fed. Reg. 31,622-80 (1980), as required by § 202 of the NGPA. 15 U.S.C. § 3342 (Supp. II 1978). The Phase II rule would extend incremental pricing to all industrial users of natural gas except those specifically exempted under § 206, *id.* § 3346. Section 202(c) provides that the Phase II rule is subject to veto by either House of Congress within 30 days of continuous session. 15 U.S.C. § 3342(c). On May 20, 1980, the house voted 369-34 in favor of a resolution (H. Res. 655) to disapprove the FERC's Phase II rule, thereby restricting incremental pricing to industrial boiler fuel users. 126 CONG. REC. H3855 (May 20, 1980).

The Commission has proposed or promulgated numerous other rulemakings with respect to incremental pricing, including proposed rulemakings which would provide for: (1) state-wide rulemaking exemptions from incremental pricing, Doc. No. RM78-47, 45 Fed. Reg. 1081-84 (1980); (2) extending the category of exempt agricultural users, Doc. No. RM80-28, 45 Fed. Reg. 15,563-66 (1980); (3) permanent exemption of small boiler fuel facilities (under 300 Mcf/day) that have or will come into existence after November 9, 1978, Doc. No. RM79-48, 44 Fed. Reg. 57,783-88 (1979); and (4) permanent exemption of exempt small

objective of sheltering certain consumers from higher natural gas prices may be laudatory but the means employed by Title II to accomplish this goal are complex in theory and confusing in application.

IV. THE IMPACT OF INCREMENTAL PRICING

It is the highest impertinence and presumption . . . in kings and ministers, to pretend to watch over the economy of private people If their own extravagance does not ruin the state, that of their subjects never will.¹⁹⁸

There is presently no empirical evidence, tested by adjudication, demonstrating either the folly or the merit of Title II incremental pricing.¹⁹⁹ One congressman recently stated that incremental pricing will have a "beneficial effect"²⁰⁰ because it: is "an essential substitute for wellhead price controls as a wellhead market ordering device;"²⁰¹ "protects residential gas users from initial wellhead price increases;"²⁰² and "will not drive industry off natural gas."²⁰³ In contrast, the debate preceding the passage of the NGPA reveals that several legislators believed that incremental pricing was inequitable because it would apply only to the passthrough of certain gas acquisition costs to industrial facilities that are "served by an interstate pipeline,"²⁰⁴ and those "served by a local distribution company that is

boiler fuel users in existence as of November 9, 1978, as required by § 206(a)(2), 15 U.S.C. § 3346(a)(2).

198. A. SMITH, *THE WEALTH OF NATIONS* 329 (1937).

199. See *A New Wharton Study May Prove That Dropping Title II Would Benefit Residents* in *INSIDE F.E.R.C.*, Dec. 24, 1979, at 11, which commented:

Rep. Richardson Preyer argued that incremental pricing will "actually result in higher costs for all consumers," even though incremental pricing "is intended to protect residential gas users from inflated energy prices." Preyer disclosed that Wharton Econometric Forecasting Associates is conducting an analysis that will compare the inflationary impact of straight rolled-in pricing with the program outlined in Title II. "Based upon both common sense and the economic analysis conducted to date, I can speculate that the results will not be supportive of incremental pricing," Preyer said in his statement. The Wharton study is a follow-up to a study commissioned by the American Gas Ass'n to gauge the impact of a broad second phase of incremental pricing compared with the first phase effort now being put into place. Preyer cited the results of that study, which concludes that a worst case second phase would drop the Gross National Product by an aggregate \$22 billion by 1989 (1979 Dollars) as well as increase unemployment by 600,000 workers, compared with phase I. FERC proposed last month the kind of broadly based incremental pricing program that was the subject of the Wharton study.

200. 126 CONG. REC. E59 (daily ed. Jan. 23, 1980) (remarks of Rep. Dingell).

201. *Id.* at E60.

202. *Id.*

203. *Id.*

204. See 15 U.S.C. § 3341(a)(2) (Supp. II 1978).

served by an interstate pipeline.”²⁰⁵ As a consequence, competitive disadvantages and economic favoritism could result.²⁰⁶ Senator Hollins commented:

The bill is bad because it will hurt industry and cost jobs in the consuming States since the bill imposes incremental pricing on industry in consuming States but not on industry in producing States. An industry's gas costs will be lower in the producing States. Industry and the jobs it provides will be drawn from the consuming to the producing States.²⁰⁷

Representative Coughlin was more explicit:

The cockeyed direction of this legislation is evidenced even more in the incremental pricing provisions which could, figuratively and literally, produce disaster in consuming States such as Pennsylvania. Industrial users in producing States could buy natural gas at lower prices than industrial users in other States. This is the opposite of today's pricing mechanism. To attempt to cure this by the provisions drafted in this bill may help kill off more industry in the beleaguered Northeastern States. It is encouraging industries to relocate to producing States to take advantage of lower gas prices. As a Congressman from Pennsylvania, I find this to be particularly bad practice. I can understand the need for equity, but I cannot understand this blatant discrimination.²⁰⁸

In addition to the foregoing problems, it can be assumed that the Congress was also aware of the potentially adverse economic impact of Title II incremental pricing.²⁰⁹

205. The term “interstate pipeline” for incremental pricing purposes refers to pipelines that are subject to the FERC's jurisdiction under the Natural Gas Act. Moreover, for purposes of incremental pricing, “Hinshaw” pipelines, which are exempt from FERC jurisdiction under § 1(c) of the Natural Gas Act, will be treated as local distribution companies, to the extent they are served by an interstate pipeline. See CONFERENCE REPORT, *supra* note 77, at 96.

206. See 124 CONG. REC. H13129 (daily ed. Oct. 14, 1978) (remarks of Rep. Stockman).

207. *Id.* at S16233 (daily ed. Sept. 27, 1978) (remarks of Sen. Hollings). Representative Edwards from Oklahoma, a major natural gas producing state, expressed a similar concern:

Incremental pricing applies only to the interstate gas system, and therefore will result in great inequities among regions and among customers, because pipelines that have large numbers of residential customers [or] small numbers of industrial customers will have to pass these higher costs directly on to residential customers.

Id. at H13125 (daily ed. Oct. 14, 1978). Representative Anderson stated in debate on the same day that “several interstate pipelines are making plans already to deal with the movement of industry from their service industries [*sic*] because of incremental pricing” and that a distribution company in his district “foresees large employers shifting production or new expansion to gas-producing States where incremental pricing is not required by the legislation.” *Id.* at H13125-13126 (remarks of Rep. Anderson).

208. 124 CONG. REC. H13147 (daily ed. Oct. 14, 1978) (remarks of Rep. Coughlin).

209. An economic analysis accompanying the NGPA prepared by a House subcommit-

Notwithstanding the present absence of judicial review, Title II incremental pricing can be subjected to analysis. Essentially, it is our assessment that the rate design mandated by Title II of the NGPA is unsound economic policy, contrary to important national and social objectives, and will not accomplish the intended objectives.

This article has observed that Title II incremental pricing is simply a rate design methodology which shifts a "cost" to one category of a pipeline's consumers (industrials) in order to subsidize another category of consumers (residential). Such a rate design methodology is not inherently wrong or undesirable. To the contrary, it is in theory politically attractive. However, Title II incremental pricing loses whatever virtue it may possess because it does not shift a true cost of the pipeline. Instead, Title II allocates a "cost" to industrial consumers based upon another commodity, the ever increasing cost of OPEC priced fuel oil. Thus, the subsidy to the residential market bears little relation to the true cost of natural gas consumed by those individuals.

Our criticism of Title II incremental pricing is not that of a purist who believes that public utility rates must only be cost-based but that of one who is aware of the skyrocketing price of oil.²¹⁰ As a consequence, the subsidy to be paid by the industrial market is potentially enormous. Since the industrial market will pay substantially more for its energy inputs, there will be increases in the cost of virtually all goods produced in this country. Such increases will be translated into higher consumer prices and further inflation.²¹¹ They may also result in competitive disadvantages among industrial users both here and abroad.²¹²

In addition to its direct adverse economic impact on the industrial market, higher consumer prices, and inflation, Title II incremental pricing will: result in discrimination; produce an undesirable "camouflaging effect"; and be contrary to our goal of conserving energy. These three impacts can be predicted because, first, Title II incremental pricing only shields or subsidizes residential users of natural gas. A home or apartment using fuel oil

tee concluded that the projected cost under Phase II incremental pricing to nonexempt industrial users in 1985 would be \$4.00 per MMBtu. If only the Phase I rule were applicable, the analysis projected that the cost to nonexempt industrial users would be \$5.60 per MMBtu in 1985. See ECONOMIC ANALYSIS, *supra* note 90, at 18.

210. See note 14 *supra*.

211. See note 11 *supra*.

212. Since Title II incremental pricing does not apply to sales of natural gas from intrastate sources, a manufacturer buying from such a source may have an economic advantage over a competitor who buys from an interstate source that is subject to Title II incremental pricing.

receives no subsidy.²¹³ Second, Title II incremental pricing camouflages costs to the consumer. Although his natural gas bill may be slightly lower, the cost of all goods that he purchased will be higher because the increased energy cost to the industrial sector will be passed through and multiplied through the production and distribution chain. Finally, Title II incremental pricing will also provide a disincentive for conservation by the residential market. Since for certain consumers, the cost of natural gas will not be increasing (or may even remain stable) as compared with the cost of all other goods or even their neighbor's fuel oil costs, there is little incentive to conserve the natural gas.

The foregoing criticism of Title II incremental pricing is only partially complete because it is predicated on the assumption that the industrial market is locked into using only natural gas and will not leave the pipeline systems. This assumption, in our view, is not fully valid. It can reasonably be anticipated that industrial users will abandon interstate pipeline systems and either switch to alternative fuels (the price of which, unlike natural gas, is negotiable) or relocate their plants to take advantage of intrastate gas sources. If this occurs, the fixed and increasing purchased gas costs of the interstate pipeline companies will have to be borne by their remaining customers: the residential market. Thus, the consumers sought to be protected by Title II incremental pricing will be forced to pay higher prices for natural gas. This clearly will frustrate one of the primary objectives of Title II of the NGPA.

In sum, Congress will have erred if it does not take steps to defer or repeal Title II incremental pricing.²¹⁴ Such a rate design methodology may have been reasonable when the price of oil was approximately one-third of its current price.²¹⁵ However, in today's energy market, Congress should require all the costs of all forms of energy to be based upon market conditions. To do otherwise would be contrary to national production and salutary social objectives.

V. CONCLUSION

The 1970's were particularly unkind to American consumers of fuels and power, but those years were only a prologue: the 1980's

213. Since § 206(c)(2) of the NGPA, 15 U.S.C. § 3346(c)(2) (Supp. II 1978), does not apply to "the generation of electricity by any electric utility," residential users of electricity also are subsidized.

214. Under subsection 202(c)(1) & (2) of the NGPA, 15 U.S.C. 3342(c)(1) & (2) (Supp. II 1978), Congress has the opportunity to review and disapprove FERC action dealing with Phase II incremental pricing.

215. See note 14, *supra*.

will be by far harsher. Indeed, the crossover into a world of permanent petroleum shortages, once predicted to occur in the mid-to late-1980's, is now at hand, foreshadowing oil-driven economic crises, social unrest and the growing possibility of military action — the time-honored remedy of nations whose peacetime policies have failed.²¹⁶

It is readily apparent that the energy future for the United States is grim. One expert has predicted that by the year 2000 we must increase our energy sources by forty percent just to maintain our present standard of living.²¹⁷

Against this prospect of significant imbalances in the consumption and production of non-renewable fossil fuels, Phase II incremental pricing will produce undesirable results that will undermine principles of public utility ratemaking, and exacerbate our natural gas and petroleum fuels crisis. The solution is legislative. It is urged, therefore, that Congress review Title II of the NGPA and determine that the factual predicates of stable and relatively low oil prices,²¹⁸ which existed when the NGPA became law, no longer exist. Instead, we are and will continue to be confronted with oil supply disruptions and continuing price increases. Thus, Title II of the NGPA is bad law since it forces undesirable patterns of energy consumption.

Mindful of Mr. Justice Holmes' observation that "[g]eneral propositions do not decide concrete cases,"²¹⁹ Congress should eschew the legislation of rate design methodologies to accomplish political objectives. Moreover, Congress should not mandate that the FERC adopt a "hard and fast rule"²²⁰ when its experience is based upon insufficient knowledge of the regulatory impact.²²¹ Instead, Congress should reevaluate Title II incremental pricing, and should repeal this provision of the NGPA in view of current and projected impacts and realities.

216. O'Leary, *Wash. Post*, Jan. 22, 1980, § A, at 19, col. 2.

217. Berstein, *Profiles*, *THE NEW YORKER* 49, 50 (Dec. 17, 1979).

218. *See* note 14 *supra*.

219. *Lochner v. New York*, 198 U.S. 45, 76 (1905) (Holmes, J., dissenting).

220. *See Securities and Exchange Comm'n v. Chenery Corp.*, 332 U.S. 194, 202 (1947).

221. *See North Carolina v. Federal Energy Regulatory Comm'n*, 584 F.2d 1003, 1012-15 (D.C. Cir. 1978).