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NATURAL GAS PRICES:

A PROPOSED COMPROMISE SOLUTION

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Background - The Current Dispute

The dispute between proponents and opponents of natural gas price deregulation centers around two seemingly irreconcilable differences: (1) the impact of unrestrained market prices on supply, demand, consumer costs and producer profits; and (2) the allocation of declining supplies between the interstate and intrastate markets.

As to the first, the advocates of decontrol argue that the existing gas shortage was caused largely by twenty years of regulatory constraints on interstate gas prices which have kept them for at least the last 12 years below their real market value. The only way to correct this situation, they argue, is to let prices for newly found gas, or for all gas upon expiration of existing contracts, rise to their true market level. This would curtail demand and stimulate the search for supplies, thus reversing the growing gap between the two.

Opponents to deregulation argue that an increase in new gas prices to market levels would have very little impact on supplies, since existing and proposed controlled prices ($1.45 and $1.75 per Mcf, respectively) provide sufficient incentives to search for gas. Yet, since decontrolled new gas supplies would initially represent only small increments to existing controlled old gas supplies, many buyers would be willing to offer very high prices for these increments which they could roll in with their much lower-cost old supplies to obtain an average price well below the cost of the new gas. This, it is argued, would raise the market price for new gas for some time well above its long-term equilibrium price and give producers windfall profits. In the intrastate vs. interstate gas controversy, deregulation advocates argue that a policy which has proved such a demonstrable failure in the interstate market should not now be extended to the one market where price has been determined by competitive forces and which has therefore not suffered the distortions and consequent shortages of the interstate market. Furthermore, rolling back existing intrastate prices for new gas, which the proposals for intrastate control would do would be unfair to producers whose investment decisions to search for and develop this gas were based on the assumption of continued free market prices.

Proponents for extending price controls to the intrastate market point out that as a consequence of the higher intrastate prices 80-90% of all gas found in areas under state jurisdiction in the last several years has stayed there, thus contributing substantially to the growing shortage in the gas deficit states. They see the extension of controls to intrastate markets as necessary to give interstate buyers equal access with intrastate buyers to this increasingly scarce resource. If this were done through deregulation, they argue, it would raise the price of both interstate and intrastate gas substantially, given the large unmet demand (actual and potential) in the interstate market.

The Proposed Compromise Price

All of the above arguments have some validity and all have considerable partisan support. The question is whether a compromise can be reached which is logically justifiable on economic and equity grounds and thus could provide a more permanent solution of the dispute than any arbitrarily selected price whose only purpose would be to mollify the opposition of the moment for voting purposes. Such a solution would have to be based on a long-term supply price determined by demonstrable competitive factors; it would have to include built-in assurances against excessive short term price increases; and it would have to put interstate and intrastate buyers on the same basis but not let them outbid each other for new supplies.

We believe a price incorporating all these features exists now: the intrastate price for new gas and for renegotiated gas. The FPC has been publishing both prices periodically for the past 2 1/2 years, so we know their movements and will continue to do so. Hence, if the ceiling on interstate prices for new gas were to be the published intrastate prices for such gas, after some adjustments, and if interstate buyers were given access to renegotiated old intrastate gas on the same terms as intrastate buyers, this would establish an economically justifiable as well as equitable basis for pricing newly available gas in the interstate market.

Interstate Prices for New Gas

Let us look first at new gas prices. Table I on the following page gives the quarterly national average prices for new intrastate contracts for one year or longer, as computed by the Federal Power Commission for the latest 18 month period.

Table I

NEW CONTRACT PRICES FOR INTRASTATE GAS
¢/Mcf

	U.S. Average	Range	% Sold For $1.00 or Less
1st Q 1976	154.80	212.80-31.61	6.5
2nd Q 1976	158.80	216.08-14.55	2.6
3rd Q 1976	143.42	216.78-40.22	11.4
4th Q 1976	180.41	233.00-46.25	0.0
1st Q 1977	183.66	239.00-19.41	1.4
2nd Q 1977	183.06	224.00-31.89	2.6

The figures show changes in both directions but an overall upward movement of 18% from the beginning to the end of the period. This would correspond to an increase of slightly below 1% a month, substantially less than the increase in controlled interstate prices. The range between the highest and the lowest prices shown is very wide but the weight of the low range figures is obviously far less than that of the high range ones in determining the average. It would appear that most of these prices are determined by arms-length bargaining between buyers and sellers in an adequately supplied market with price elasticities on both the supply and the demand side.

There are some exceptions, though, primarily at the low end of the price range. Clearly, any sale of new gas for $1.00 or less per Mcf in today's market does not reflect market value but some special non-competitive circumstances such as intra-company transfer prices or physical inaccessibility to alternate buyers. Thus, if interstate gas prices for new supplies are to be based on average new intrastate prices, the lowest of these prices should be excluded in computing the average, since they are not determined by competitive factors or forces. As is shown in Table I, new contract sales for $1.00/Mcf or less amounted to only a small fraction of the total, except for the third quarter of 1976 when the national average price dropped sharply because of the relatively high volume of such sales. For the period as a whole, average prices would be several cents/Mcf higher if all such sales were excluded.

In addition to intra-fuel competition (competition between gas sellers), the intrastate gas price is also significantly affected by inter-fuels competition. The latter exists primarily in Texas and Louisiana which together account for about 70% of U.S. gas production and close to 80% of interstate gas sales. In both states nearly 90% of all gas is consumed in industrial and power plants. The majority of these plants has actual or potential access to residual fuel oil from local refineries as an alternate fuel source. The sharp increase in residual fuel oil consumption in both states in recent years is evidence of the growing dual fuel capability of the natural gas consumers in the two states. A comparison of the latest (April-June 1977) intrastate wellhead prices for new gas contracts in these states with spot prices for low-sulfur (0.7%) residual fuel oil at the Gulf Coast during the same period shows the value of the two fuels to be closely related. On a Btu equivalent basis the residual fuel oil price was about $1.95 per million Btu while the gas prices averaged $1.96 in Louisiana and $2.05 in Texas per million Btu. This proximity of fuel oil prices and new intrastate gas prices in the two states has existed throughout most of the period since 1975. Thus, new intrastate gas prices in the principal gas exporting states are kept competitive both by the availability of additional gas supplies and through competition with other fuels. If these prices were to be adopted as the ceiling prices for new interstate gas sales, the same competitive price limitations would be extended to the interstate market. On-shore producers of new gas would not receive windfall profits but would merely be made indifferent to intrastate vs. interstate contract sales, since both could command the same price. Access of interstate buyers to this market on the same terms as intrastate buyers might raise the intrastate price somewhat but not significantly, because interstate buyers could never outbid intrastate buyers and because of the competitive ceiling provided by residual fuel oil at the Gulf Coast.

Gas producers in the Outer Continental Shelf (OCS) where prices are under federal jurisdiction and all sales are considered interstate would benefit somewhat from our proposed ceiling price which would be higher than the Administration's proposed new interstate gas price ($1.75/Mcf). Yet, since offshore production is more costly and risky than onshore production, the increased benefits to this producer segment could be justified.

A more important difference is that the Administration's proposed ceiling is yet another fixed price adjusted only for extraneous changes to the gas market itself and thus is no more likely to end the arguments for price adjustments than the existing or previous ceiling. The intrastate price as a ceiling, by contrast, would reflect real market conditions at any given moment and relate the value of gas to that of directly competitive fuels. It would be much more difficult to dismiss such a market-responsive price as irrelevant at some later date than any arbitrarily selected one. It should be pointed in this connection that our proposal for new interstate gas prices is not intended to apply to that type of new gas which under the Administration's proposal would receive unregulated prices because of unconventional sources or costs.

Interstate Access To Old Intrastate Gas
Upon Contract Expiration

In addition to new gas a substantial volume of old gas becomes available in the intrastate market each year as a result of contract expiration. In the 12 months ending June 30, 1977, expiring intrastate contracts for about 460 billion cubic feet of old gas, equal to 2.3% of total U.S. consumption, were renegotiated or amended, generally at prices fairly close to those for new intrastate gas (see Table II below).

Table II

RENEGOTIATED OR AMENDED CONTRACTS FOR INTRASTATE GAS
¢/Mcf

	U.S. Average	Range	% Sold For $1.00 or Less
1st Q 1976	178.03	220.94-25.32	12.0
2nd Q 1976	165.62	223.91-16.10	12.5
3rd Q 1976	163.29	229.39-20.11	6.5
4th Q 1976	165.52	217.11-47.66	8.8
1st Q 1977	177.78	235.27-34.23	9.4
2nd Q 1977	194.09	239.00-29.50	1.0

Source: FPC

Under present regulations, or those proposed by the Administration, interstate buyers can not bid for this gas since they cannot match the offers of intrastate buyers. We propose that interstate buyers be permitted to offer as much as the intrastate buyer in bidding for this gas. This could be accomplished by putting a ceiling on such bids from interstate buyers, equal to the average state, regional or national (whichever the regulation specifies) intrastate price for renegotiated gas, as published periodically by the FPC. Again, contracts calling for sales at $1.00 or less per Mcf should be excluded in computing the average, for the reasons explained in the previous section.

Such a widening of the interstate market, which would not require extension of controls to the intrastate market, would not give any significant additional benefits to intrastate producers but, would merely render them indifferent to intrastate vs. interstate contract offers. It would increase the cost to interstate consumers only for gas which at a lower price would not be available to them. The price would of course be considerably less than most other supplementary gas sources such as imported gas or synthetic gas.

Our proposal would not affect the price of renegotiated, or "rolled-over", old gas currently selling in the interstate market and is thus not meant as a substitute for the Administration's proposal to raise the price for such gas to $1.45/Mcf upon contract expirations.