INTERSTATE: NATURAL GAS SUPPLIES
H. R. 9464 (HOS)

SMITH, NEAL

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FACT SHEET

INDEPENDENT PRODUCER DEREGULATION
PROPOSAL OF NEAL SMITH (D-IOWA)

An "independent producer" is defined as a person whose total marketed production of natural gas (including the total marketed production of any affiliate) does not exceed 100 million Mcf per year. The 100 million Mcf dividing line excludes the largest 20-25 natural gas producers, along with their producing affiliates and the affiliates of pipeline and distribution companies, from the category of independent producers.

Deregulation of independent producers under this definition would result in continued Federal regulation, based upon new regulatory standards, including prospective costs and incentives to encourage increased exploration and development, especially of high-cost areas and deeper reservoirs, of 70 to 75% of interstate natural gas production. Natural gas production of the approximately 3,500 to 7,000 independent producers who control approximately 25 to 30% of the natural gas supplied to the interstate market would be exempted from the Federal price regulation.

Although the "majors" control only 70% of production, concerns have arisen regarding the competitive impact of deregulation because the concentration of new natural gas reserve additions in the very largest firms, the top 8 producers, in specific areas have exceeded 95% of the reserve additions in the area. This indicates that the future trend of natural gas production is likely to be toward greater concentration and greater oligopoly power because the very greatest firms are controlling on an increasing basis the new reserves from which future production will come.

Testimony by independent producers has indicated that independent producer activities are significant with respect to exploration for new natural gas supplies onshore. However, the major natural gas producers dominate almost totally Outer Continental Shelf exploration and development. Unfortunately, U.S. Geological Survey projections of future discoverable domestic natural gas resources indicate that the great bulk of undiscovered natural gas resources are located on the Outer Continental Shelf.

The Federal Energy Administration in the Natural Gas Deregulation Analysis Technical Report (FEA 76-3), dated January 23, 1976, indicates that natural gas production from the Outer Continental Shelf during at least the next decade is not responsive to price increases because constraints on increased production not related to price limit the capability of Outer Continental Shelf production to respond to price increases. These non-price constraints include the rate of Federal leasing, environmental constraints on OCS development, etc. This factor, the long lead times involved in development of OCS lands as well as the unique character of OCS as a public resource for which the Federal government is trustee is implicitly recognized in the Krueger proposal as the basis for continued regulation of OCS production for the next 5 years.

The distinction made between onshore and offshore production by the Krueger proposal is, however, both unworkable and anti-competitive. The present division between interstate and intrastate markets has resulted in the division of new natural gas supplies to the unregulated intrastate market. Similarly, regulation of only the offhsore would be likely to result in a diversion of exploration and development efforts and investment in natural gas production from the OCS to onshore prospects. Such a diversion would be counter-productive to encouraging exploration and development of those regions which hold the greatest prospects for substantial supplies of new natural gas. In addition, the onshore-offshore distinction would discourage the increased participation by independent producers in development of the OCS.

A distinction drawn upon the difference in size of producers, i.e., continuing regulation for the majors and deregulating production by independent producers would have substantial pro-competitive impacts. The major oil companies are committed to a certain level of exploration and development which will continue under modified regulation. Indeed, to the extent that Federal regulation uses prospective costs and permits incentives to encourage expanded exploration and development the exploration and development efforts of the major natural gas producers on the OCS are likely to be increased. It should be remembered that the investment decisions of the major natural gas producers are to a large measure characterized by utility-type decision-making. Therefore, continued regulation of the major producers would not produce incentives to their abandoning the OCS in favor of an unregulated onshore.

Deregulation of independent producers would focus the incentive for expanded exploration for hard-to-find supplies of onshore natural gas on the class of producers who have traditionally played the more significant role in development of those onshore supplies. Deregulation of independent producers might enable independents to increase in size and thereby increase their ability to compete with major producers. Deregulation of independent producers would provide independents with a new source of capital not otherwise available to them. In this respect, major producers enjoy access to capital from other sources unavailable to independent producers, and, therefore, the continued regulation of major producers is not a significant limitation on their ability to attract the capital necessary for natural gas exploration and development. Finally, deregulation of independent producers would encourage and expand participation in OCS development.

Deregulation of the independent producers would have significant administrative and regulatory benefits. By limiting regulation to the largest 20-25 producers the burden of the Federal Power Commission would be greatly reduced. The major producers have similar costs; incur similar risks; enjoy similar diversification, which tends to reduce their risks; possess similar corporate structure; and have like capital requirements. Therefore, continued regulation of only the 20-25 largest producers would reduce the number of regulated producers to a level which could be regulated on a more rational and responsive basis than is currently possible, while retaining price surveillance over the bulk of the natural gas supply.

Any legislation which segregates similar persons into two classes is subject to charges of discrimination or unfair treatment, unless the classification is reasonable. McLaughlin v. State of Florida 379 U.S. 184, 191 (1964). However, there can be no doubt of Congressional authority to enact legislation necessary to regulate the interstate natural gas industry, pursuant to the commerce clause. F.P.C. v. Natural Gas Pipeline Co. 315 U.S. 575, 582 (1942). Furthermore, this authority to regulate interstate and foreign commerce is complete in itself and may be exercised to its utmost extent. There is no requirement that the classes created by Congress in exercise of its commerce clause powers must be uniform. Currin v. Wallace 306 U.S. 1, 13-14 (1939), Sunshine Anthracite Coal Co. v. Adkins 310 U.S. 381, 401 (1940). The courts give to Congress the widest possible discretion in choosing which aspects of a problem to regulate and which ones to exempt. On judicial review, Congressional classification is given the benefit of every conceivable circumstance which might suffice to characterize it as reasonable rather than arbitrary and invidious. McLaughlin v. State of Florida, supra.

The exemption of small producers is not vulnerable to the charge that it is "arbitrary", for there is substantial justification for such an exemption. Regulatory distinctions between large and small producers have been approved even without specific legislation. As the Court of Appeals said, while overturning Order No. 428, Texaco v. F.P.C. 474 F.2d 416, 430-431 (D.C. Cir., 1972), reviewed and remanded No. 72-1490 (slip opinion issued June 10, 1974):

> "All this is not to say that a proper regulatory determination, within the letter and spirit of the Natural Gas Act, could not set a just and reasonable rate for small producers higher than that for large producers. Given the special problems and practices of small producers, such a result is certainly conceivable."

The justification for such a distinction having already been judicially noticed, the proposed legislative classification stands little chance of being deemed so arbitrary as to be violative of due process. See also F.P.C. v. Hunt 376 U.S. 515 (1964).

Further, one of the basic purposes of the proposed legislation is to induce more competition in the oil and gas industry. The Department of Justice and the courts have always looked upon fringe competitors as being of great importance in maintaining some competition in markets which are oligopolistic or otherwise heavily concentrated. The Supreme Court first recognized this fact in U.S. v. Aluminum Co. of America 377 US. 271 (1964). The Court felt that where an oligopoly develops:

> ". . .The greater is the likelihood that parallel policies of mutual advantage, not competition,

will emerge. That tendency may well be thwarted by the presence of small but significant competitors." (Emphasis supplied)

Thus, the Court has recognized the importance of small competitors, as a separate class, in the efforts to keep an industry competitive.

Thus, the courts have always strived to maintain the small, independent company, as a protected class, to be a competitive force in heavily concentrated industries. The role of this small competitor is highly important: to thwart tendencies toward mutual cooperation among the industry leaders.

Another line of cases deals with the horizontal mergers of firms with a relatively small market share in markets which are not highly concentrated, but which have a strong tendency toward concentration. These cases show the important role of the small company as a brake against concentration.

In conclusion, the Court has recognized two important roles for the small company:

(1) as a fringe competitor, thwarting the tendency toward cooperation among the industry leaders, and

(2) as a brake against concentration.

These are reasons for treating small companies as a separate, protected class in the efforts to preserve competitive markets that would justify the proposed legislation.

PROPOSAL OF NEAL SMITH (D-IOWA)
INDEPENDENT PRODUCER EXEMPTION
REGULATORY SIMPLIFICATION AND WORKABILITY

Regulation limited to large producers would have substantial administrative, procedural, and economic advantages over the present system of regulation. It would no longer be necessary for the Commission to base its cost findings on outside data, mainly unaudited statistics from industry sources. Instead, the Commission would be able to use data compiled from regular reports filed by the large producers and subject to audit by the Commission's staff. Having access to company records on drilling and other operating and capital costs and on reserves, the Commission could do a more effective job of rate regulation based on prospective costs including reasonable profits. Similarly, it would be feasible for the Commission to monitor the performance of the regulated companies and use its regulatory authority to stimulate improved performance, through incentive pricing.

The Commission would have the option of group ratemaking, individual company rate regulation, or a combination of the two. Group ratemaking for large producers would not have the infirmities of a national rate for all producers, such as the national rate recently established in Opinion No. 699. A group rate applied to large producers, each having geographically diversified operations and huge financial resources, is more equitable than a national rate applied to thousands of dissimilar companies, mostly very small operators with limited ability to spread their risks or withstand losses. If a group rate was established for large producers, the individual companies would each have an incentive to improve their efficiency over group average and, thus, earn more than average profits.

Under individual company rate regulation, the Commission would be able to evaluate each company's costs and return requirements and set rates which avoid unjustified windfalls. Careful consideration could be given to any special circumstances or requirements of individual companies. With 20 to 25 producers to regulate, the Commission's case load would be more manageable than the present Commission involvement in cumbersome and costly national rate rulemakings plus a steady flow of optional certificate, limited-term certificate, and special relief cases.

PROPOSAL OF NEAL SMITH (D-IOWA)
INDEPENDENT PRODUCER DEREGULATION
ECONOMIC AND COMPETITIVE CONSIDERATIONS

The gas producer market in the United States is dominated by a small number of very large companies. These control the bulk of the country's oil industry.

If "large producers" are defined as companies with annual production exceeding 100 million Mcf of gas, there were 24 companies of that size in 1972. These few companies accounted for 65.7 percent of total national production in that year, while the remaining gas producing companies, probably numbering over 5,000 companies, accounted for 34.3 percent. Continued regulation of the 24 "large producers," together with their affiliated companies and the producing divisions and subsidiaries of interstate pipelines, it is estimated would continue Federal regulation over 75.6% of total interstate natural gas production.

The market position of the very large oil and gas producing companies has become a matter of grave public concern during the recent period of supply shortages. All of them are involved in numerous joint drilling ventures, joint bidding consortia, lease farmouts, and other anti-competitive relationships which negate the incentives for price competition. As a result, they share a community of interest in avoiding interfirm rivalry to bring their products to the market at the lowest possible price. This proposal meets this problem, insofar as the interstate market for natural gas is concerned, by keeping the very large companies under a modified form of regulation.

To the extent that there is a potential for workable competition among gas producers, it is limited to the small producer sector of the market. While there are some who believe that the best way to inject more competition into the industry is to use the antitrust laws to break up the vertically integrated petroleum companies and prohibit joint ventures and similar anti-competitive arrangements, such a solution is, at best, a long-term remedy. A more promising approach for the immediate future is to take positive steps to strengthen the position of small producers so that they will be able to make inroads on the market share of the very large gas producers. This can be done by exempting small producers from price regulation.

In today's market, taking the small firms out from under price ceiling regulation will add substantially to their revenues, since the regulated prices of gas are below prevailing market prices. This will make more capital available to small producers and place them in a better position to expand their exploratory programs and acquire leases independently of large producers. They will also have the economic incentive of a higher price to accelerate their current drilling efforts and market the out put as early as possible. The prospect that next year's regulated prices will be higher than this year's will not influence their operations -- indeed, the unregulated market price on sales by small producers may prove to be higher in the short run than over the long term because of the huge backlog of unsatisfied demand at present. Furthermore, with greatly improved profit opportunities for small producers, many new entrants will be attracted to the industry. This will place added competitive pressure on the large producers to increase their production in order to protect their share of the market.