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Notes

Administrative Law—FPC v. Texaco: Congress, not the Court, Should Deregulate Natural Gas Producers

The Federal Power Commission is authorized by the Natural Gas Act\(^1\) to insure that rates charged for natural gas sold or transported in interstate commerce are "just and reasonable."\(^2\) In reviewing FPC rate regulations to determine if the test of "just and reasonable" has been met,\(^3\) courts have pursued a policy of flexibility based upon the assumption that a Commission order is a "product of expert judgment which carries a presumption of validity."\(^4\) Pursuant to this policy, the courts have sustained Commission ordered rates based upon a variety of formulas.\(^5\) When the Commission, however, prices gas on the basis of contract prices or upon the unregulated intrastate market price,\(^6\) conflicting judicial attitudes have emerged.\(^7\) The Court in FPC v. Texaco, Inc.\(^8\) finally defined the role that market price could play in rate determinations for producers. The Court rejected the standard of market price as the sole determinant of "just and reasonable" but stated that it could be a relevant factor in future rate considerations. Although the Court restricted the Commission’s use of market price, it did further the earlier policy of flexibility by approving for the first time a different method of rate regulation for small producers.\(^9\)

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2. Id. § 717c.
3. Commission orders are subject to initial review by a court of appeals of the United States, subject to final review by the Supreme Court. Id. § 717r(b).
5. See, e.g., id. (individual company cost-of-service method of regulation); Permian Basin Area Rate Cases, 390 U.S. 747 (1968) (area price approach).
6. It is estimated that there are some 30,000 domestic oil and gas producers. AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH, NATURAL GAS DEREGULATION LEGISLATION 15 (1973). The FPC has jurisdiction over producers involved in the sale or transportation of gas interstate. There are approximately 4,000 interstate producers. See note 17 infra. The sizeable intrastate market, consisting of the remainder of producers, is not regulated by the FPC. These intrastate producers currently account for almost 40% of the volume of gas produced. C. Hawkins, Structure of the Natural Gas Producing Industry, in REGULATION OF THE NATURAL GAS PRODUCING INDUSTRY 137, 156 (1972).
7. The Court in Permian Basin Area Rate Cases, 390 U.S. 747 (1968), concluded that the Commission could find in the future that market price would protect consumer interests; whereas the Court in FPC v. Sunray DX Oil Co., 391 U.S. 9, 25-26 (1968), stated that the Commission's use of market prices as the final measure of reasonableness would contradict the assumption of Congress that the market for natural gas is uncompetitive and requires regulation.
9. "A 'small producer' was defined as an independent producer, not affiliated with
FPC ORDER NO. 428 AND THE COURT'S DECISION

FPC v. Texaco resulted from FPC Order No. 428\(^\text{10}\) that exempted small producers of gas from direct rate regulation and allowed them to sell their gas at any price obtainable on the open market. Since large producer and pipeline companies purchase most of the gas produced by small producers, the Commission decided to review small producer prices for gas only at the large producer and pipeline level. Thus, small producer prices would be regulated, but only indirectly. Large producers and pipelines would have to justify the prices paid to small producers before these costs could be passed along to the consumer. If the prices paid by these companies to small producers were deemed excessive by the Commission, then large producer and pipeline companies would alone be responsible for absorbing the excesses. Small producer charges would never be subject to refunds to large producer or pipeline companies under the order. The Commission hoped that freeing small producers from direct rate regulation would result in greater exploration and increased supplies of natural gas.\(^\text{11}\)

Large producer and pipeline companies objected to Order 428 arguing that allowing small producers to charge market prices, in effect deregulated the small producers in contravention of the Natural Gas Act.\(^\text{12}\) Large producer and pipeline companies sought judicial review of Order 428 in the District of Columbia Court of Appeals. That court, agreeing with the large producers, set aside the FPC order\(^\text{13}\) and the Commission appealed to the Supreme Court.

The Supreme Court vacated the Court of Appeals decision and upheld the method of indirect regulation provided in the order by stating that the Natural Gas Act calls for no specific method of regula-

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\(^{10}\) Texaco, Inc. v. FPC, 474 F.2d 416, 418 (D.C. Cir. 1972), rev'd, 417 U.S. 380 (1974). The major goal of Order 428 was to increase gas supplies. The natural gas shortage has been judicially recognized. See Louisiana Power & Light Co., 406 U.S. 621 (1972); Placid Oil Co. v. FPC, 483 F.2d 880 (5th Cir. 1973), aff'd sub nom. Mobil Oil Corp. v. FPC, 417 U.S. 283 (1974); Southern La. Area Rate Cases v. FPC, 428 F.2d 407 (5th Cir.), cert. denied, 400 U.S. 950 (1970).


\(^{13}\) Texaco, Inc. v. FPC, 474 F.2d 416 (D.C. Cir. 1972).
It remanded Order 428 to the Commission, however, with the instructions that, although market prices could be considered, they could not be the sole factor in determining whether the prices charged by small producers were "just and reasonable." The Court reasoned that allowing the Commission to rely solely on market prices would be tantamount to deregulation of small producers in contravention of Congress's mandate in the Natural Gas Act that gas prices be regulated. The Court felt bound by the congressional finding that the natural gas industry is not competitive and that prices charged by gas producers must be justified on a basis other than the unregulated market standard.

**COURT'S POLICY OF FLEXIBILITY**

The Commission and the courts have struggled with the regulation of interstate natural gas producers since the Supreme Court decided in *Phillips v. Wisconsin* that the FPC had jurisdiction over producers. *Phillips* added over 4000 producers to the regulatory burdens of the Commission. Since this decision, the Court has followed a policy of

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14. *FPC v. Texaco, Inc.*, 417 U.S. 380 (1974). Before the Supreme Court, the FPC joined by small producers argued that Order 428 was simply a new technique of regulating a segment of the industry and that the Natural Gas Act does not specify any method of regulation. They maintained that indirect regulation of small producers would spur exploration by these companies by eliminating cumbersome administrative filing requirements and direct review. Regarding the court of appeals decision that a market price standard for reviewing small producer rates resulted in deregulation in violation of the Natural Gas Act, the Commission and small producers advanced different arguments justifying the standard as expressed in Order 428. In its brief, the Commission maintained that the court of appeals misread Order 428. The Commission contended that the standard for review of small-producer charges in the order did not rest exclusively on market price. It argued that the order called for the consideration of "other relevant factors" in addition to market price. Small producers directly confronted the issue of a market price standard by stating that nothing in the Natural Gas Act requires regulation of all producer prices. They argued that, upon a determination by the Commission that market prices could effectively protect consumer interests (insure "just and reasonable" rates), such a standard is permissible under the Act. See *Brief for Petitioner at 18, Brief for the Small Producer Group as Amicus Curiae at 7 n.3, FPC v. Texaco, Inc.*, 417 U.S. 380 (1974).

15. The Court found that the standard upon which small producer charges would be reviewed was the market standard despite Commission attempts to explain that it would consider other relevant factors upon review. The Court stated that "we cannot accept appellate counsel's *post hoc* rationalizations for agency action. . . ." 417 U.S. at 397, quoting *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962).

16. 347 U.S. 672 (1954). This decision was based on language in the Natural Gas Act that the Court determined required submission of natural gas producers to regulation under the Act. The decision was not based on any congressional findings regarding the existence of a monopoly in the gas producing industry as there was in the 1930's when gas pipeline companies were initially subjected to FPC regulation under the Act. See *Note, Legislative History of the Natural Gas Act*, 44 GEO. L.J. 695, 721-23 (1956).

17. There are several different figures reported for the number of producers subject
flexibility towards Commission attempts to find a workable method of regulation. The Commission's first efforts to assure "just and reasonable" prices to consumers were based on an individual company, cost-of-service analysis. This method required Commission review of each individual gas producer for a determination of the proper rates it could charge based on its costs of operation. The Court in *FPC v. Hope Natural Gas Co.* had earlier sustained this method of regulation for pipelines by stating very simply that, so long as the result of the Commission's regulation is protection of consumer and investor interests, the program would be sustained.

The cost-of-service analysis proved to be very time consuming, however, and the Commission soon formulated a new method of regulation. It divided the country into five geographic regions and allowed producers within each region to charge prices that were based on the average costs of production within their particular area. This scheme greatly reduced the administrative burdens of the Commission although it did not effectively deal with small producers. The Court in *Permian Basin Area Rate Cases* sustained this new method of regulation continuing its earlier announced policy of flexibility in dealing with FPC regulation of producers. Nonetheless, it admonished the Commission to the Federal Power Commission's jurisdiction in 1954 when *Phillips* was decided. In 1955, Dr. John W. Boatwright, economist for Standard Oil Company of Indiana, testified that there were some 8,100 producers of natural gas in the United States. *Hearings on S. 712, S. 1248, S. 1853, S. 1880, S. 1926, & S. 2001 Before the Senate Committee on Interstate and Foreign Commerce*, 84th Cong., 1st Sess. 143-44 (1955). The figure of "over 4,000 producers" is reported in *American Enterprise Institute for Public Policy Research*, *supra* note 6, at 11.

18. E.g., cases cited note 5 supra.


21. "Under the statutory formula of 'just and reasonable' it is the result reached not the method employed which is controlling." *Id.* at 602.

22. By 1960 only ten cases of 2900 had been decided by the Commission. The *Phillips* case alone, for example, required eighty-two days of hearings. See Breyer & MacAvoy, *supra* note 19, at 952-54.

23. The five areas were: (1) The Permian Basin (Texas and part of New Mexico); (2) Southern Louisiana (including the offshore area in the Gulf of Mexico); (3) Hugoton-Anadarko (part of Oklahoma and Kansas); (4) Texas Gulf Coast; and (5) Other Southwest (Mississippi, Arkansas, and part of Alabama, Texas and Oklahoma). *Id.* at 958 n.65.

to deal with the problems of small producers in future rate proceedings.

The judicial policy of flexibility regarding Commission experiments in regulation has, however, not been consistently applied when the Commission has attempted to allow market price to determine "just and reasonable" rates. Several lower courts rejected market price in initial pricing proceedings under section 7 of the Act because there was no evidence introduced to support a finding that the unregulated price in the field, if adopted by a producer, would meet the test of "just and reasonable." There was, however, no holding in these cases that, if proof could be offered that the unregulated price would protect consumer interests, market price would not be sustained. Permian intimated that market price could be the sole determinative standard for area rates in the future so long as consumer and investor interests were protected. There is, however, one case, FPC v. Sunray DX Oil Co., that maintains in dicta that, even if evidence were introduced to support a finding that market price could protect consumer and investor interests, the Commission and the court could not allow use of such a scheme. The Court in Sunray stated that regulation based upon unregulated market prices would conflict with the congressional assumption expressed in the Natural Gas Act that the industry requires regulation because the market for natural gas is not competitive. According to the language in this case, the Commission could never justify the unregulated market price as a "just and reasonable" price and still comply with the Natural Gas Act.

FPC v. Texaco, Inc. followed the policy of flexibility expressed in earlier court reactions to FPC experiments in regulating producers. By sanctioning a scheme of indirect regulation, the Court indicated that it would allow the Commission not only to treat small producers differently in an attempt to encourage more gas production in a time of

25. See, e.g., United Gas Improvement Co. v. FPC, 290 F.2d 133 (5th Cir. 1961); Forest Oil Corp. v. FPC, 263 F.2d 622 (5th Cir. 1959). The Natural Gas Act requires that a company desiring to engage in the transportation or sale of natural gas, subject to the Commission's jurisdiction, obtain from the Commission a certificate of public convenience and necessity. 15 U.S.C. § 717f(c) (1970). Since the Court's decision in Atlantic Ref. Co. v. Public Serv. Comm'n, 360 U.S. 378 (1959), initial rates must be determined to be in the public interest prior to proceedings under section four of the Act, where the Commission finally sets the rate that meets the requirement of "just and reasonable." 15 U.S.C. § 717c (1970).

26. 390 U.S. at 795.


28. Id. at 25.

shortage, but also to place upon large producers and pipelines the burden of justifying in later proceedings the costs of small producer charges. The Court, relying on Hope, pointed out that the Natural Gas Act does not require any particular method of regulation.\textsuperscript{30} Indeed, the Court's inquiry is not focused upon the method utilized but upon whether that method ensures "just and reasonable" rates. The Court also pursued a policy of flexibility regarding the application of market price to the standard of "just and reasonable." It stated that market price should and would be an appropriate consideration in determining the standard of "just and reasonable" prices.\textsuperscript{31} But the Court refused to let market price be the sole determinant of this standard. Instead, it held that, so long as Congress intends to regulate the interstate natural gas industry, unregulated prices like those found in the intrastate market can never be the final measure of "just and reasonable" rates. The Court emphasized that, if the market has become competitive (as recent economic studies suggest), it is the responsibility of Congress to take steps towards deregulating the industry.\textsuperscript{32} Thus, the Court in Texaco pursued the policy of flexibility towards Commission regulatory experiments to the limits of congressional intent as expressed in the Natural Gas Act. This decision properly places upon Congress the obligation to respond to an alarming shortage of natural gas. Congress should now seriously consider deregulating the natural gas producing industry.

\textbf{AN ARGUMENT FOR CONGRESSIONAL DEREGULATION}

In determining whether deregulation is the appropriate response by Congress to the shortage of natural gas, the results of regulation under the Act and the present market structure of the gas producing industry must be examined. Initially, Congress sought to regulate the natural gas industry because it believed that major pipeline companies had monopolized the market and were exploiting consumers by charging excessive prices.\textsuperscript{33} The same rationale is applied to producers as

\textsuperscript{30} Id. at 391-92. See also Note, Public Utility Rate Regulation—Time for Reevaluation, 51 N.C.L. Rev. 1140 (1973).

\textsuperscript{31} Id. at 394-97. FPC v. Texaco has recently been cited for this holding in Moss v. FPC, 502 F.2d 461, 466 (D.C. Cir. 1974).

\textsuperscript{32} 417 U.S. at 400. The Court recognizes in a footnote that economists have found that the natural gas market has become competitive and that further regulation would prove counterproductive; however, the Court stipulates that it is bound by congressional intent. Id. at 400 n.9.

\textsuperscript{33} These congressional findings were based on a report by the FTC on the natural gas industry. F.T.C., Final Report, S. Doc. No. 92, 71st Cong., 1st Sess., pt. 84-A (1936).
a result of the Court's finding in Phillips that the Natural Gas Act includes the regulation of natural gas producers. Regulation of the industry was expected to reduce prices paid by consumers by eliminating windfall profits to producers. Congress's primary goal of lower consumer prices for natural gas has resulted from regulation. Yet, through cost-benefit analysis, economists conclude that the long term effect of regulation has not benefited the consumer because lower prices have had a negative impact on the supply of gas.

A study conducted by Professors Breyer and MacAvoy shows that producer regulation saved consumers about $660 million annually assuming that every cent of price reduction at the wellhead was passed through to the ultimate consumer. They maintain, however, that consumer losses far outweigh the benefits of lower prices. They contend, as have other economists, that FPC price regulation has been the major inhibitor of the supply of gas. Regulation has produced greater demand at lower prices, but lower prices have not produced the incentives necessary for exploration and development of gas reserves that are now more difficult and expensive to find. Breyer and MacAvoy conclude that the present federal regulation of natural gas imposes high costs on the interstate consumer by forcing him to purchase more expensive alternative fuels, reducing the dependability of his gas supply and subsidizing the industrial user of natural gas in intrastate markets.

With this evidence that regulation has not benefited the consumer, the more important question for Congress is whether increased supplies

34. See note 16 supra.
35. See, e.g., K. Brown, Introduction to Regulation of the Natural Gas Producing Industry 1 (1972); C. Hawkins, supra note 6, at 137; M. Russell, Producer Regulation for the 1970s, in Regulation of the Natural Gas Producing Industry 219 (1972); Breyer & MacAvoy, supra note 19, at 976-79.
36. Breyer & MacAvoy, supra note 19, at 980.
37. Breyer and MacAvoy report that due to lower regulated prices, the supply of natural gas was reduced. As a result of decreased supplies some consumers (usually those consumers in new or growing population centers) had to do without gas and find other more costly sources of energy, such as oil or electricity. In addition, Breyer and MacAvoy maintain that FPC ceiling prices resulted in the development of fewer gas reserves. This meant that consumers had to give up a substantial amount of their guarantee of future service. For example, gas reserves promise an availability of gas service for the consumer who has invested in gas appliances. Breyer and MacAvoy present data which estimates that at current ceiling prices additional gas reserves are being developed at less than half of anticipated consumer needs. Furthermore, they explain that most of the gas reserves now being discovered and developed are being sold in the intrastate market at higher prices. The major purchasers and consumers of intrastate gas are industrial users rather than residential consumers. Thus, the industrial user is more assured of gas supplies at the expense of the residential consumer whose supply normally comes through interstate sales. Id. at 977-84.
of gas would be forthcoming at acceptable prices absent regulation. Several recent economic studies show the market for natural gas to be at least workably competitive.\(^3\) Two principal indicia are traditionally used by economists to measure the degree of monopoly power (market power) contained within a specific industry: the ratio of concentration and barriers to entry of new gas producing groups. Breyer and MacAvoy report that FPC statistics show that in the early 1960's the largest gas producer accounted for less than ten percent, and the fifteen largest producers, for less than fifty percent of natural gas production.\(^5\) In the separate area markets, statistics indicate that the degree of production concentration is "lower than that in 75-85 percent of industries in manufactured products."\(^4\)

Another economist, Clark Hawkins, has reported similar findings.\(^4\) He found that the largest eight firms in the natural gas production industry account for 40% of all sales, while the rest of the market is relatively unconcentrated.\(^4\) He argues that the large unconcentrated sector could be considered a competitive constraint on the behavior of the largest eight firms. Regarding barriers to entry, the Hawkins study concludes that they are substantially less than in most manufacturing industries, except for possibly the risk factor.\(^4\) In addition to these studies by economists, at least one court\(^4\) and the Commission\(^4\) have concluded independently that the market for natural gas now appears to be competitive.

Since competitive forces should keep prices down while increasing supplies of gas, deregulation of the natural gas industry now appears to be the only realistic policy to elicit more supplies of gas.\(^4\) During the first year that Order 428 was in effect with small producer prices

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\(^3\) See authorities cited note 35 supra.
\(^4\) Breyer & MacAvoy, supra note 19, at 946.
\(^4\) C. Hawkins, supra note 6, at 141.
\(^4\) Id.
\(^4\) Id. at 138. Hawkins argues that the risk factor may not have a significant effect since high-risk ventures produce high returns and some types of investors are anxious to support gas producing ventures.
\(^4\) Recently President Ford advocated the deregulation of natural gas in a message to Congress, 120 CONG. REC. 10,120 (daily ed. Oct. 8, 1974). Although higher prices would result for consumers in a time of rampant inflation, more energy supplies are considered essential.
tied to the higher market price, significant exploratory activity occurred.\textsuperscript{47} This evidence dispells arguments by some skeptics of deregulation that the supply of natural gas is not responsive to price and that higher prices for gas would result in windfalls to producers.

Consumer prices under deregulation would necessarily rise to elicit new supplies. Yet, if the findings by economists and the Commission are correct, these higher prices would not be the result of monopolistic forces but would represent the incentives necessary to increase exploration and development of gas reserves. The impact on consumer prices for three different levels of price increases has been estimated by Foster Associates, an economic consulting group.\textsuperscript{48} At the middle level of sixty-five cents per mcf\textsuperscript{49} (150\% of the present national ceiling rate) annual consumer expenditures for gas would rise from approximately $155 in 1972\textsuperscript{50} to $196 by 1980,\textsuperscript{51} only a 3.4\% yearly increase.\textsuperscript{52} In comparison with annual consumer expenditures for other goods, this hardly seems excessive.\textsuperscript{53}

Deregulation of the natural gas industry by Congress would also seem preferable to further Commission efforts to increase supplies by formulas based on cost-of-service, average geographical area costs or any other calculations. The Commission has been unable to arrive at any satisfactory regulatory formula over the past twenty years. One commentator maintains that further attempts would be equally unsatisfactory. He describes present Commission attempts to arrive at a regulated price as

\[\text{pseudo-science to a degree it would be difficult to equal. At the determination [of rate proceedings], the examiner's fumbling among the numbers and making a cafeteria-style selection from those presented, plus the commission adding a few delicate adjustments of its own, make the whole thing nothing short of ludicrous.}\textsuperscript{54}\]

\textsuperscript{47} 1 FPC, NATIONAL GAS SURVEY, ch. 9, at 52 (Preliminary Draft 1970).
\textsuperscript{48} FOSTER ASSOCIATES, INC., THE IMPACT OF DeregULATION ON NATURAL GAS PRICES (1973).
\textsuperscript{49} Mcf (thousand cubic feet) is the traditional volume measurement for natural gas.
\textsuperscript{50} FOSTER ASSOCIATES, INC., supra note 48, at 15.
\textsuperscript{51} Id. at 22.
\textsuperscript{52} Id. at viii.
\textsuperscript{53} Foster reports that average annual consumer expenditures for toilet articles are $117, for tobacco products $189. It is in relation to these expenditures that consumer costs for natural gas are compared. Id. at 18.
\textsuperscript{54} C. Hawkins, supra note 6, at 165. See also Subcomm. on Administrative Practice and Procedure of the Senate Comm. on the Judiciary, 86th Cong., 2d Sess., Report on the Regulatory Agencies to the President-Elect 54 (Comm. Print 1960), where the Landis Commission concluded that "[t]he Federal Power Com-
An example of such fumbling is the FPC's recent response to the Court's remand of FPC Order 428 in *FPC v. Texaco*. The Commission in a proposed rule-making order seeks again indirectly to regulate small producers similar to the terms of Order 428, but proposes to set the standard for a "just and reasonable" price at 150% of what large producers may sell gas for at the applicable ceiling rate. The Commission does not define how it arrived at the 150% figure; it simply states that given small producer higher costs and their valuable contributions to exploration activities such a higher rate would be justifiable. Of course, as with other proposed orders, the Commission invites comments on the rate and submits that the figure they present is subject to change before the final order, if evidence suggests that some other percentage better meets the test of "just and reasonable." But nonetheless, this latest proceeding raises the suspicion that present efforts at regulating the natural gas industry are based more upon Commission guess-work than expertise.

**CONCLUSION**

In sum, further Commission attempts to arrive at a magic formula for regulating the interstate natural gas industry is a dubious exercise. Given recent conclusions that the market for natural gas is workably competitive, further FPC regulation is unnecessary and counterproductive. The decision in *FPC v. Texaco, Inc.*, given the current wording of the Natural Gas Act, could not allow the Commission to experiment with partial deregulation of the producer industry. What is needed is congressional action. In the face of severe shortages of natural gas, it is now imperative that Congress react to this decision, the latest economic findings and the advice of the President by deregulating the natural gas producing industry.

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mission without question represents the outstanding example in the federal government of the breakdown of the administrative process.”