Research Department
Federal Reserve
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Gas Decontrol?

The current debate over the issue of oil price decontrol has been matched in intensity by another Congressional battle over the deregulation of natural gas prices. This controversy has flared up each winter, ever since shortages first began to appear on a regular basis during the early 1970's. But this year, the natural-gas shortage—and the ensuing controversy—may be far more serious than ever before. According to the Federal Energy Administration, deliveries by interstate pipelines during the winter heating season (November-March) could fall short of firm contractual commitments by 1.3 trillion cubic feet. This winter's curtailments—i.e., requirements less deliveries—thus could be 30 percent more acute than last winter, and 45 percent worse if the weather is severe.

Cutbacks in supply are expected to be most damaging in the Midwestern and Atlantic Seaboard states. Since residential and commercial users will receive first priority for available supplies, the industrial sector will bear the brunt of almost the entire deficit. Unless manufacturing firms in deficit areas are able to substitute alternative fuels for natural gas or to obtain surplus intrastate supplies, numerous plant shutdowns could result. North Carolina, Virginia and Maryland may be the hardest hit, but Ohio, Pennsylvania and New Jersey are also vulnerable to supply curtailments.

Natural-gas producers, abetted by Administration spokesmen, contend that artificially low prices have been responsible for creating the shortage, and that prices for at least "new" interstate-market supplies should be allowed to reach free-market levels to slow demand and stimulate production. On the other hand, opponents of deregulation argue that higher prices would not necessarily lead to increased production, but instead would raise consumer energy bills by $5 billion annually while boosting the profits of natural-gas producers. To support their arguments, they point out that average natural gas prices already have more than doubled over the past three years without reversing a long-term drop in reserves.

Regulatory history

The controversy can be traced back to a Supreme Court ruling, issued in 1954, regarding Federal Power Commission authorization to regulate interstate pipeline operations. Until the early 1950's, the FPC maintained that it was empowered only to regulate the prices charged by interstate pipeline companies, and not the "wellhead" or "field" prices which natural-gas producers charge the pipelines. The FPC's rationale was that producers operated in a competitive environment, and that the price paid by consumers thus could be controlled by regulating interstate pipeline prices. But as prices rose on the basis of the huge postwar increase in gas

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demand, consumer groups began to agitate for further controls, and the Supreme Court at least partially concurred by approving FPC regulation of wellhead prices for natural gas sold in interstate commerce. However, prices for gas sold to pipeline companies operating solely within the producing states remained exempt from controls.

In implementing that decision, the FPC found that traditional pubic-utility procedures used in setting interstate pipeline prices were ill-suited to the more highly competitive structure of the producing sector. At first, it sought to determine prices by reviewing costs of service on a company-by-company basis. This method proved unmanageable, because there were too many producers and too many elements of cost jointly incurred in the production of both gas and oil. Then, in 1960, it adopted a method of setting wellhead prices based on area-wide costs, but this method also proved to be complex and time-consuming. In a period of rapid inflation, historical cost data would become outdated even before a decision could be reached. In addition, price ceilings based on average costs would not compensate producers adequately for developing higher-cost reserves in less accessible areas and formations. Consequently, the FPC last December began to establish rates on a national basis, but it still came under criticism for the small size of its posted increases.

Low-cost gas

As a result, the average producer price for natural gas has lagged not only behind the increase in the overall price level, but even behind the sharp increases recorded for other fuels. Between 1960 and 1972, average natural-gas prices rose 33 percent, compared with a 41-percent rise for all consumer prices and a 63-percent rise for bituminous coal. Then between 1972 and 1975, natural-gas prices jumped 120 percent, but domestic producer prices for coal and oil rose 148 and 141 percent, respectively. The differential is even more striking when placed on a heat-equivalent basis. Natural gas clearly is not only the cleanest burning but is also the least expensive fossil fuel. At 43 cents per thousand cubic feet (Mcf), the average wellhead price is roughly equivalent to $0.42 per million Btu, whereas the costs for an equivalent amount of heat obtained from coal and oil are $0.83 and $1.69 per million Btu.

This relatively low price of natural gas has stimulated consumption but has also discouraged producers from drilling for new supplies. Between 1960 and 1972, natural-gas consumption almost doubled, rising from 28 to 32 percent of total energy consumption—and despite shortages, it still accounts for 30 percent of the nation's total energy consumption and almost one-half of its nontransportation requirements. But ever since 1968, the annual additions to reserves have consistently failed to match pro-

duction. As a result, proven domestic reserves (including a major Alaska find) dropped from 293 trillion cu. ft. in 1967 to 237 trillion cu. ft. in 1974—equivalent to only 10 years' production at current rates.

Federal ceilings on interstate prices have created a two-tier price system and thus serious supply distortions. The average price of interstate (regulated) gas now stands at around $0.43 per Mcf, but intrastate (nonregulated) prices average $1.50 or more. Consequently, most new reserves have been found in existing producing areas, and most new supplies have been absorbed by the intrastate market, creating a surplus in the producing states of Texas, Louisiana and Oklahoma. Available new supplies in the interstate market have declined almost 70 percent in the past five years, and total deliveries (including long-term contract commitments) have also turned downward.

Towards decontrol?

this crisis situation led to a prolonged legislative debate over decontrol, which culminated in late October in the Senate's passage of the Natural Gas Emergency Standby Act of 1975. (The House has yet to act.) Title I of the Act incorporates emergency measures which are designed to see the economy safely through this winter's heating season. Title II contains long-range decontrol measures, somewhat watered down from the original Administration proposals.

Title I authorizes those interstate pipelines which are unable to meet the requirements of their high-priority customers to disregard FPC price ceilings in purchasing supplies until April 4, 1976. To limit the expected price upsurge, however, they would be forbidden to pay more for gas than the highest intrastate price paid within each producing state in June-July 1975.

Title II of the Act covers the decontrol period following April 4, 1976. This provision lifts price controls on "new" gas from *onshore* wells that have been brought into production since January 1, 1975 and on gas assigned to interstate commerce for the first time on or after that date. However, gas sold under expiring contracts would continue to be subject to controls when new contracts take effect. The price of new Federal *offshore* gas would be allowed to rise in stages, with controls elapsing entirely on January 1, 1981.

The definition of "new" has been narrowed so much under the amended legislation that the amount of gas to be freed from controls in 1976 probably would amount to only about 8 percent of total annual production. Nonetheless, strong opposition may arise in the House even to these watered-down provisions, so that only the emergency provisions may pass. In that event, producer pleas for permanent decontrol are likely to be heard more loudly next year.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/29/75	Change from 10/22/75	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	85,054	– 513	+ 1,717	+ 2.06
Loans (gross, adjusted)—total	63,648	– 363	– 3,025	– 4.54
Security loans	783	– 78	– 724	– 48.04
Commercial and industrial	22,623	– 101	– 1,444	– 6.00
Real estate	19,627	+ 8	– 344	– 1.72
Consumer instalment	10,055	+ 16	+ 264	+ 2.70
U.S. Treasury securities	8,663	– 64	+ 4,476	+ 106.90
Other securities	12,743	– 86	+ 266	+ 2.13
Deposits (less cash items)—total*	86,326	+ 133	+ 5,678	+ 7.04
Demand deposits (adjusted)	23,890	+ 302	+ 964	+ 4.20
U.S. Government deposits	324	– 63	+ 73	+ 29.08
Time deposits—total*	60,467	– 89	+ 4,501	+ 8.04
States and political subdivisions	5,801	+ 21	– 263	– 4.34
Savings deposits	21,223	+ 7	+ 3,234	+ 17.98
Other time deposits‡	29,922	– 82	+ 1,385	+ 4.85
Large negotiable CD's	15,666	– 188	+ 609	+ 4.04

Weekly Averages of Daily Figures	Week ended 10/29/75	Week ended 10/22/75	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	42	18	+ 6
Borrowings	1	7	286
Net free (+) / Net borrowed (–)	+ 41	+ 11	– 280
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+) / Net sales (–)	+ 301	+ 1,029	+ 918
Transactions of U.S. security dealers			
Net loans (+) / Net borrowings (–)	+ 213	+ 354	+ 770

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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