

**WHAT EVERY PENNSYLVANIA  
GENERAL PRACTITIONER NEEDS TO  
KNOW ABOUT NATIONAL NATURAL  
GAS POLICY**

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**Our Goals**

- Explore the history of national gas policy upon natural gas development in the United States
- Explore the history of national gas policy upon natural gas pricing in the United States
- Explore this impact of national gas policy upon natural gas development in the United States
  - Impacts gas producers and related industries
  - Impacts landowners
- Consider the current state of national gas policy
- Consider the conflicting stakeholders in the evolving national gas policy

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**Why should I care?**

- National gas policy affects all of our clients
  - Landowners
  - Operators
  - Ancillary businesses to operators
  - Banks and investment houses
  - Communities
  - Consumers

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## How ?

- Pricing of the commodity
- Cost of transportation and distribution
- Cost of exploration and production
  - **Regulation**

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## Early history

- Early use of gas for commercial / residential purposes actually used a form of manufactured gas
  - **Expensive**
  - **Limited distribution**
- Gas encountered in early petroleum industry was largely wasted for lack of market
- Some used in production

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## Earliest natural gas activity

- Combined exploration, production and distribution companies
- Largely local
  - **Intra state**

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## Early regulation

- None
- Public utility regulation as a state function
- Relatively effective because of the nature of the industry

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## Early regulatory challenge

- Development of petroleum industry involving dedicated exploration and production companies
- Development of interstate sales of natural gas that evaded state public utility regulation
- Perceived pricing issues with gas produced in one state and sold to distribution companies in another state

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## The basis for federal action

- Congress heard the people's cry alleging the existence of an unregulated activity loose in the land
- Rule 1 (be sure to take this down!):

**Congress abhors a regulatory vacuum**

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### The basis for federal action

- But, how to do it?
- Congress can regulate

–INTERSTATE COMMERCE

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### WHY?

- Same basis for intrastate utility regulation
  - The capital cost of distributing natural gas to homes and businesses is so high that it creates a monopoly (only one seller)
- BUT also
  - The capital cost of building and operating interstate pipelines not only has a monopolistic impact but also
  - A free new word here for some :
  - A **monopsony** (only one buyer)!

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### So what did Congress do?

- VWALLAH !
- The Natural Gas Act of 1938
- Regulated the price of interstate transportation of natural gas AND companies involved in that business
- Regulated the price of gas sold into interstate commerce

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## What was the Result?

- Created three distinct markets for American natural gas
  - Gas produced within one state and distributed to ultimate consumers in that state subject to state public utility regulation
  - Gas produced in one state by a one company and sold to another company in that state thus escaping public utility regulation
  - Gas produced in one state and sold into interstate commerce

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## So what?

- Little impact on combined E&P/Distribution companies EXCEPT
  - To the extent the regulated price of interstate gas was LESS than the cost of exploration and production in the state, in-state development became imprudent
- The availability of gas on the interstate market fluxuated based upon the relative price of unregulated intrastate gas and regulated interstate gas

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## How was it implemented?

- Regulation of interstate pipeline companies
- Pricing was, thus, set at the transmission line
- Stated as a "well head" price BUT
  - It really was the price paid by pipelines, at the pipeline for gas to be introduced into interstate commerce
- Thus, when gas became "deregulated" core costs became stranded absent changes in field practice

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### An Interesting Artifact of Regulatory Excess

- NGA administered by the Federal Power Commission
- In 1947 the FPA denied a certificate of public convenience to *Interstate Natural Gas Company*
- ING wanted to pipe gas in interstate commerce to replace coal at an electric power plant

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### Why? One may ask?

- Pretext of denial:
  - **Electric power generation is less valuable than other possible uses for natural gas and should not be permitted!**
- Real reason?
  - **Coal is king?**
- Why care?
  - **Clear example of regulatory over-extension into fundamental policy issues**

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### Other than that, Mrs. Lincoln, how did it go?

- While deciding that electric power was too unimportant to consume natural gas
- FPC largely limited its use of its regulatory power to controlling pipelines from 1938-1954
- FPC responded to a 1947 US Supreme Court decision suggesting it had the power to do so, FPC extended regulation to producers into interstate commerce and was upheld by the USSCt in 1954

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## Results

- FPC now attempted to regulate price of interstate gas from wellhead to the burner tip of the ultimate consumer
- Restrictions upon the price of interstate gas made sale into interstate commerce less profitable than intrastate sales
- Market became totally distorted
- Gas shortages occurred in major population areas
- How could anyone not see this coming?

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## Congressional Response

- The Emergency Natural Gas Act
- Implemented by President Carter who declared a "Natural Gas Emergency"
- FPC ordered companies to ship massive quantities of gas to shortage areas
- **AT THE HIGHER PRICES THEN PREVAILING FOR INTRASTATE GAS!**

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## AND

- **So much for effective, rational national gas price regulation**
- **In fairness**
  - **US Federal system creates unique challenges in that**
    - **Only states can regulate intrastate utility pricing**
    - **Only the federal gvt can regulate interstate activities**
    - **Neither can regulate non-monopoly/ non-monopsony businesses**

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## Last Major Federal Effort

- Natural Gas Policy Act of 1978
  - Attempted to extend federal price control to intrastate natural gas markets
  - Divided gas into
    - NEW gas (developed after 1978) and regulated subject to price changes-- AND
    - OLD gas (developed prior to 1978) and not subject to price increases under Act
  - Top price of NEW gas was tied to the price of refined oil
  - OLD gas did not benefit from increases

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## Politics at Play

- Act suggested that price controls would go away beginning in 1985
- Act contained complex formulae to set prices—that really were a political effort to force the bulk of future cost increases in production and treatment of gas to be absorbed and hidden in targeted cost increases to “industrial boiler fuel facilities”
- Congress LOVES hidden taxes

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## NPGA Impact on PA

- Brought Pa the “Medina” gas boom of the late '70's and early '80's
- Set a very high price for gas produced from “tight sands” such as the Medina to encourage development of US sourced gas
- Companies wary that price could be sustained through cost recovery periods
- NPGA fostered the growth of “take or pay” contracts
- Companies needing gas, signed them

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## The Take or Pay Boondogle

- Distributors and consumers of gas were forced to pay artificially high prices for natural gas AND to pay for gas NOT consumed when seasons, economic downturns, etc. required less gas
- Defaults under take or pay contracts
  - Put purchasing side at risk of substantial claims
  - Put producers at risk of not recovering “guaranteed” costs of non-competitive gas

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## Take or Pay

- By mid 1980's pipeline “take or pay” liabilities were estimated at \$ 9 BILLION !
- Pipelines tried to
  - Buy out
  - Negotiate market out clauses
  - Claim financial/economic force majeure
- FERC (the Federal Energy Regulatory Commission) tried, unsuccessfully, to create alternative economic tools for producers
- Another regulatory induced MESS !

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## Deregulation

- In the wake of the “tight sands” and “take or pay” experience, FERC finally deregulated the price of natural gas
- Currently, natural gas is a market based commodity
- Bush administration approach to natural gas policy
  - Build LNG ports and import it—let the global market set the price
- Obama approach---in process

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### Why is natural gas < \$3.00 today?

- Economic downturn
  - **Reduced economic activity reduces consumption**
- Excess world supply of LNG
- US high quality facilities to import LNG
- BUT
  - **Forecast from pre-October 2008**
    - 3 years
    - China / India will complete LNG ports
    - World price will skyrocket

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### Other Federal Regulations

- The tax code
- The Environmental Laws
- OSHA
- *Etc.*
- All move in some fashion with the national policy views of a party in power
- All stagnate and move more unpredictably when governmental power is gridlocked

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### What does history teach?

- Energy regulation is complex
- Energy regulation is important to producers, landowners, service companies, governments and --- to all citizens
- The US has never figured out how to do it effectively and safely
- Energy regulation is certain to entice federal political interest
- As lawyers, we need to know history and be prepared to interpret pending regulations

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### Why should we care?

- Pa has economic challenges
- Penn state study of economic impact of Marcellus Shale
  - <http://pamarcellus.com/>
- How to advise our clients?
- Who should set the policy to balance economic advancement, social and environmental concerns?
- We the people---it's too important to abandon to professional politicians and bureaucrats !

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