THE NATURAL GAS COMPROMISE

Natural Resources and Commerce Division
Congressional Budget Office
Washington, D.C. 20515
August 2, 1978

THE NATURAL GAS COMPROMISE

The CBO has not performed an independent analysis of the Natural Gas Policy Act of 1978. Instead we have reviewed the two existing studies which compare current policy to the House and Senate passed bills as well as to the Conference report. These two studies are: The Joint Explanatory Statement of the Committee on Conference (received July 31, 1978), and the Pricing Proposals by the Energy Information Administration (dated June 14, 1978; updated August 1, 1978). Given that review and our previous background in the natural gas area, we have made a number of qualitative and quantitative judgments regarding the potential impact of the Conference report. Essentially three topics are addressed in this overall review:

1. The objectives of the new legislation on natural gas pricing and the extent to which H.R. 5289 attains those objectives.

2. The current policy problem, that is, what should be assumed about future natural gas supplies, allocation of those supplies, and prices in the absence of new legislation.

3. A brief review of some of the strengths and weaknesses of the quantitative analysis contained in the Conference Committee Explanatory Statement.

The Goals of New Legislation

The principal objectives of H.R. 5289 are:

1. To permit interstate pipelines to compete with intrastate pipelines for new supplies of natural gas.

2. To increase the incentives for exploration and production of new natural gas.

3. To incrementally price at least some gas users who have realistic fuel alternatives so they will convert to coal or oil. This provision should also prevent wellhead prices from rising above the levels of competing fuels when deregulation finally takes effect.

4. To accomplish the above objectives with the minimum impact on the overall rate of inflation and, specifically, with the minimum impact on the prices paid for natural gas by residential users who, in general, are unable to switch to other fuels.

Advantages — CBO believes that H.R. 5289 accomplishes these goals reasonably well. The Conference agreement ends the price discrepancies between the intra and interstate markets and thereby enables the two groups to compete equally for new gas. Thus, gas curtailments, common in recent years in parts of the country served by interstate pipelines, will be reduced and possibly eliminated. Further, regions of the country not hitherto served by gas pipelines may have the opportunity to obtain natural gas.

H.R. 5289 raises the price for new interstate gas up to the approximate price of intrastate gas and allows for an orderly and predictable rise in prices over the next eight years. These price rises, combined with the special pricing provisions for high cost gas, should increase the supply of domestically produced gas by about .7 to .8 trillion cubic feet in 1985. This increase in domestic production could, in turn, reduce the demand for costly LNG imports and for other higher cost energy sources, including electricity. H.R. 5289 contains incremental pricing provisions that should transfer a portion of the new higher prices onto interstate boiler fuel users. This is the same group that is the target of the coal conversion portions of the Natural Energy Act. More than and other single group of fuel users outside the utility sector, industrial boiler fuel users have the technical potential to replace gas boilers with coal fired units. The advantage of these incremental pricing provisions is therefore not only to protect residential consumers from rapid large price increases, but it allocates the high cost gas to those consumers who can shift from natural gas to other fuels (principally oil and coal). Thus, at least a partial ceiling will be placed on the prices of new gas once complete deregulation takes effect.

Although the original analysis by the Energy Information Administration indicated that the Senate bill would have lower prices to residential consumers than the Conference agreement, CBO believes that their interpretation of the incremental pricing provision in the Senate bill was in error. (A letter to the Chairman of the Energy and Power Subcommittee of House Interstate and Foreign Commerce from the EIA Administrtion dated August 1, 1978 acknowledged the misinterpretation in the EIA analysis).

It is also important to note that the legislation gives the Federal Energy Regulatory Commission the right to extend the incremental pricing provision to all interstate industrial users which would, in turn, provide greater protection to residential consumers. Whether or not this will be implemented, however, is difficult to determine.

Disadvantages -- H.R. 5289 has three major disadvantages. First it represents a wealth transfer from consumers of gas to producers of gas. This transfer goes beyond the high prices paid for truly new gas and includes, in many cases, higher prices for already flowing gas. The Conference Committee has estimated these costs to be no more than $11 billion from now until 1985. In the view of the CBO, this $11 billion estimate is most likely an underestimate, but probably by no more than $9 billion. That is, the transfer from consumers to natural gas producers over the next 7 years is unlikely to exceed $20 billion. After consumer savings resulting from the increased domestic production are included, the net costs to consumers are unlikely to exceed $16 billion between now and 1985. (Details discussed in the last section of this paper).

Second, by immediately deregulating the prices for high cost gas, while retaining controls on all other gas, there is a possibility that the price of the high cost gas will increase dramatically. If such were the case, producers might channel their investment funds into these high cost resources and pass over lower cost and more accessible gas that was still under price controls. In such a situation, producers would be profiting at the expense of consumers who would be denied access to lower cost gas.

Third, the Natural Gas Policy Act of 1978 is extremely complex and, therefore, there are likely to be implementation problems. Despite the good intentions of the bill's authors, it is fair to say that this bill may allow abuse and legal challenge by producers. The extent of this abuse is, however, difficult to estimate at this time.

The Current Policy Problem

A major difficulty in estimating the consumer cost of H.R. 5289 is the great uncertainty over what gas prices would be in the absence of new legislation. Unlike oil and coal prices, where the major uncertainties evolve around OPEC prices and energy demands, interstate gas prices are regulated by the FERC. The current pricing policy used by the FERC (opinion 770 A) provides for increases in interstate gas price of one cent for each calendar year quarter. Nevertheless, many experts believe that, in the absence of new legislation FERC would diverge from this current policy and follow previously announced pricing formulas, thereby increasing interstate prices significantly. Other experts feel that the FERC would try to keep regulated prices constant in real terms. Further, those pricing decisions depend on the future price in the intrastate market. Given the great uncertainty with respect to pricing policies in future years, most analyses (including CBO) have assumed that gas prices will remain approximately constant in real terms in the absence of any new legislation. However, it is possible that without new legislation average gas prices would rise dramatically in real terms over the next decade. Were that to be the case, of course, H.R. 5289 could hold down consumer costs for natural gas.

Strength and Weaknesses of the Conference Committee Report

In the opinion of the CBO, the economic analysis contained in the Conference Committee is technically competent and relatively unbiased. It addresses the major sections of an extremely complex bill and makes reasonable estimates of the bill's impact.

Producer Revenues and Consumer Costs — The principal conclusion of the Conference Committee's economic analysis is that, H.R. 5289 will increase producer revenues (for the same quantity of gas) by $7.4 to 10.8 billion from now until 1985. However, according to the Conference Report, consumers won't pay all these costs because H.R. 5289 will also stimulate .7-1.4 TCF of new natural gas production which will replace more expensive alternative energy sources, thereby reducing consumer costs to a net amount of $1-5 billion from now until 1985. On the basis of these calculations, the report concludes that the overall macroeconomic reports are virtually zero.

While CBO agrees with the direction of the estimates in the Conference report, we believe that toal consumer costs could be some what higher but no more than $8-16 billion higher than the projections of current policy, over the 7 year period. The details of these differences are as follows:

1. The economic analysis of H.R. 5289 makes a complex set of assumptions regarding the volume of gas that would qualify for deregulation under the high cost provisions and for relatively high (regulated) prices under, for example, the stripper provisions. While this is difficult to forecast, the CBO's judgment is that the Committee may have understated the volumes of gas qualifying for the high priced categories, particularly for deep gas and for the stripper wells. Recent growth in the number of oil wells qualifying for the stripper provisions of EPCA would support such a conclusion. Therefore, the CBO believes that producers' revenues for this category may be understated slightly in the Conference report--possibly on the order of $3-5 billion from now until 1985.

2. The Committee seems to have made a strong effort to minimize the possibility that producers will take advantage of H.R. 5289 in a way not intended by its principal authors. Yet, in light of the extreme complexity of this bill, the possibility remains that producers will find a way to increase their revenues above the levels predicted by the Committee. CBO has no special knowledge in this area but believes that it is important to recognize the possibility of abuse under H.R. 5289.

3. The ranges of truly new production forecast by the Committee are, in the opinion of the CBO, too optimsitic. We believe that additional production on the order of .7 TCF in 1985, which corresponds to the conservative estimate presented in the Conference Committee report, is the most likely outcome.

In summary, CBO believes that the likely increase in producer revenues over the 7 year period would range from $12-20 billion more than current policy. Offsetting those revenues by $4 billion in consumer savings from new gas production, the likely consumer costs range from $8-16 billion.

A final point that may be important regarding price changes for a particular region. The high wellhead price of gas in 1985 in the intrastate market which is claimed in the EIA report under the terms of Conference agreement is, in the view of CBO, misleading. Because the compromise regulates gas prices until 1985 it is true that there is the potential for large increases thereafter to clear the market. However, the alternative proposed by the Senate is to allow prices to rise in the earlier years and thereby reduce potential price rises in the later years. The key point is that the consumer is not concerned solely with the new price in 1985. It is the average price that really matters and there is no doubt but that the Compromise agreement provides for lower consumer prices in 1985 then does the Senate bill. Examination of Table 2 in EIA's August 1, 1978 supplement clearly supports that statement.

<u>Macro-economic Impacts</u> -- Depending on the extent to which increased producer revenues are funneled into productive investments, the overall effects could be either slightly positive or slightly negative. However, in a $2 trillion economy, the effect would be relatively small in any event.

Regarding inflation, the effects are also likely to be small. If the increased consumer cost for gas were spread out evenly over the 7 year period, we expect the rate of increase of the GNP deflator would increase by a maximum of .05-.1 of one percent per year. If, as seems likely, the effects are very low in the initial years and build up in the later years, then we could see slightly larger inflation impacts in the 1982-1985 period.