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The Area Rate Proceedings: An Unsettled Experiment in Public Control of Natural Gas Prices

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THE AREA RATE PROCEEDINGS: AN UNSETTLED EXPERIMENT IN PUBLIC CONTROL OF NATURAL GAS PRICES

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THE AREA RATE PROCEEDINGS: AN UNSETTLED EXPERIMENT IN PUBLIC CONTROL OF NATURAL GAS PRICES

by
William Warfield Ross*

IT IS well known that the Federal Power Commission is now engaged in a major attempt to develop and impose “area” rate ceilings to govern prices charged by independent natural gas producers for sales of gas in interstate commerce. The outline of this regulatory program, now becoming visible for the first time, is clouded by a unique combination of legal and practical problems not previously encountered in governmental price regulation. The success or failure of the area program will affect not only the interests of the consuming public, the gas producers, and those dependent on them but also the direction of federal business regulation in general.

It is difficult to appraise the area rate proceedings without some knowledge of producer regulation during the past ten years. Since producer regulation has remained in an experimental state from the time it was imposed suddenly in 1954, the procedures and the ultimate legality of the Commission’s area proceedings will be influenced heavily by past efforts to regulate producer prices. Furthermore, these past efforts to regulate producers are not mere background; they raised specific legal issues that are still being litigated and that will have an obvious bearing when the pending area proceedings are litigated in the courts.

This Article, which is concerned primarily with the area proceedings, first reviews in summary fashion the current legal issues engaging the Commission, with critical comment as to their ultimate disposition in the light of the area proceedings. An attempt will be made to forecast the grounds upon which the area rate orders are likely to be challenged and the considerations that may influence courts in deciding on their validity.

I. PRODUCER REGULATION AS A PRELUDE TO AREA RATES
A. The Genesis Of Producer Regulation — A Brief Summary

A review of the legislative history of the 1938 Natural Gas Act leaves little doubt that it was enacted primarily to control the burgeoning activities of natural gas pipelines which then held monopo—
listic positions in many gas producing and marketing areas. Whatever meaning was latent in the wording of the statute, the history suggests strongly that the Congressmen responsible for its enactment were thinking principally, if not exclusively, of interstate pipeline companies and not of natural gas producers which were not interstate pipelines or closely affiliated with them. Further, nothing in the act is particularly adapted to producers, for it gives evidence of a preoccupation with the problems and characteristics of pipelines.

Nevertheless, in the celebrated Phillips decision the Supreme Court read the language of section 1(b) of the act as giving the FPC jurisdiction over the rates and service of producers on a basis equivalent to that exercised over interstate pipeline companies. While originally the Commission had expressed concern over its inability to regulate the rates of independent producers selling to interstate pipelines, it was stunned by the implications of the decision. It attempted for several years to obtain congressional relief from the Phillips decision.

The Natural Gas Act gives the Commission two principal powers over gas producers selling to interstate pipelines. First, before physical transfer of the gas can take place, the Commission must issue certificates of public convenience and necessity if it determines that such sales are "required by the present or future public convenience and necessity." This includes the power to issue "temporary cer-

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1 The story has often been told. For a good summary see Note, F.P.C. Regulation of Independent Producers of Natural Gas, 75 Harv. L. Rev. 549 (1962).
4 Sec. 1(b):
   The provisions of this chapter shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or the production or gathering of natural gas. 52 Stat. 821 (1938), 15 U.S.C. § 717(b) (1959).
7 Sec. 7(e):
   No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations: Provided, however, That if any such natural-gas company or predecessor in interest was bona fide engaged in transportation or sale of natural gas, subject to the jurisdiction of the Commission, on the effective
tificates” authorizing service for limited periods in certain specified circumstances. Since the Commission does not regulate the actual activity of producing and gathering gas and since the pipeline’s need for the gas is established in other proceedings, almost invariably the only dispute in a producer certificate proceeding is the price, i.e., whether the proposed price is “required by the present or future public convenience and necessity.”

Second, the act requires that natural gas companies, including producers, file rate schedules governing all jurisdictional sales and keep them up to date. The act empowers the Commission to determine whether rates charged by producers in sales to interstate pipelines are “unjust, unreasonable, unduly discriminatory, or preferential.” At any time the Commission may initiate, on its own motion or pursuant to complaint, a section 5 (a) hearing to test an existing field rate...
against this standard. Furthermore, any change in a rate schedule must be filed pursuant to section 4(d). When a producer files an increased or revised rate, the Commission, under section 4(e), may

complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: Provided, however, That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.


Sec. 4(d): Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulations, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published. 52 Stat. 822 (1938), 15 U.S.C. § 717c(d) (1959).

Sec. 4(e): Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission or gas distribution company, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge classification, or service; and, pending such hearing the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect, and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is
suspend the rate's effectiveness for a maximum of five months and initiate a hearing into its lawfulness. The standard employed in this proceeding is the same as that employed in a section 5 (a) hearing into existing rates. If the hearing has not been terminated before the suspension period ends, the producer may place the revised rate in effect, but subject to refund if subsequently found unlawful. There are two distinctions between a section 5 (a) and a section 4 (e) proceeding. First, under section 4 (e) the Commission has the power of reparation, whereas under section 5 (a) it has no such power. Second, under section 4 (e) a producer filing a changed rate must sustain the burden of proof concerning the rate's lawfulness, whereas under section 5 (a), which governs existing rates, the burden of proof falls upon the Commission. However, the latter distinction has become blurred by the Commission's practice of holding consolidated section 4 (e) and 5 (a) proceedings.

To summarize, the Commission's regulation of independent producers is concerned almost exclusively with rates under either the "public convenience and necessity" standard of section 7 or the "just and reasonable" standard of sections 4 (e) and 5 (a). The difference, if any, between these standards is considered hereafter.

After the Supreme Court's Phillips decision, the Commission issued procedural regulations calling for the filing of all existing producer sales contracts as "rate schedules" and also required the filing of grandfather and new certificate applications. However, it has already been noted that the Commission did little to shape a regulatory program for several years. In retrospect, the Commission's apprehension of undertaking a task of this magnitude is understandable, since it was required to apply to one of the most aggressive of American raw material industries a statute devised for the regulation of interstate pipeline companies on more or less standard public utility grounds. Although an interstate pipeline has many of the elements of a conventional public utility, an independent producer, with the possible exception of its use of a long-term sales contract,
exhibits none of these elements. The difficulty of fitting the language of the Natural Gas Act to the domestic gas industry has continued to occupy the Commission since the Phillips decision, and a successful resolution of this problem is not yet in sight.

1. The First Attempt: The Rise and Fall of the Individual Company Rate Proceeding

The history of the Commission's early attempts at regulation has been told frequently and will merely be summarized. When efforts to reverse the Phillips decision failed in Congress, the Commission in 1956-1957 initiated individual rate investigation proceedings (under sections 4(e) and 5(a) of the Natural Gas Act) against fourteen of the largest producers of natural gas. These cases, a number of which proceeded separately in hearings before examiners, represented an attempt to apply a traditional public utility approach to regulate the rates of the larger producers. The first of the cases to reach the decisional stage, the remanded Phillips proceeding, was decided in 1959 by a Commission examiner in a massive opinion along traditional public utility lines. However, in reviewing the examiner's decision, the Commission decided to abandon the company-by-company approach to producer regulation because the impracticality of dealing with the producers on an individual company basis made it necessary to develop a "commodity" type of rate regulation, i.e., rates that would be applicable to all sales of gas in a given area, not merely to the rates of a particular producer. This decision to terminate the Phillips proceeding and to turn to a new form of regulation

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18 The Commission in 1956, relying on City of Detroit v. FPC, 230 F.2d 810 (D.C. Cir.), cert. denied, 352 U.S. 829 (1956), held that it could not rely on current field price values arrived at by arm's length bargaining in setting "just and reasonable" rates under §§ 4 and 5 of the act. The Court of Appeals for the District of Columbia had held that cost of service must be used at least as a point of departure in determining the amount which a natural gas pipeline could include in its "cost of service" for its own production. See note 128 infra and accompanying text. The individual company cases involved a § 5(a) general investigation of all existing rates of the particular company together with all outstanding § 4(e) rate increase proceedings involving that company. The principal cases were: Continental Oil Co., No. G-16966, FPC; Tidewater Oil Co., No. G-13310, FPC; Cities Serv. Co., No. G-12780, FPC; Socony Mobile Oil Co., Inc., No. G-12401, FPC; Union Tex. Natural Gas Corp., No. G-11563, FPC; California Co., No. G-10784, FPC; Union Oil Co., No. G-10783, FPC; Superior Oil Co., No. G-10501, FPC; Hunt Oil Co., No. G-10414, FPC; Sinclair Oil & Gas Co., No. G-9291, FPC; Humble Oil & Ref. Co., No. G-9287, FPC; Atlantic Ref. Co., No. G-9283, FPC; Pan Am. Petroleum Corp., No. G-9279, FPC; Champlin Oil & Ref. Co., No. G-9277, FPC; Phillips Petroleum Co. No. G-1148, FPC. Subsequently, in 1959-1960, the Commission initiated seven more such proceedings, a total of 21 including the remanded Phillips case.


20 The order was not specific as to how such rates would be derived other than that they would not be based on the cost experience of individual companies. Id. at 547.
was affirmed by a divided court of appeals\textsuperscript{21} and subsequently by the Supreme Court in \textit{Wisconsin v. FPC}.	extsuperscript{22} The implications of the Supreme Court's decision for future regulation in this field will be discussed hereafter.

Pending the conclusion of the \textit{Phillips} rate proceeding, producers had been selling increasing quantities of gas under new contracts to interstate pipelines which were then involved in a massive expansion program to all parts of the country. Demand for gas to support these expansions had led to increased contract prices which the Commission, somewhat reluctantly, authorized and permitted to go into effect under section 7 of the act. The Commission was relying on its power to reduce the prices subsequently to reasonable levels, but only prospectively (that is, without reparation)\textsuperscript{23} under section 5. In addition, producers also filed pursuant to section 4(d) numerous increases in existing rates relying on contract provisions authorizing increases in price.\textsuperscript{24} Since the Commission had no developed method for determining the reasonableness of these rate increases under section 4(e) of the Natural Gas Act, it was forced to allow them to accumulate subject to refund. In time, this contingent liability reached gargantuan proportions, probably aggregating three quarters of a billion dollars in refundable rate increases which might have to be repaid to interstate pipelines.\textsuperscript{25}

The Commission's unwillingness to control increases in initial producer prices in certificate applications resulting from increased demand for natural gas did not go unchallenged. After prolonged litigation the Supreme Court instructed the Commission in the well-known CATCO decision\textsuperscript{21} to "hold the line" on initial prices pending the completion of the existing section 4(e)-5(a) proceedings. The


\textsuperscript{22} \textit{Wisconsin v. FPC}, 373 U.S. 294 (1963) (four Justices dissenting).


\textsuperscript{24} Long term producer contracts for sales to interstate pipelines typically contain one or more provisions authorizing price increases. The most frequently encountered provisions are: fixed price increases at specified time intervals (e.g., one cent per Mcf every five years); clauses providing for price redetermination at fixed intervals (based on some external standard such as the average of the three highest prices in the same producing area); and so-called favored-nations clauses, the most common of which provides that the producer will automatically receive the highest price paid by the pipeline purchaser for gas of comparable quality produced in the same area. Favored nation clauses are said to be "triggered" by a qualifying pipeline purchase from the same or another producer at a higher price. The prevalence of favored-nation clauses has been a complicating factor in producer regulation because of the possibility of the "triggering" of general rate increases. See note 51 infra and accompanying text.


Commission, after considerable further litigation, has construed CATCO to empower it to authorize new sales only on condition that producers reduce the proposed price to pre-existing levels.

Contemporaneous with the remanded Phillips decision in which it had announced the intention of shifting to a new form of rate regulation, the Commission, in response to CATCO, issued a Statement of General Policy, in which it set forth separate ceiling rates governing initial sales ("new gas") and increased rates ("old gas") for twenty-three producing areas. Since these prices were issued without the notice or hearing possibly required by the Administrative Procedure Act, their exact legal status remained in considerable doubt for some time. The principal question was whether the Commission could use the "new gas" ceiling prices to limit or hold down initial prices under the section 7 "public convenience or necessity" standard without providing the producer a chance to contest the lawfulness of the ceilings in a public hearing.

A few months after the Statement of General Policy was issued, the Commission initiated the first area rate proceeding. This proceeding covered the west Texas-New Mexico Permian Basin area—one of the major, but by no means the largest, gas producing areas.

The Phillips decision, the Statement of General Policy, and the accompanying Permian area proceeding were the most significant regulatory actions by the Eisenhower Commission. When a new Commission, entirely appointed by President Kennedy, came into office early in 1961, it quickly ratified its predecessor's change in direction toward an "area" type of rate regulation.

Consequently, almost ten years after the Phillips decision the new Commission confronted the following regulatory picture:

(1) Initial (i.e., new contract) field prices had become stabilized as a result of economic forces and the pressure of the area ceilings; producer revenues similarly had tended to stabilize, although producers were still able to recover additional amounts for their gas as a result of rate increases which were permitted to become effective by the Commission subject to refund or without refund obligation if

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28 Statement of General Policy 61-1, 25 Fed. Reg. 13969 (1961). The "new gas" standard was to be employed in controlling initial (i.e., new contract) price levels under § 7 and the "old gas" standard in deciding whether or not to suspend and investigate rate increases under § 4(e).

29 Brief for FPC, No. 16175 (D.C. Cir.).
the prices were below the existing area ceiling for "old gas."

(2) The large number of producer rate increases had resulted in the accumulation of massive refund obligations, subjecting the producers to considerable uncertainty as to both past and future revenues. The increased field prices had in turn resulted in the filing of numerous increased pipeline rates which were similarly subject to refund under section 4(e), creating uncertainty on the part of gas consumers as to the past and future level of gas rates.

(3) Most new producer sales contracts were made at the ceiling price levels for "new gas," although producers continued unsuccessfully to attempt to sell unusually large blocks of gas at above-ceiling prices.

Pending the development of the area rate concept, two principal areas of legal controversy developed between the Commission and the producers: the first, already mentioned, involved the Commission's power to impose its policy statement prices or "in-line" prices as virtually automatic ceilings in proceedings under section 7 of the Natural Gas Act for certification of initial sales. The second involved the right of the producers to file for increased rates at levels provided by their contracts after the sale in question had been authorized by the Commission at a lower level.

2. The Initial Price Problem: CATCO and After

The area price levels were amended by the Commission on seven occasions to reflect changing Commission views as to appropriate price levels and were used frequently in deciding whether to suspend price increases or to certify initial sales at contract rate levels without price conditions. The Eisenhower Commission, in issuing the Statement of General Policy adopting the area ceilings, appeared also to have intended to use these ceilings to impose specific initial prices in granting certificates under section 7, although not to determine just and reasonable rates in later proceedings under section 4(e) or 5(a) of the Natural Gas Act. That Commission stated:

These price levels, as announced by Appendix A attached to this statement, are for the purpose of guidance and initial action by the Commission and their use will not deprive any party of substantive rights or fix the ultimate justness and reasonableness of any rate level. As with the areas, the prices will be adjusted from time to time as such facts as may come before us compel such adjustments. For the present, and in the absence of compelling evidence calling for other action by us, proposed initial sales of natural gas by independent producers which include rates higher than those indicated in the appendix attached to

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this statement shall be denied a certificate or certificated only upon the condition that lower rates be filed, and all rate changes filed under existing contracts which call for a rate exceeding the indicated price level in the appendix to this statement shall be suspended. (Emphasis Added.)

Since the rate levels suggested in the Statement of General Policy had been promulgated without notice or hearing of any kind, they raised a substantial question as to validity of the Statement under the Administrative Procedure Act and under the hearing requirement of section 7 of the Natural Gas Act. It was not surprising, therefore, that in a major south Texas certificate proceeding the Kennedy Commission finally disclaimed any intention to utilize the "new gas" policy statement ceilings to set initial producer rates in permanent certificate proceedings. Rather, the Commission stated that the ceilings were to be used merely in deciding whether to scrutinize a proposed initial rate in hearings under section 7 of the Natural Gas Act and not in setting such rates at specified levels. Furthermore, the Commission would determine an "in-line" price (to be used in setting initial rates) in separate hearings in individual producer certificate proceedings.

The Commission avoided the question of the validity of the policy statement ceilings only to face the question of what, if any, evidence could be introduced by the producers in initial rate proceedings (section 7) and in rate increase proceedings (section 4(e)) to establish their right to collect an initial price higher than the area ceiling. Since rates had not presented a serious problem in pipeline certificate proceedings, the Commission had no previous experience in applying the "public convenience and necessity" standard of section 7 to proposed rate levels. If pipeline certificate applications presented possible rate problems, the Commission usually approved the rates, subject to retroactive adjustment after the pipeline had acquired sufficient operating experience to permit a cost-of-service determination. The Commission had used the "original cost, prudent investment" method sanctioned in *FPC v. Hope Natural Gas Co.* in testing pipeline rates under the section 5(a) "just and reasonable" standard.

From the beginning of producer regulation the Commission con-

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26 The Commission continued, however, to employ the policy statement ceilings in imposing price conditions in granting temporary certificates under § 7(c). The history of the Commission's exercise of its temporary certificate powers deserves an article in itself, but is omitted here. See Public Serv. Comm'n v. FPC, 327 F.2d 893 (D.C. Cir. 1964) and cases there cited.
27 Alabama-Tennessee Natural Gas Co. v. FPC, 203 F.2d 493 (1d Cir. 1953).
28 320 U.S. 591 (1944).
The Commission has consistently taken the position that there was some evidence that would be probative on these questions, but invariably had declined to inform the producers what such evidence was. The Commission, in fact, had told the producers on a number of occasions that the initial development of standards under which the producers could meet their burden of proof under both section 4(e) and section 7 was their responsibility and not that of the Commission. Although this attitude was perhaps defensible during the early stages of producer regulation, it became increasingly apparent that the Commission had no intention of allowing an individual producer to collect more than the “in-line” price in a particular area. This “in-line” price was defined by the Commission as (very roughly) the price at which the substantial bulk of the gas had been sold in interstate commerce during the period prior to the promulgation of the policy statement prices—in other words, the predominant price in the field prior to 1959.

Attempts by the producers to establish a right to collect a rate in excess of the “in-line” price took a variety of forms. One of the earliest post-CATCO certificate cases involved sales by Gulf Oil Company and Tidewater Oil Company to United Gas Pipeline Company from the Bastian Bay Field in south Louisiana. In hearings held in 1961, the producers attempted to support an ultimate price of twenty-seven and one-half cents per Mcf by introducing field price data, detailed individual company-wide cost data, data bearing on the costs of exploration and drilling within the Bastian Bay area, and a wide variety of industry trend data, including trends of drilling costs and finding rates. This evidence sought to establish that the cost of finding and producing gas had increased sharply in recent years. The record in the Bastian Bay proceeding was voluminous, and it would be difficult to conceive of any evidentiary approach available to the producers which was not actually put forward in this proceeding in order to meet their burden of proof under section 7. However, by the time Bastian Bay reached the Commission, consideration of most of the evidence offered therein in support of the producer price had been foreclosed by other Commission decisions.

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8 Panhandle E. Pipeline Co., 27 F.P.C. 35 (1962); Union Oil Co., 16 F.P.C. 100 (1956).
9 Union Oil Co., 17 F.P.C. 89, 90-91 (1957); Forrest Oil Co., 17 F.P.C. 867, 868 (1957). The Commission’s failure to define the standards under which the producers could meet their burden of proof in individual proceedings led to the reversal of its orders in the Union Oil case in the Fifth Circuit. Bell Oil v. FPC, 255 F.2d 548 (5th Cir. 1958). The court directed the Commission to afford the producers another chance to sustain their rates.
89 The Commission progressively restricted the producers by prohibiting presentations
Thus, the Commission has ruled that in the ordinary certificate case there is no evidence (other than pre-1959 field price data) that a producer can introduce in an initial price proceeding to show that he is entitled to a price exceeding the "in-line" price. Such a result on its face seems unfair, for if the "in-line" price were subsequently found to be lower than the "just and reasonable" price level developed under section 5(a) in the area proceedings, the producer would be irreparably injured since he could never recover the additional amount from his pipeline customers.

It is not surprising that the Commission's "in-line" concept has been challenged in the courts. At first blush it is surprising, however, that four courts of appeals appear to have sustained the Commission in applying a mechanical field price test to limit initial prices, without allowing the individual producer to establish any special circumstances that would warrant his receiving a higher price.

The first challenge to the "in-line" concept arose in cases involving price conditions imposed by the Commission on the grant of temporary certificates under section 7(c) of the Natural Gas Act. Since the Commission has well established authority to grant such certificates without a hearing, the question of the producer's right to submit evidence in support of a price exceeding the "in-line" price was not necessarily at issue. In sustaining the Commission's powers to impose a price condition on the grant of a temporary certificate, however, several courts of appeals went out of their way to place a general imprimatur on the Commission's "in-line" price policy by stating or implying in dictum that it was consistent with the Supreme Court's CATCO decision and the statute.

The first square holding, however, on the producer's right to submit evidence in support of a higher than "in-line" price was in an appeal from the Commission's Red Wash Field decision. The producer introduced evidence of drilling costs in the area, as well as delivery conditions in that and other areas, in order to show that he

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40 Algonquin Gas Transmission Co. v. FPC, 201 F.2d 334 (1st Cir. 1953).
41 See Sohio Petroleum Corp. v. FPC, 298 F.2d 465 (10th Cir. 1961); J.M. Huber Corp. v. FPC, 294 F.2d 568 (3d Cir. 1961); Texaco, Inc. v. FPC, 290 F.2d 149 (5th Cir. 1961). Contra, Pure Oil Co. v. FPC, 292 F.2d 350, 353 (7th Cir. 1961); see note 48 infra.
42 California Oil Co. v. FPC, 315 F.2d 652 (9th Cir. 1963).
was entitled to a higher than "in-line" price for an initial sale under a permanent certificate. The Commission's decision relied primarily on existing field prices in adjacent areas to determine the "in-line" price for the Red Wash Field. The Commission did not reject the producer's cost evidence as irrelevant, but found merely that it did not establish any special circumstances which would warrant the departure from the prevailing field price pattern in adjacent areas. The Ninth Circuit, in sustaining the Commission, went further:

We do not think that the Commission was required in this case to consider the exploration and drilling costs or the cost of delivery services in arriving at the 'in-line' price in a certification proceeding. The consideration of these matters may properly be left to a Section 4 proceeding.\(^4\)

In another permanent certificate proceeding that reached the court of appeals at almost the same time as the California Oil decision, Atlantic Ref. Co. v. FPC,\(^4\) the producer argued that the Commission should look at his individual financial position which was sufficiently different from other producers to show that he was entitled to a higher than "in-line" price. The court seems to have rejected this claim, indicating that it regarded individual company experience as irrelevant to the issues under section 7 of the Natural Gas Act:

Petitioner also asserts that its sale should have been considered on an individual basis, that its financial position, its costs of production, were different from those of producers who were able to sell gas at 16.5 cents from the same area at the same time. Petitioner offered no proof before the Commission to show any such difference. What evidence there is in the record indicates that drilling costs in the area would be generally the same for all producers. In any event, the Commission is not required to subsidize high cost producers with consumers' money. Moreover, because of the difficulties inherent in determining what costs of production of natural gas actually are, the Commission should be allowed some latitude in fixing initial prices on an area basis in order that hearings under Section 7 will not become as interminable as Section 5 hearings have been. Of course, if area pricing degenerates into mere acceptance of the contract price in the producing area, then will be time enough to stay the Commission's hand.\(^5\) (Emphasis added.)

Obviously, two courts of appeals have gone out of their way to place a seal of approval on the Commission's practice of excluding any evidence other than prevailing field price evidence in section 7 proceedings. Although the question is still being litigated\(^6\) and a

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4 Id. at 660.
4 316 F.2d 677 (D.C. Cir. 1962).
4 M.H. Hill v. FPC, No. 20373 (5th Cir.).
conflict may develop, thus far the producers have had a singular lack of success in establishing their right to submit evidence to show that their price is consistent with the public convenience and necessity standard.

B. Effect On Area Rates Of Restrictions On The Right To File Rate Increases

1. Validity of Restrictions in Initial Certificate Orders  A virtual prohibition against a producer establishing that he is entitled to a price higher than prior prices received in the area was by no means compelled by the CATCO decision. In fact, CATCO suggests that comparative cost information and value of service evidence is relevant in determining whether a given price is required by the present or future public convenience and necessity. It is probable, however, that the courts have gone along with the Commission's "in-line" price program principally because they believe that the producer is entitled to collect his contract price, subject to refund, even though the initial price is conditioned to a lower level.

The foregoing courts thus seem willing to permit the Commission to impose a mechanical field price standard in setting initial prices only because they believe the producer is fully protected by an absolute right to file for his contract price at any time after it has been granted a permanent certificate, at least where the Commission has not made a determination that a particular rate level is just and reasonable. Furthermore, in H. L. Hunt v. FPC the Fifth Circuit has held in the first direct test of the issue that a producer has an absolute right to file rate increases to which it is entitled by contract. H. L. Hunt involved an attempt by the Commission in granting a temporary certificate under section 7(c) to deny the producer the right to file rate increases above policy statement "new gas" ceilings during pendency of the certificate. Although the Commission's discretion in conditioning a temporary certificate (as to which neither notice nor hearing is required) would seem broader than in a perma-

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47 None of the decisions following CATCO, see note 27 supra, specifically advised the Commission as to the proper measure of proof in producer certificate proceedings.

48 Thus, the Fifth Circuit in Texaco, Inc. v. FPC, 290 F.2d 149, 156 (5th Cir. 1961), and the Ninth Circuit in California Oil Co. v. FPC, 315 F.2d 612, 660 (9th Cir. 1963), recognize this right, and this holding seems implicit in J.M. Huber Corp. v. FPC, 294 F.2d 568 (3d Cir. 1961), and Sohio Petroleum Corp. v. FPC, 298 F.2d 465 (10th Cir. 1961). The Seventh Circuit in Pure Oil Co. v. FPC, 292 F.2d 350, 353 (7th Cir. 1961), refused to concede automatic applicability to the "in-line" price as a conditioning rate level because of its concern for the producer's equities. It apparently did not occur to the court that the producer might be protected by a right under § 4(e) to file for and collect the higher contract price subject to refund.

49 306 F.2d 334 (5th Cir. 1962), rev'd, 32 U.S.L. Week 4294 (U.S. 1964).
The Fifth Circuit refused to make any distinction between permanent and temporary authority and concluded that in neither case could the Commission foreclose a right to file rate increases provided by the sale contract as a condition to granting the certificate authority. This was the first direct test of the issue.

The Supreme Court reversed, limiting itself to the holding that the FPC could condition the award of a temporary certificate on the applicants' maintaining a specific rate level pending permanent certification.

The existence of broad discretionary power in the Commission to condition temporary certificates appears to us to be vital to its ability to hold the line in pricing. The extent of that power in permanent certification is not before us now, since each of these applications is for temporary certification.50

It seems probable that the Commission's rate powers in granting a permanent certificate will eventually be considered by the Supreme Court. A holding extending the Hunt rationale to permanent certification would appear to undermine the rationale of the foregoing decisions approving the Commission's "in-line" price program. If the producer is not able to collect his contract price subject to refund so as to protect his right to receive that price if it is ultimately found lawful, there would seem to be substantial constitutional problems involved in denying him the right to show that some price higher than prevailing field price levels is required by the "public convenience or necessity," which is the effect of the Commission's present procedures.

The Commission's attempt to prohibit rate increases above "in-line" price levels clearly was motivated by a desire to avoid the problem presented by widespread filing of rate increases caused by "triggering" of favored nations or price redetermination clauses in existing contracts.51 Since the Commission has apparently succeeded in its efforts—described below—to eliminate or restrict these escalator clauses, the strength of this justification for an absolute prohibition against "above the line" rate increase filings has been weakened.

2. Regulations Restricting the Right to File Rate Increases Based on Escalation Clauses

The success of the Commission's area rate program may depend upon the Commission's ability to prohibit or control by regulation the timing of rate filings at levels that would breach

51 That is, such clauses usually permit rate increases to the level of the highest going price in the area. Thus, when an "above the line" price is filed, it provides other producers a contract right to file to the same level, even though the original increased rate is subject to refund and ultimately may be reduced retroactively.
its area ceilings. The current litigation concerning the Commission’s efforts to limit rate filings may have a decisive effect on the feasibility of the area programs.

The Commission has attempted to prevent large numbers of rate increase filings to above-policy-statement levels by rulemaking procedures as well as the application of price conditions in individual section 7 cases. In Order 242 the Commission ruled that it will reject contracts filed in support of certificate applications which contain spiral escalation clauses, favored nation clauses, or price redetermination clauses other than those which provide for redetermination no more frequently than five year intervals based solely on Commission-approved prices in the area. Appeals seeking to review this order at the time of issue were dismissed as premature. The Tenth Circuit in Texaco, Inc. v. FPC, an appeal by producers from orders rejecting certificate applications, declared Order 242 invalid as an improper exercise of the Commission’s rulemaking powers. However, the Ninth Circuit in a similar appeal, Superior Oil Co. v. FPC, upheld the regulation.

In Texaco the Tenth Circuit held that Order 242 was invalid because, by authorizing summary rejection of certificate applications, the Order violated the section 7(c) requirement that the Commission “shall set [the application] for hearing . . .” and because review of the Commission’s order on a record under section 19(b) of the act was precluded. The Supreme Court granted certiorari, noting the conflict with Superior, and reversed Texaco. It held, relying on United States v. Storer Broadcasting Co., that the Commission

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52 27 F.P.C. 339 (1962), issued in reliance on § 16 of the Natural Gas Act, note 62 infra.
53 A relatively rare price provision pegging the producer’s price to the price received on resale by the pipeline.
54 See note 24 supra.
55 Shell Oil Co. v. FPC, No. 14058, 3d Cir., July 17, 1962; Hunt Oil Co. v. FPC, 306 F.2d 878 (5th Cir. 1962).
56 317 F.2d 796 (10th Cir. 1961), rev’d, 32 U.S.L. Week 4370 (U.S. 1964).
57 322 F.2d 601 (9th Cir. 1963).
58 Texaco, Inc. v. FPC, 317 F.2d 796 (10th Cir. 1963), rev’d, 32 U.S.L. Week 4370 (U.S. 1964).
59 72 Stat. 947 (1958), 15 U.S.C. § 717r(b) (1958). The court was also troubled by the fact that the Order 242 findings spoke in terms of the "public interest" rather than the public convenience and necessity, but it is unlikely this was an important ground of the result reached.
had statutory authority under section 16 of the act to prescribe by regulation the qualifications of certificate applicants under section 7. The hearing requirement of section 7 was held to be satisfied by giving the applicant an opportunity to seek a waiver of the regulation in his case.

Justice Douglas' opinion (to which only Justice Stewart dissented) appears to construe the Commission's rulemaking authority in broad terms:

The main issue in the case is whether the 'hearing' granted under § 4 of the Administrative Procedure Act is adequate, so far as the price clauses are concerned, for purposes of § 7 of the Natural Gas Act. We think the Court of Appeals erred, that the present case is governed by the principle of United States v. Storer Broadcasting Co., 351 U.S. 192, and that the statutory requirement for hearing under § 7 does not preclude the Commission from particularizing statutory standards through the rule-making process and barring at the threshold those who neither measure up to them nor show reasons why in the public interest the rule should be waived. . . .

The rule-making authority here, as in Storer, is ample to provide the conditions for applications under § 4 or § 7. Section 16 of the Natural Gas Act gives the Commission power to prescribe such regulations 'as it may find necessary or appropriate to carry out the provisions of this Act.' . . .

To require the Commission to proceed only on a case-by-case basis would require it, so long as its policy outlawed indefinite price-changing provisions, to repeat in hearing after hearing its conclusions that condemn all of them. There would be a vast proliferation of hearings, for as a result of Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672, there are thousands of individual producers seeking applications. See Wisconsin v. Federal Power Comm'n, 373 U.S. 294, 300. We see no reason

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62 Sec. 16:
The Commission shall have power to perform any and all acts, and to prescribe, issue, make, amend, and rescind such orders, rules, and regulations as it may find necessary or appropriate to carry out the provisions of this chapter. Among other things, such rules and regulations may define accounting, technical, and trade terms used in this chapter; and may prescribe the form or forms of all statements, declarations, applications, and reports to be filed with the Commission, the information which they shall contain, and the time within which they shall be filed. Unless a different date is specified therein, rules and regulations of the Commission shall be effective thirty days after publication in the manner which the Commission shall prescribe. Orders of the Commission shall be effective on the date and in the manner which the Commission shall prescribe. For the purposes of its rules and regulations, the Commission may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters. All rules and regulations of the Commission shall be filed with its secretary and shall be kept open in convenient form for public inspection and examination during reasonable business hours. 52 Stat. 830 (1938), 15 U.S.C. § 717o (1959).

63 See note 7 supra.
why under this statutory scheme the processes of regulation need be so prolonged and so crippled.\textsuperscript{44}

This language suggests that the Commission would have the power to prescribe by general rule the time and circumstances of rate increase filings under section 4. However, other language in the opinion seems designed to limit the Commission's rulemaking powers to a determination of the qualifications of applicants:

The present regulations do not pass on the merits of any rate structure nor on the merits of a certificate of public convenience and necessity; they merely prescribe qualifications for applicants. . . . Whether Pan American can qualify for a certificate of public convenience and necessity has never been reached. It has only been held that its application is not in proper form because of the pricing provisions in the contracts it tenders.\textsuperscript{65}

The Court also does not concern itself explicitly with the character of review over the regulation, a point which had been discussed by the Ninth Circuit in \textit{Superior}:

In determining the propriety of rules of general application, only a legal question is presented—whether on the factual premise upon which the Commission acted, the rule promulgated is unreasonable, arbitrary, capricious or discriminatory. If the factual premise itself were open to review, then it would be necessary for all general rulemaking to include a trial-like hearing. As stated earlier in the opinion, this is not required.\textsuperscript{66}

However, the Supreme Court decision appears to pass upon the reasonableness of the regulation and hold that the prohibition of multiple rate filings is sanctioned by the consumer protection purpose of the Natural Gas Act.

It would seem clear that a producer is entitled at some point to obtain review of the lawfulness of the regulation—whether this review is restricted (as the Ninth Circuit views it in \textit{Superior}) to a question of law or whether it is broader and takes into account the Commission's appraisal of the facts from which it drew its conclusions as to the need for the regulation. If, as the courts have held, the producer cannot review the regulation at the time it issues, it would seem desirable to allow the producer to argue the arbitrariness of the regulation in the context of the rulemaking proceeding record. This record usually will be the only record available that bears on the genesis and purpose of the regulation. The producer may be able to do this by referring to the rulemaking proceeding record in its

\textsuperscript{44} 32 U.S.L. Week 4370, 4372-73 (U.S. 1964).
\textsuperscript{65} \textit{Ibid.}
\textsuperscript{66} \textit{Superior Oil Co. v. FPC}, 322 F.2d 601, 619 (9th Cir. 1963). See Fitzgerald, \textit{ supra} note 60.
pleadings and briefs to the court. If he is denied this right, it would seem that the decisions barring review of Order 242 should be reconsidered.

It can be argued that Order 242 constitutes a more reasonable balancing of producer and consumer interests than would an absolute bar on price increases as a condition to the grant of a permanent certificate in an individual case. Since the order operates prospectively only, producers presumably have been able to tailor their contracts, so as to provide increases above “in-line” prices through fixed price escalation clauses, as well as price redetermination clauses on a five-year basis. Such provisions would seem to provide a substantial amount of protection against the possibility that the Commission’s “in-line” prices will ultimately be found to be too low under the section 4(e)-5(a) standards in the area proceedings. If, however, the Commission succeeds in imposing permanent price increase prohibitions, the producers will be in difficulty, since they will be subject to a price “freeze” at “in-line” levels that may well prove too low when measured against the standards of section 4(e) and 5(a) of the act.

It has already been pointed out that the validity of the Commission’s Order 242 as well as its permanent certificate conditions against filing rate increases have a clear bearing on the current area rate proceedings. If the Commission cannot control the contract bases for rate increase filings and the timing of increased rate collections, it is doubtful that it will be able to work out a practicable area rate method since such a method presupposes simultaneous review of all rates in an area rather than filings and collection of individual rates by each producer.  

C. Current Jurisdictional Issues Bearing On The Feasibility Of Area Rates

The feasibility of area rates as a regulatory method would be questionable if producers could avoid Commission control of substantial amounts of gas moving interstate and thus receive higher prices for such gas. The existence of a second, higher price level for some sales would make it far more difficult for the Commission to gain acceptance of its area ceilings and would place great pressure on the Commission to raise such ceilings to the nonjurisdictional level.

Since buyers on the intrastate market for the most part have not been willing to pay more than the going interstate price, it is questionable whether higher intrastate sales prices that might undermine
area regulation would exist. However, producers have relied on a number of jurisdictional devices to avoid FPC field price regulation over gas moving interstate so as to be able to collect above-ceiling prices, particularly in selling unusually large blocks of gas.

1. Direct Sales to Industrial Purchasers One of the first devices involved direct sales by producers to large volume industrial purchasers; the gas was transported in interstate commerce by the pipeline under a contractual arrangement with the purchaser. This transaction was subject to the Commission's certificate authority under section 7 since interstate transportation was involved, but avoided FPC rate regulation of the price charged the direct purchaser since the sale would not be a "sale for resale in interstate commerce" within the meaning of section 1(b). The Commission, however, refused to certify such an arrangement because of its adverse impact on field price regulation; this was sustained by the Supreme Court in FPC v. Transcontinental Gas Pipeline Corp. Other direct sale arrangements are now pending before the Commission, and it remains to be seen whether the Commission will be willing to authorize transportation of gas sold at an "above-the-line" price directly to an industrial purchaser if this would have the effect of breaching the area price ceiling or the "in-line" price level which has been established. The device seems of limited utility to the producers because most gas must be sold to pipelines for distribution for multiple uses, including resale to other customers. However, authorization of even one major transaction of this type could have a significant impact on general price levels in a producing area.

2. Leasehold Sales The producers have also attempted to avoid price regulation by the device of leasehold sales, i.e., the producer, instead of selling a specified volume of gas from its own producing properties over a specified period of time, conveys the leasehold in the underlying reserves or "working interest" to the pipeline purchaser. The first of these transactions involved conveyances by a number of producers in the Rayne Field to Texas Eastern Transmission Corporation, which simultaneously sought authorization under section 7 to construct facilities to take the gas. The original Commission order granting a certificate to the pipeline was reversed by the Court of Appeals for the District of Columbia for failure to determine the

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68 See note 4 supra.
70 365 U.S. 1 (1960).
71 Public Serv. Comm'n v. FPC, 287 F.2d 143 (D.C. Cir. 1961).
per-Mcf cost of the gas to the pipeline in deciding whether the pipeline facilities were required by the public convenience and necessity (or, alternatively, to condition the certificate so as to allow a future determination). The court assumed without deciding that the Commission had no jurisdiction over the producer sale in itself. On remand, the Commission reversed itself and ruled that it had jurisdiction over leasehold transfers to interstate pipelines; it concluded that the leasehold sales were essentially, if not in form, sales in interstate commerce for resale within the meaning of section 1(b).

The Commission relied partly on the fact that the transaction resembled a conventional gas sale in a number of respects, including the retention by the producer of rights in minerals other than gas; the gearing of payment to production rates; the requirement that the buyer pay separately for natural gas liquids production; and the fact that the seller continued to operate the property under a contract with the buyer.

The Rayne Field order has been appealed. However, at least one major leasehold sale project has been abandoned in the light of the Commission’s ruling, and unless the Commission’s theory is squarely rejected by the courts, the leasehold sale device appears of doubtful value as a means of avoiding field price regulation, particularly in the light of the above mentioned District of Columbia Circuit decision requiring scrutiny of the unit cost of the gas transferred to the pipeline.

3. Commingled Gas Another jurisdictional problem now engaging the Commission and currently in litigation concerns natural gas that moves in an interstate pipeline, but, as a matter of contract, is to be consumed prior to movement out of the state of production. The Commission held in its Lo-Vaca opinion that a sale of such gas to El Paso Natural Gas Company was subject to its jurisdiction since

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72 I.e., the amount which the pipeline was paying per thousand cubic feet for the gas reserves: a figure which the court regarded as relevant to the "public convenience and necessity" standard under § 7.
75 M.H. Marr v. FPC, No. 20560 (5th Cir.).
77 It is possible that the Fifth Circuit will affirm the Commission on a narrow ground, relying on the above described special characteristics of the transaction to label it a sale of a real property interest in name only. If so, it might be possible for producer counsel to draft sales agreements that would qualify as bona fide real property transactions and thus escape direct price regulation.
the gas was commingled with other gas moving in interstate commerce. The rationale adopted by the Commission was as follows:

The touchstone to the question whether a sale of gas is for resale in Interstate Commerce is what is done with the gas, not what the parties may say about the transaction, verbally or in writing.

The Commission's decision was reversed by a panel of the Fifth Circuit, one Judge dissenting. The court relied on the facts that (1) the transaction was contractually segregated, (2) the gas in question was metered separately, and (3) gas molecules in the amount specified by the purchase contracts were in fact produced, transported, and consumed within the same state. The court held that the molecular commingling of the gas in the interstate line was not a significant factor from a jurisdictional standpoint. The Commission was denied rehearing en banc and has sought certiorari to review this decision.

The amount of natural gas which would be subject to the Commission's jurisdiction under this theory is probably small relative to amounts now moving in interstate commerce, but the issue may be important because of the possible effect of such intrastate pipeline sales on general field price levels and on area prices. Something can be said for both sides of the controversy. As the Commission pointed out in its opinion, the El Paso interstate line is an integrated system which moves large volumes of natural gas from producing areas within Texas to out-of-state points. It is true that the Commission could not regulate the sale if the gas had been transported by El Paso in a separate line running from the point of production within the state only to points of consumption within the same state. The Commission argued, however, that in adopting the Natural Gas Act, Congress contemplated overall regulation of interstate pipelines; hence, a party should not be permitted to "contract out" certain portions of the flow of the line from federal jurisdiction by designating particular gas supplies for intrastate sales. The Commission certifies interstate lines based on dedicated gas revenues, and if it cannot control intrastate sales off such lines, the pipeline might be free to sell possibly low cost reserves to intrastate customers and leave the interstate market with inadequate or higher cost supplies.

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79 Lo-Vaca also involved another sale contract which restricted the gas sold to consumption by the purchasing pipeline outside the state of production. The issue there was whether the sale was jurisdictional merely because the gas was commingled with other gas that would be resold in interstate commerce. The court held that it was not.

80 Lo-Vaca Gathering Co., 26 F.P.C. 606, 613 (1961), vacated, 323 F.2d 190 (5th Cir. 1963).

81 Lo-Vaca Gathering Co. v. FPC, 323 F.2d 190 (5th Cir. 1963).
On the other hand the producers argue with force that the particular gas molecules delivered intrastate off the El Paso line were in fact produced, transported, and consumed all within the same state and that had Congress intended to regulate this type of sale, it would have excluded sales by interstate pipelines from the general exemption covering intrastate sales.

It is clear from the legislative history of the act that Congress contemplated divided regulation over natural gas, part federal and part local. Although arguably it might be more convenient for the Commission to have exclusive jurisdiction over sales by interstate pipelines, Congress clearly intended that the states would continue to regulate local sales of local gas. Furthermore, all of the practical considerations leading the Commission to seek jurisdiction over intrastate sales made off lines running out of state are equally applicable to sales made by interstate pipeline companies from purely local facilities, yet these are indisputably nonjurisdictional.

*Peoples Natural Gas Co. v. Public Serv. Comm'n* and *North Dakota v. FPC* provide substantial support for the producer position. It seems probable that should the Supreme Court review the question, the Fifth Circuit's *Lo-Vaca* decision will be affirmed.

The foregoing issues are of more than transient importance since they will inevitably arise, even if in altered form, in the area pro-

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84 270 U.S. 510 (1926). In *Peoples* a company transported West Virginia gas to Pennsylvania where it was commingled with Pennsylvania gas and delivered to customers. The company resisted Pennsylvania rate and certificate jurisdiction over a particular Pennsylvania sale on the ground that the entire commingled stream was in interstate commerce. The stream contained sufficient Pennsylvania gas to supply the customer in question. The Supreme Court upheld the state commission's jurisdiction stating:

> As respects the Pennsylvania gas we think it must be held to be in intrastate commerce only. Feeding it into the same pipelines with the West Virginia gas works no change in this regard. Of course after the commingling the two are undistinguishable. But the proportions of both in the mixture are known and that of either readily may be withdrawn without affecting the transportation or sale of the rest. So for all practical purposes the two are separable, and neither affects the character of the business as to the other. *Id.* at 554-55.

85 247 F.2d 173 (8th Cir. 1957). The Eighth Circuit held that the FPC had no jurisdiction over gas purchased under a contract restricting its sale to the state of production but which was commingled in a line going out of state—a close parallel to *Lo-Vaca*.

86 Space does not permit consideration of a number of other jurisdictional problems confronting the Commission, including *inter alia*, its jurisdiction over transportation of gas produced offshore outside the boundaries of a state (United Gas Pipeline Co., No. 401, FPC, Aug. 26, 1963); gas processing facilities (Phillips Petroleum Co., 24 F.P.C. 537, 562-564 (1960)); transportation and sale of liquified methane; (FPC Release No. 12,443, Jan. 10, 1963); and so-called "gathering" facilities (Ben Bolt Gathering Co., 26 F.P.C. 825 (1961), aff'd, Ben Bolt Gathering Co. v. FPC, 323 F.2d 610 (5th Cir. 1963)).
ceedings. No doubt awareness of this fact has been one reason for the producers' vigorous resistance to the Commission's continuing attempt to restrict filing and contracting practices which lead to rate increases. In the following pages, an effort will be made to project these issues forward into the context of area regulation and to anticipate some of the new issues which inevitably will arise in the pending area proceedings.

II. THE AREA RATE PROCEEDINGS

Although group or aggregate rate regulation is by no means new in American law, no regulatory body heretofore has attempted to apply maximum price regulation to a raw material industry. It must be recognized at the outset that the Commission's primary problems in producer regulation are as much practical or economic as legal; for example, the Commission must resolve the following questions: How to obtain adequate data on gas reserves and production? What regulatory factors, if any, will induce producers to explore for and develop gas reserves? What will be the future demand for natural gas? Can producers explore for and produce gas separately from other hydrocarbons? What can be done about that figure of folklore and fact, the one-well producer? Is gas production an increasing cost industry? Such economic questions, strictly speaking, are outside the scope of this Article, but they will influence the decision of the legal issues. Conversely, the legal uncertainty confronting the Commission since the Supreme Court's Phillips decision has greatly complicated its task and paralyzed its initiative in dealing with operational and practical problems of gas regulation.

Hence, an examination of the legality of the Commission's projected area rates should include some appraisal of the economics of the industry; the Commission's administrative problems and limitations; and the nature of the demand for or the utilization of natural gas. Unfortunately, at least until the area proceedings have concluded, it will be difficult to describe the economic realities and the administrative conditions against which the Commission's area program will be judged. However, in the following discussion, an effort will be made to place the legal issues in this context.

A. Present Posture Of The Area Rate Proceedings

The Commission, as noted above, has initiated two area rate proceedings, one involving the Permian Basin in west Texas and Kansas, in which hearings have concluded, and the second involving south-
ern Louisiana, in which hearings commenced in Spring, 1964. The Commission has announced that it intends to initiate two additional area proceedings covering gas production in the Texas Gulf Coast and in the Hugoton-Anadarko area encompassing Kansas and parts of Oklahoma and Texas. The timetable for these proceedings is uncertain, but it is clear that they could not be completed for several years at best.

Although no examiner's decision has yet issued in any area proceeding, an outline of these proceedings is becoming visible as a result of rulings by the Commission as well as the evidence presented by the parties in the first such proceeding. The Commission has made it clear that it will not base an area rate on individual company costs, and it has refused to permit the producers to submit such cost evidence in the area proceedings. The Commission, in the Permian proceeding, has collected cost data from all of the producer-respondents, both on a national and area basis, from which it has been possible for various parties to construct a national or area composite cost (i.e., revenue requirement) for the test year 1960. Although the methods employed by the parties naturally have varied—particularly in allocating costs between gas and condensate products and in assigning exploration costs to the particular area—it seems probable at this juncture that the area rates ultimately adopted by the Commission will be related in some way to national and area costs developed in the area proceedings. The range of possibilities has been considerably narrowed by the actual evidence submitted by the parties because it is improbable that the Commission will adopt a method or approach to area cost finding or rate making that has not been suggested by one of the parties and for which no substantiating evidence has been introduced. This is not to say that the Commission could not adopt a combination of the various methods submitted, but rather that it is unlikely to go entirely outside the record and adopt some distinctly new approach to regulation.

Furthermore, the examiner in the Permian Basin proceeding has
given the parties his "tentative" conclusions on important issues."
Although these of course represent merely one examiner's current
views, they offer an example of a regulatory method which could
be adopted by the Commission. Using this examiner's approach
merely by way of illustration, it is possible to anticipate certain con-
stitutional and legal problems that the Commission will encounter in
any method of area rate regulation that it might adopt.

The parties in the Permian Basin proceeding introduced composite
cost studies from which it was possible to determine a national total
"cost" of producing gas during the 1960 test year; they also intro-
duced limited production costs for the Permian Basin area. After
weighing this evidence as well as other considerations such as the
value of the gas to the ultimate purchaser and the need for incentives
to continue exploration or production, the examiner tentatively con-
cluded that the unit revenue (or revenue requirement) of the pro-
ducers for gas under contracts filed prior to January 1, 1961, in the
Permian Basin area ("old gas") should be a specified number of cents
per Mcf. This unit revenue would be applicable to all production
within the area.

The examiner made a separate determination of a unit revenue re-
quirement for gas covered by contracts filed with the Commission on
or after January 1, 1961 ("new gas"). In doing this, he looked
primarily to the national cost figures because he regarded it important
that producers be given an incentive to explore and produce in the
lowest cost areas, a feat that would be achieved by a uniform price
ceiling for "new gas."

The examiner then proposed two ceiling prices ("old gas" and
"new gas") applicable to the Permian Basin area at a level slightly
in excess of the two unit revenue requirements he had determined.
He also stated that it would be necessary to scale down these prices
for gas that was inferior in quality. He proposed that existing rates
on file should be reduced to the extent necessary to bring each pro-
ducer's unit revenues to the gas ceiling levels. The new gas ceilings
should be applied to limit the initial prices that the Commission would
authorize in section 7 certificate cases governing contracts filed after
January 1, 1961. The examiner also stated that he would favor hon-
oring periodic contractual increases in existing and new contracts to
take into account rising costs or inflation.

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83 Record, pp. 30257-365, Area Rate Proceeding, 24 F.P.C. 1121 (1960).
84 Further details of the examiner's tentative unit revenue determinations are omitted
here as irrelevant for present purposes.
B. The Problem Of The High Cost Producer

If such a regulatory method were adopted in the Permian area and then extended by the Commission to the other major producing areas, the producers would receive unit revenues for "old gas" that would reflect in part the aggregate cost of production in each area (but not their individual cost of producing the gas), as well as value factors and other considerations. Such prices presumably will not be uniform from area to area, although the degree of variation might not be particularly wide in view of the fact that only the production cost component would vary significantly.

For "new gas" the producer would be entitled to recover unit revenues based on a more or less uniform national ceiling which would reflect primarily the aggregate cost of producing gas on a national basis. This "new gas" ceiling would be subject to downward adjustments for gas that was of inferior physical quality. Gas of lesser value to the purchaser for other reasons, e.g., casinghead gas, would be sold at a lower price. Producers presumably would be allowed to increase their rates up to the level of the ceilings when authorized by contract, and rates could be increased above the initial area rate to some extent by periodic escalations if the producer was entitled contractually to make the filing.

A number of problems immediately spring to mind. In the simplest case a small producer exploring and producing only within a single area has unit costs averaged over a substantial period (say five years) which exceed the allowable old gas and new gas unit revenue requirement. He may be selling gas currently at rates that yield a unit revenue equal to or in excess of his unit costs. If his rates are reduced to a level that will produce only the allowable unit revenues for the area, it is possible that as a direct result of federal regulation he will be required to operate his exploration and production business at less than a utility "return" on his investment or even at a loss.

Assume in the case presented that the small producer will not be able to recover in full his anticipated future costs of operation (including any exploration costs) out of the revenues allowed him by

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44 Casinghead gas is produced in conjunction with oil, which in most states is subject to proration controls that restrict production. Hence, such gas may not be available to the purchaser at times or in quantities desired.

45 Conventional returns for public utilities in recent years have ranged from 5% to 7% on "investment," variously determined. See Bonbright, Principles of Public Utility Rates 149-51 (1961). What return would be considered appropriate for a gas producer is a question of great difficulty. Atlantic Ref. Co. v. FPC, 316 F.2d 677, 678-79 (D.C. Cir. 1963). The Commission allowed approximately 11% in Phillips and its staff experts' recommendations in producer proceedings have ranged between 9% and 12%. 24 F.P.C. 537, 574 (1960). One virtue of the area approach from the Commission's standpoint is that the problem can be subordinated, although not entirely avoided.
the Commission's ceilings. This assumption of course ignores the possibility that the producer may have better luck in the future in that his unit cost of gas found and produced may decline sharply as a result of a successful strike. If this does not occur, the producer has two alternatives—short of selling off his leaseholds and retiring from the business or merging with a larger company. First, he can continue to produce and sell gas under his existing contracts so long as revenues exceed his out-of-pocket operating expense of producing the wells. Any revenues exceeding out-of-pocket operating expense can be devoted either to further exploration or development or to recovery of a portion of his fixed investment. He will never be able, however, to recover his entire past exploration and development expense and investment, nor will he earn a utility return on his investment. The other alternative which may be open to the producer is to abandon his sale if the Commission will permit him to do so and to sell at a higher price in the intrastate market. Although well over half of the natural gas is sold interstate at regulated prices, this alternative assumes that the producer will be able to obtain a higher price in the intrastate market.

C. Does The Natural Gas Act Sanction Area Rates?

Two primary legal questions are presented by the foregoing example. First, does the Natural Gas Act permit the application of an "area" rate to the producer, or did Congress intend that a producer's rates be tested against his individual costs? The second question is whether holding the producer to a level that renders his operations unprofitable and requires him to earn less than a fair return on its investment (or even a loss) amounts to a violation of the due process clause of the fifth amendment. Assuming that the Commission does not obtain exemption of all producers in this category from requirements of the act and assuming that it does not set its area ceilings so high as to cover the requirements of the highest cost producers in any area, the Commission may have to face both questions in appeals

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86 Section 7(b) of the act provides:

No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment. 52 Stat. 824 (1938), 15 U.S.C. § 717f(b) (1959).


88 Both assumptions seem sound. The Commission has never sought legislation to exempt the smaller producers and apparently believes that this would be impracticable. The basic concept of area or "bulk line" pricing assumes that the uniform rate will be based on
brought by small producers caught in a revenue-cost squeeze.

Concerning the question of the lawfulness of the area proceedings under the Natural Gas Act, the Commission can argue that the act does not specify or require the determination of individual producer rates based on individual producer costs. It is true that the act calls for the filing of rates by the individual producer and for the testing of those rates against the justness and reasonableness standards set forth in section 5 (a). The act does not, however, state that the test of justness and reasonableness is whether the producer receives an excessive or inadequate return based on his individual investment. Accordingly, the Commission will argue that it is not bound to any particular formula for determining a just and reasonable rate and that so long as the end result is reasonable the Commission’s rate orders must be sustained.99

The producer can counter with the argument that legislative history indicates that Congress intended a conventional, individual, cost-rate method of regulation;100 that the structure of the act (e.g., section 6) contemplates individual rates based on individual company costs; and that section 4(e) of the Natural Gas Act contemplates individual rate filings and directs the Commission unequivocally to hold a “full hearing” on individual rate increases that it suspends and investigates. The mechanical application of an “area” ceiling to allow or disapprove rate increases is no substitute, so the producer can argue, for the full hearing on rate increases specified by the act. Hence, the Commission is not free to approach the matter on an area basis.

The producer will point out that the Natural Gas Pipeline, Hope, and Colorado Interstate cases101 were concerned with appropriate methods for regulating individual pipelines—specifically with methods for determining those particular companies’ costs. Moreover, the Supreme Court’s observations regarding the Commission’s freedom to select a regulatory method were entirely within the framework of individual company regulation. The producer also will point out that when Congress intends to authorize group or area regulation of utilities or carriers, it does so expressly, as in Part I of the Com-

100Hearings on H.R. 11667, H. Interstate & Foreign Commerce Committee, 74th Cong. 2d Sess. 12; 81 Cong. Rec. 6727 (1936).
101See note 99 supra and accompanying text.
merce Act.\textsuperscript{108} Also, if Congress wishes rates to be governed by criteria in addition to individual cost-of-service so as to reflect industry or group costs or revenue requirements, it does this expressly, as in the Federal Aviation Act\textsuperscript{109} and the Commerce Act.\textsuperscript{110} Hence, the Natural Gas Act cannot be applied as if it contained criteria or authorized procedure when in fact it does not.

It appears likely that the Commission will be sustained in approaching producer regulation on an area or group cost basis and that the validity of the Commission's program will depend not on statutory construction but on a due process challenge by high-cost producers. This view is influenced by the dictum\textsuperscript{106} of the majority in \textit{Wisconsin v. FPC}\textsuperscript{106} approving in concept the Commission’s area approach under the Natural Gas Act. The Court majority goes far out of its way to underline its willingness to accept an approach based on area or group costs rather than individual company costs,\textsuperscript{107} and the four dissenting Justices do not appear to challenge the Commission's basic power to utilize an area or group cost approach under the act. However, the dissenters have substantial doubts as to the constitutionality of area rates if applied mechanically to high-cost producers, an issue discussed hereafter.

It also is possible that the Commission's area rates will be challenged by state regulatory bodies or other consumer representatives because they provide a windfall to one or more producers with unusually low costs. The challenger might contend that permitting such a producer to collect the area rate levels would per se sanction “unjust and unreasonable rates” and violate the Natural Gas Act. This would be tantamount to arguing that only rates based directly on individual company costs-of-service are lawful under the act—a conclusion which seems doubtful in the light of the Supreme Court's dictum in \textit{Wisconsin v. FPC}.

\textbf{D. Do Uniform Area Rates Violate The Due Process Clause Of The Fifth Amendment As Applied To A “High Cost” Producer?}

It seems likely, therefore, that the Commission's area proceedings

\textsuperscript{108} 41 Stat. 488 (1920), 49 U.S.C. \S\ 11(a) (1959).
\textsuperscript{110} 41 Stat. 488 (1920), 49 U.S.C. \S\ 15(a) (1959). The relevance of rail and air carrier regulation to the constitutionality of the Commission’s area rate approach (as opposed to its validity under the Natural Gas Act) is considered in note 133 infra and accompanying text.
\textsuperscript{106} Although only dictum, the court's language clearly seems designed to reassure the Commission in its pioneering effort. Time or the retirement of justices may of course prove such assurance illusory.
\textsuperscript{107} Id. at 309-10.
\textsuperscript{108} Id. at 327.
THE AREA RATE PROCEEDINGS

will not be outlawed merely because individual company costs are not the basis of determining just and reasonable rates under the Natural Gas Act. On this assumption, the small producer in the foregoing example must rely on establishing that his property has been taken without due process of law as a result of the area ceilings—because of his inability to earn a utility return or his being forced to operate at a loss.

It is now time to complicate the question. The due process issue may also be raised by producers operating in more than one area. Consider a simple example—a producer operating in two areas. If in area A such a producer has unit costs below the area ceilings and is receiving unit revenues higher than the area ceilings, then reduction of unit revenue to the area ceiling would leave the producer with a smaller unit profit in area A. However, if in area B the producer's unit revenue and unit cost is above the area ceiling, reduction of unit revenue to the area ceiling would cause the producer to sustain a loss in area B. Thus, even if the unit profit in area A is more than the unit loss in area B, the producer still may not receive a utility return. Moreover, if the unit loss in area B is more than the unit profit in area A, the producer will not recover his investment. This simple analysis can be applied to a producer operating in all areas.

In each of the foregoing cases it is assumed that the producer can demonstrate his historical average unit costs by submitting a cost-of-service study for a series of recent test years. This will consist not only of his development, production, overhead, and investment expenditures during the period, but also of exploration and investment expenditures incurred during the period in the search for new gas discoveries to replace or enlarge existing reserves. A claim of confiscation in any of the foregoing instances necessarily implies that the producer's average historical unit costs will not change significantly in future years. However, the extent, and more particularly the success or failure, of exploration programs can drastically change a producer's unit costs in any given period, and development expenditures fluctuate widely from year to year even with large producers.

Despite these uncertainties, it is assumed at this point that one or more producers will be able to raise the due process issue by showing a record of past performance indicating a strong probability that

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109 Whether or not there are in fact producers with historically "high" cost experience is considered in the text accompanying notes 149-50 infra. The hearings in the individual company rate cases, now abandoned by the Commission, were primarily devoted to such studies for single test years. A number of producers have attempted unsuccessfully to introduce such studies in the Permian Basin proceeding. Record, p. 225, Area Rate Proceedings, 24 F.P.C. 1121 (1960).

110 Record, p. 11462, Area Rate Proceedings, 24 F.P.C. 1121 (1960).
reduction of their rates—present and future—to area ceilings will yield less than a reasonable return on their past investment from future sales.

The facts of the cases finally reaching the courts may influence the end result. For example, under area ceiling rates the individual producer's unit revenue (1) may fall short of recovering fully distributed cost and an allowance for a reasonable return on investment; (2) may recover fully distributed costs (including the amounts expended for exploratory operations during the period), but may not allow a reasonable return; (3) may recover out-of-pocket cost of operating and developing the producer's existing properties, but permit no exploratory activities; or (4) may recover merely the out-of-pocket cost of producing developed leaseholds.

The Commission's defense of the application of area rates to deny a reasonable return to such a "high-cost producer" would rely on a broad view of governmental powers under which police regulations limiting private conduct are tested by weighing public versus private need or injury, \( i.e. \), the injury to the citizen from the police regulation is weighed against the need of the general public for the regulation. If on balance the need is sufficiently great or the private injury sufficiently slight, the regulation is "reasonable" and any resulting private injury is not proscribed by the due process clause of the fifth amendment. Obviously, there are no precise scales on which to weigh these conflicting interests, and the judicial sense of reasonableness will be influenced by many factors.

There have been only a few cases involving statutes in any way comparable to the Natural Gas Act as applied in the projected area rates, and it is impossible to distill from past decisions a definitive list of controlling factors. However, the Commission, in defending its area price orders, will no doubt rely on \textit{Tagg Bros. & Moorhead v. United States}, \textsuperscript{111} \textit{Aetna Ins. Co. v. Hyde}, \textsuperscript{112} and \textit{Bowles v. Willingham}. \textsuperscript{113}

\textit{Tagg Bros.} involved a challenge under the due process clause of the fifth amendment to a uniform schedule of rates imposed on commission merchants under the Packers & Stockyards Act, \textsuperscript{114} which empowers the Secretary of Agriculture to set "just and reasonable" and "non-discriminatory" rates for commission merchant services. The commission merchants had established uniform rates for their

\textsuperscript{111} Nebbia v. New York, 291 U.S. 502 (1934).
\textsuperscript{112} 280 U.S. 420 (1930).
\textsuperscript{113} 275 U.S. 440 (1928).
\textsuperscript{114} 321 U.S. 503 (1944).
services on the Omaha Exchange which the Secretary found excessive and unlawful measured against the cost of performing the services on an efficient basis. Some merchants sued to enjoin the rate reduction on the ground of confiscation. A three-judge court found that the costs of the merchants varied widely and that some undoubtedly would lose money under the new rates. Despite this finding, the court sustained the Secretary’s order as a reasonable exercise of the federal police power, relying on the statutory finding of a need for regulation to protect the public against the merchants’ monopolistic power to set prices free of competitive influences. In such circumstances the court held (1) that an inefficient or high-cost commission merchant had no constitutional right to a rate covering his costs plus a reasonable return and (2) that one of the legitimate purposes of federal regulation was to force such merchants to greater efficiency or to eliminate them from the business. The court stated:

It was not incumbent upon the Secretary to fix the rates so high that all agencies in the business would make money, whether they did substantial business or not. The stock exchange itself did not attempt that. . . .

The Secretary found a maximum for the other items of costs of carrying on the market agencies in substantially the same way that he arrived at the salesman cost. He refused to be bound by either the lowest cost he found, or by the highest, or by any mathematical average. He found the cost which he deemed normal and reasonable, well below the highest and well above the lowest. As to each item there is proof that some agencies are getting the thing done in actual operation well within the maximum fixed. In each instance there are some agencies that are not keeping within the maximum. Necessarily so. Undoubtedly, if rates were fixed so high that certain profits were assured to all regardless, the agencies would multiply much faster than live stock could be brought to the market, and an endless chain of rate increases would be necessary. It is not the purpose of the regulation to bring this about.

The court’s conclusions were sustained without discussion by a unanimous Supreme Court speaking through Mr. Justice Brandeis.

The Aetna Ins. case involved an order by the Insurance Department of the State of Missouri which sought to regulate on a group basis the rates of certain insurance underwriters in that state. The department had aggregated the costs and revenues of the underwriters over a twelve-month period and found that they were

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107 Id. at 755.
earning a return in excess of that which the department considered reasonable. Accordingly, the department reduced the rates of all underwriters by ten per cent. The underwriters as a group challenged the order under the due process clause of the fourteenth amendment to the federal constitution, claiming that many of their members had experienced much greater than the average industry costs and perhaps would operate at a loss as a result of the rate reduction. However, none of these companies submitted individual costs to establish the confiscatory character of the rate reduction as applied to them. The Supreme Court, in sustaining the order in an opinion by Mr. Justice Butler, did not rely exclusively on this lack of evidence. It seems to have held that individual underwriters could not complain of the impact of the uniform rate order, so long as it reasonably reflected the aggregate or typical costs of such companies and included a reasonable return. Thus, the Court stated:

It has never been and cannot reasonably be held that state-made rates violate the Fourteenth Amendment because the aggregate collections are not sufficient to yield a reasonable profit or just compensation to all companies that happen to be engaged in the affected business. . . . The petitioners are competitors and each carries on business for itself. While they may by joint action pursue the remedy given by § 6284, it does not follow that the Constitution safeguards aggregate profits sufficient to constitute just compensation for all the companies. . . .

The most recent decision, Bowles v. Willingham,\(^{120}\) upheld the constitutionality of the World War II rent control legislation applying uniform rent ceilings to landlords, regardless of their individual costs. The Supreme Court sustained a uniform rent ceiling as an exercise of the general police powers of the federal government, even on the assumption that it was unfair to the individual landlord. In so doing, it relied on the following grounds: (1) it would not be practicable to prescribe ceilings individually tailored to the millions of landlords throughout the country; (2) the landlord was not compelled to rent the property; and (3) a party could not avoid an otherwise reasonable government price regulation on the ground that his individual costs made it confiscatory:

It is implicit in cases such as Nebbia v. New York . . . that high cost operators may be more seriously affected by price control than others. But it has never been thought that price-fixing, otherwise valid, was improper because it was on a class rather than an individual basis.\(^{125}\)

Although Bowles v. Willingham is of course distinguishable in

\(^{120}\) Id. at 447-48.
\(^{121}\) 321 U.S. 503 (1944).
\(^{125}\) Id. at 518.
that it involved an exercise of the police powers of the federal government during a war emergency, the Court, by implication at least, has indicated that the mere fact a uniform price regulation bears heavily against an individual with above-average costs does not predetermine its constitutionality. Rather, that question must be decided on the basis of all of the circumstances, including the public need for the regulation.

These three decisions suggest that in deciding the constitutionality of area rates as applied to a “high cost” producer, the courts will discuss the following questions:

1. **What is the Nature of the Public Need for Gas Regulation—Do Market Conditions Require Uniform Prices To Achieve the Purpose of Congress, or Are Occasional “High” Prices (Where Cost-Justified) Consistent With That Purpose?** The Commission necessarily must argue that under the statutory standard, “public convenience and necessity,” it is authorized to forbid commerce in natural gas at a price that is significantly higher than the price at which the bulk of the gas can be produced and introduced into interstate commerce. Producers that are inefficient or unlucky will have to sell their gas at a price that does not return a reasonable profit, and producers which are very fortunate or efficient will receive windfall profits. The Commission will contend that this would be the case under conditions of unregulated competition because there the inefficient or unlucky producer could hope to receive no more for his gas than the price established by the free play of supply and demand in the market place. In the long run the prices in such a market would cover, within broad limits, the average experienced cost of production, including investment and financing costs. Higher prices could only be obtained by a producer that had monopolistic or semi-monopolistic control over the source of supply in a given area at a given time.²⁸⁸

The Commission will argue that the Natural Gas Act constitutes an irrebuttable legislative finding that the industry is sufficiently non-competitive or has other inelastic characteristics so as to require government regulation, and thus its existing prices reflect such influences.²⁸⁹ Generally, in industries in which the market mechanism

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²⁸⁹ It can be argued that Congress, in referring in the Natural Gas Act to the Report of the Federal Trade Commission, was relying on findings of that Commission as to lack of effective competition in the distribution and sale of natural gas:
Section 1 (a):
As disclosed in reports of the Federal Trade Commission made pursuant to Senate Resolution 83 (Seventieth Congress, first session) and other reports.
does not operate in a purely competitive manner, federal regulation such as is embodied in the Natural Gas Act is imposed to obtain an equivalent of pure competition through public control and surveillance. Accordingly, uniform area prices based on average or mean costs would be a reasonable exercise of governmental police powers and would be consistent with the public interest. Hence, the loss suffered by the high-cost producer would not be a taking of property without due process of law, but rather the result of economic forces establishing a "mean" or average price which is then reflected in regulation designed to eliminate a departure from that price caused by imperfect competition.

It could be argued to the contrary that any analogy of area prices with a "pure" competitive market is unpersuasive. A pure competitive market is a theoretical model in which analysis of the effect on the market of rigidities and imperfections is eliminated. In the real, unregulated market the producer is often able to find a buyer for his gas at prices that would yield him a reasonable return on his investment, even if this price is higher than some mean or average price. Moreover, a "pure" market would be characterized by sharp fluctuations in the uniform price level of a kind wholly impracticable in this industry. In fact, so the argument would run, the conditions under which the high-cost producer originally sold his gas at above ceiling prices represented as close an approach to a freely competitive raw material market on the seller's side as can be found in the American economy. Since an unregulated, but effectively competitive market in a product such as natural gas would not be characterized by uniform prices, it is highly improbable that Congress intended to impose such a pricing structure in adopting a "just and reasonable" standard in the Natural Gas Act, particularly at the cost of confiscation to many producers. Moreover, economists would not necessarily consider uniform prices as "optimum" prices from the standpoint of industrial efficiency.

Hence, although the congressional findings of scarcity of supply made pursuant to the authority of Congress, it is hereby declared that the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest, and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is necessary in the public interest. 52 US.

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Admittedly, this would be because he held a "monopolistic" position at a particular time and place by possessing unusually desirable (location, amount, or type) gas reserves. Such transient "monopolies" are not atypical, however, of markets with effective competition, i.e., without marked inelasticities or inequities in bargaining power. Chamberlin, op. cit. supra note 123, at 204-18.
and inelasticity of demand in the gas industry arguably may support some form of federal regulation of individual prices, the producers will argue that the findings do not support a taking of the property of producers who are not earning an excessive return by utility standards and who have found a buyer willing and able to purchase their gas at compensatory prices.

The nature of competition in the producer market has been examined in the Permian Basin area rate proceeding and in other economic studies. There consensus of opinion seems to be that there is little or no evidence that producers conspired to set prices in the field or in fact that producers have anything approaching the monopolistic powers exercised by the commission merchants in the Tagg Bros. case. It is evident that producers' bargaining strength vis-à-vis their pipeline purchasers has varied from area to area and time to time, so that generalizations about the state of competition or supply-demand elasticities in the market are difficult to make or to apply to the legal issue here under consideration.

Hence, the present economic justification for producer regulation, if any, would seem to rest on periodic or regional scarcity of supply coupled with the inelasticity of pipeline and consumer demand, rather than any lack of workable competition. Since under the area rate making method it is assumed that the greater part of the gas will be sold at uniform rates which are compensatory to the sellers, it seems unlikely that higher cost producers could sell much gas at higher prices, even if free to do so. The sales of such producers by definition could not significantly affect the market price. Hence, it could be argued that there is not sufficient public need for protection against higher prices to justify depriving the high-cost producer of his profits—to the extent that he is able (if at all) to sell gas at above ceiling rates—because the injury to him is disproportionate to the public's need for absolutely uniform gas prices.

In addition, the few instances in which the Supreme Court has sanctioned group or aggregate price regulation have not involved a price-responsive supply of a commodity with a relatively inelastic demand. The supply of rental housing in World War II was basically constant. There was obviously no likelihood of a shortage of commission merchants and insurance underwriters in the Tagg Bros. and

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127 See notes 115-18 supra and accompanying text; see also Record, pp. 484-531, 7079-7371, Area Rate Proceedings, 24 F.P.C. 1121 (1960); MacAvoy, Price Formation in Natural Gas Fields (1962); Neuner, The Natural Gas Industry, Monopoly and Competition in Field Markets (1960).

128 For example, a single pipeline purchaser held a monopoly position in certain producing markets for long periods, a condition referred to as monopsony.

129 Neuner, op. cit. supra note 127; MacAvoy, op. cit. supra note 127.
Since the problem of eliciting supply was not paramount in these cases, it was feasible to ignore the revenue position of the marginal individual. In gas production, in contrast, the controlling regulatory factor is what price will elicit the minimum necessary supply. Hence, the economic incentive of the individual producer may be more important, and less ignorable, than in any case heretofore in which the confiscation issue has been raised. Such a factor may well influence the outcome of constitutional issues.

The Commission's primary response to this argument will probably be a claim that it would be infeasible administratively to determine the individual costs of every producer seeking exemption from the area ceilings—and this is the second issue likely to be argued to the courts.

2. Is Area Rate Making Essential for Workable Field Price Regulation?

Uniform war-time rent control regulation was sustained in *Bowles v. Willingham* in part because, the court concluded, there was no other method of achieving the goal of preventing inflation and the resulting economic and social dislocation during war scarcity. The inability of the rent controllers to set cost-based rental for every landlord in the country seemed obvious to the Court. The impracticality of regulating natural gas producers on their individual cost-of-service is perhaps not quite so obvious. Before abandoning this method, the Commission had initiated comprehensive rate cases involving twenty-three producers selling over half the gas moving in interstate commerce. Many of these cases were in advanced stages, and most have now been decided by Commission examiners or settled. It is true that the Commission made findings in its *Phillips* decision as to the impracticality of continuing the individual company method, and the Supreme Court stated:

> We respect the Commission's considered judgment, backed by sound and persuasive reasoning, that the individual company cost-of-service method is not a feasible or suitable one for regulating the rates of independent producers. We share the Commission's hopes that the area approach may prove to be the ultimate solution.

With due deference to the Court's "respect," as well as to its "hope," it is questionable whether the individual company approach was wholly infeasible—as distinguished from unwise or less desirable than some other approach. It is highly improbable that decision of the existing individual producer cases would have taken longer than

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130 321 U.S. 503 (1944).
131 See notes 20-22 supra and accompanying text.
conclusion of the various area proceedings or that conclusion of these cases was impossible with the Commission's existing staff. The individual company approach probably would require partial exemption or special treatment of the numerous small producers which in aggregate sell only a small percentage of interstate gas, since it would seem impractical to treat each of these producers in all respects like a major producer by holding individual rate cases. However, it is possible that this small producer treatment could have been achieved without amendment of the act. The Supreme Court's recent Hunt decision contains a strong hint that the Court would look with favor on an FPC exemption of small producers, akin to the Labor Board's exemption of many small employers despite the fact that it has jurisdiction over them under the statutory test of a business "affecting commerce."

Hence, although the individual company approach presents obvious difficulties, the high-cost producer can argue with some force that the Commission has not shown the impossibility of any other form of regulation, so as to justify a "taking" of its property through uniform price regulation.

The rate practices of the Interstate Commerce Commission under Part I of the Commerce Act and the Civil Aeronautics Board under the Federal Aviation Act have little bearing on the correct interpretation of the Natural Gas Act because of important differences between the Aviation and Commerce Acts on the one hand and the Natural Gas Act on the other. However, they do cast light on the weight to be given to administrative feasibility in determining the constitutionality of a group or area rate program. The Commerce Act, as already pointed out, specifically contemplates the setting of group or area rates to afford an average return to the railroads in one area of the country. Although the Federal Aviation Act does not provide specifically for group rates, the CAB is directed to take into consideration in setting rates not only the "need of each air carrier for

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15 The Court's observation raises more questions than it answers. Guss v. Utah Labor Relations Bd., 353 U.S. 1 (1957), which the Court cites in this regard, deals with state jurisdiction over employers exempted by the NLRB and expressly preterms the issue of the validity of the NLRB's class exemptions. Subsequently in Office Employees Union v. NLRB, 355 U.S. 313 (1957), and Hotel Employees Union v. Leedom, 358 U.S. 99 (1958), the Court held that NLRB exemption of categories of employees, such as hotels and labor unions, was unlawful. Whether a total exemption based on size alone would be permissible is still undecided. However, the FPC could substantially relieve its administrative burden by a partial exemption of small producers, which would be more likely to be upheld under the Natural Gas Act.


See note 102 supra and accompanying text.
revenue sufficient to enable such air carrier under honest, economical, and efficient management to provide adequate and efficient air carrier service but also the following four standards:

(1) The effect of such rates upon the movement of traffic;
(2) The need in the public interest of adequate and efficient transportation of persons and property by air carriers at the lowest cost consistent with the furnishing of such services;
(3) Such standards respecting the character and quality of service to be rendered by air carriers as may be prescribed by or pursuant to law;
(4) The inherent advantages of transportation by aircraft.

Although the CAB applies the same "just and reasonable, non-discriminatory or unduly preferential" standard contained in the Natural Gas Act, it has interpreted this statutory mandate to permit group rates for classes of air carriers in particular areas based on average cost of performing the services. Such rates are not intended to, and do not, yield an adequate return to all carriers operating within the particular area or along the route.

The CAB rate orders thus far have not been challenged as unconstitutional by carriers held to an inadequate return. There are obvious differences, of course, between air carrier regulation and natural gas regulation. One in particular is the absence of long term contracts for air carrier services. Since air carriers have direct competition over most important domestic air routes, no carrier could hope to maintain a fare in excess of that offered by his competitors for any period of time. Accordingly, the Board could not set a special or differential rate for the higher cost carrier, and its only alternative to establishing a group rate based on a bulk-line or average cost would be to set the rate high enough to cover the costs plus a reasonable return of the marginal carriers. This, however, would give the most efficient carriers an enormous windfall in some cases and would, of course, discourage the use of air transportation. Consequently, the constitutional justification of the group rate under the Federal Aviation Act may be found in the practical impossibility of the Board's regulating carriers on an individual cost basis. The producer of natural gas, of course, argues that no such impossibility exists in the natural gas field.

We have noted the practice of the Interstate Commerce Com-

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138 Ibid.
140 General Passenger Fare Investigation, No. 8008, CAB, Nov. 25, 1960.
141 See notes 102, 136 supra and accompanying text.
mission in setting group rates for rail carriers under section 15 (a) of the Interstate Commerce Act based on the average cost of carrying freight and passengers. This practice also results in some carriers receiving considerably less than a utility return, but its constitutionality has never been challenged. The fact that most rail carriers have direct rail as well as other forms of carrier competition may make it impractical for the Commission to set different rates for the same commodities in the same area since this would merely divert all of the traffic to the lowest cost carrier. Accordingly, the ICC is probably in the same position as the CAB, in that it can provide a reasonable return to all carriers in a given area only by setting a rate which will yield windfall profits to the most efficient rail carriers.

These statutory analogies suggest that if the FPC can establish the absolute impracticality of regulating independent producers on an individual cost basis, the fact that its group or area rates result in some producers receiving less than a utility return is not necessarily fatal to the constitutionality of the Commission's program.

3. Does the Producer Have To Continue in Business? It will be recalled that the right of the plaintiff to abandon the regulated business was mentioned by the Supreme Court in upholding the programs of regulation involved in the Tagg Bros. and Willingham decisions. Under section 7 (b) of the act the gas producer cannot abandon a sale in interstate commerce once service commences unless the Commission finds that the gas supply "is depleted to the extent that the continuation of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment." It is probable that the Commission would not require a producer to continue production of a well if the revenues therefrom (under rates at or below the area ceiling) had reached a level inadequate to cover the out-of-pocket costs of operating the well, because continuation of production of such a marginal well would be considered "unwarranted."

The difficult case is likely to involve a well which is recovering more than out-of-pocket operating costs, but the producer, dissatisfied with his return, seeks to abandon service and either (1) shut in the well and wait for a more favorable regulatory climate or (2) sell in the unregulated, intrastate market. Assuming the Commission finds that the gas can be replaced by the purchaser pipeline from 1

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143 See note 96 supra.
144 The producer would have the further option, if he could find a buyer, of selling the leasehold. Since the purchaser would take subject to the same rate restriction and the price would reflect this, a sale would merely realize the entire loss derived from the rate restriction.
other sources, it presumably would be willing to allow either alternative if, in so doing, it avoided constitutional problems. However, neither alternative realistically is available to many producers. A small producer with "money in the ground" usually has an acute need to realize on his investment by selling gas as rapidly as possible so as to free his capital for further exploration. Only large producers can afford the cost of waiting for a more favorable sales opportunity.\textsuperscript{145}

The nonjurisdictional sales alternative assumes that the going price for intrastate gas will be higher than the area ceilings under which most natural gas would be sold to interstate pipelines. This has not been the case in the past since, historically, intrastate sales prices have closely approximated jurisdictional prices.\textsuperscript{146} There is no discernible reason why this price relationship should change, in the absence of a shortage of available supply in the field.

The right of abandonment certainly will be an issue in any constitutional challenge, and it may be assumed that the Commission would be willing to grant such a right, if supplies to consumers will not thereby be jeopardized, to avoid constitutional difficulties. However, since it is questionable that abandonment would benefit most producers, it is by no means clear that the Commission will be able to avoid due process difficulties by allowing producers to turn off the valve at the wellhead.

Finally, even if the Commission were to free "high-cost" producer rates from its area ceilings, the mere existence of the ceilings might injure such producers by depressing the going rate in the area and thus make the high-cost producer's freedom to contract for a higher price largely theoretical and valueless. If such a producer challenged the constitutionality of such an indirect "taking" of his property, the Commission would not be able to avoid a constitutional issue merely by exempting such producers. Whether a producer in this position could sustain such a challenge is another question.\textsuperscript{147}

4. How Seriously Is the Producer Hurt? The court's view of a producer's challenge to area pricing on due process grounds undoubtedly will be influenced by its appraisal of the extent to which producers generally are likely to be injured by the area rate. If the producer's complaint can be viewed as an isolated case brought by a producer who has encountered unusually hard luck in his exploratory activities but has chanced to sell the product of a single big strike at above ceiling rates, then the court is unlikely to upset the

\textsuperscript{145} Record, pp. 653-70, Area Rate Proceedings, 24 F.P.C. 1121 (1961).

\textsuperscript{146} Bureau of Mines, II Minerals Yearbook 313 (1961); FPC, Sales by Producers of Natural Gas to Natural Gas Pipeline Companies table 5 (1961).

\textsuperscript{147} Market St. Ry. v. Railroad Comm'n, 324 U.S. 548, 565-67 (1945).
Commission's regulatory program for his benefit. If, however, there is a substantial number of producers in the high-cost category whose revenues will provide little or no return if their rates are reduced to the area ceilings, then the converse is likely. Obviously then, our hypothetical producer's success will depend in part on whether producer unit costs over a substantial period tend to cluster about the industry mean or whether there is a widespread cost variation over time with a significant number of small producers more or less permanently in the high-cost category.

Unfortunately, there is little industry cost distribution data to aid in answering this question. The total unit cost data collected in the Permian Basin area proceeding shows a wide variation in costs among producers of all sizes, but such data is limited to a single test year and does not permit a determination of average costs over time. Moreover, since producer expenditures vary greatly from year to year, cost disparities between producers in a select year do not reveal whether or not producer unit costs, averaged over time, are closely grouped or widely dispersed. Furthermore, the Permian Basin area proceeding cost data was limited to fifty-nine producers selling in excess of 10,000,000 Mcf of gas during the test year; yet it was estimated that there were 1,400 to 2,600 separate production entities selling natural gas in the Permian Basin. It remains to be seen, therefore, whether there exists a class of "high-cost" producers that over time has a unit cost materially exceeding the industry average and that would be injured by an area ceiling based on such industry average.

E. Related Issues Presented By The Area Proceedings

The area rate method contemplated by the examiner, if adopted by the Commission, will raise additional legal questions. These additional questions are of lesser scope than the constitutional issue, but will nonetheless pose some difficult problems. For example, once the Commission adopts uniform area rates, presumably applicable to all sales within a given producing area, can it thereafter prohibit the filing of rate increases (if authorized by contract) above the level of those rates? Can it reject certificate applications based on contracts containing rates above the uniform area level? The Supreme Court's H. L. Hunt and Texaco decisions do not resolve these

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151 See notes 92, 93 supra and accompanying text.
152 Texaco, Inc. v. FPC, 317 F.2d 796 (10th Cir. 1963), rev'd, 32 U.S.L. Week 4370 (U.S. 1964); H. L. Hunt v. FPC, 306 F.2d 334 (5th Cir. 1962), rev'd, 32 U.S.L. Week 4294 (U.S. 1964); see notes 49-50, 58-66 supra and accompanying text.
questions although the approach, if not the holding, in *Texaco* is arguably favorable to general FPC regulations governing rate filings. Justice Douglas’ opinion sustains the reasonableness of Order 242’s proscription of certain types of price escalation provisions on the ground that “threshold” prohibition may provide more effective consumer protection than case-by-case consideration, which could lead to a “vast proliferation of hearings.” This reasoning could of course be extended to a regulation prohibiting rate increase filings other than at stated intervals. Unless the Commission can in fact prevent above-ceiling filings except at such times as it periodically reappraises and increases a particular area ceiling, most of the utility of area rates will be lost.\(^\text{153}\)

Another issue which may be raised by the area rate proceedings is whether the Commission is empowered to increase producer contract prices over the objections of a purchasing pipeline. This question may become important if after reducing all rates to the area ceilings the aggregate revenues of all producers in an area fall short of the area revenue requirement determined by the Commission. Although the presiding examiner in the *Permian Basin* area rate proceeding did not, in his tentative conclusions, suggest that producer prices be increased above contract-sanctioned levels where

\(^{153}\) At least one producer in the *Permian Basin* area proceeding, while apparently acquiescing in the general area approach to rate making, appears to reserve the right to file above-ceiling increases at any time. This producer (Phillips Petroleum Co.) argues that § 4(d) of the Natural Gas Act gives an absolute right to make whatever rate filings are authorized by contract, citing United Gas Pipeline Co. v. Mobile Gas Serv. Corp., 350 U.S. 332 (1956), and United Gas Pipeline Co. v. Memphis Light, Gas and Water Div., 358 U.S. 103 (1958).

However, if the constitutionality of the general concept of area rates is accepted, it may not be difficult to rationalize a prohibition against rate increase filings to above-ceiling levels. The Commission, it is assumed, has determined a reasonable, compensatory rate level in the area and will reconsider the appropriateness of such a level from time to time, so as to keep it in line with current producer costs. Thus, if the Commission constitutionally can impose the uniform area rate, it should be able constitutionally to compel compliance with that rate level, and not have to appraise and pass upon individual producer filings.

Phillips argues that the Commission in any case would have to obtain an amendment of § 4 in order to impose a prohibition against rate increase filings at above-ceiling levels. But, as the Supreme Court pointed out in the *Mobile* case (350 U.S. 332, 339 (1956)), “on its face, however, Section 4(d) is simply a prohibition, not a grant of power,” and merely prohibits the initiating of rate changes which have not been on file with the Commission for thirty days. Section 4(a) states that all rates charged by natural gas companies shall be “just and reasonable.” If the Commission has made a constitutional and otherwise valid determination in an area proceeding that any rates above ceiling which it has established are “unjust and unreasonable,” it may be able to bar the filing of such rate increases rather than merely suspend and investigate them after they have been filed, since there is nothing specifically in § 4 which gives the gas company a right to file unjust and unreasonable rate increases.

It seems, therefore, that this question turns on whether or not the Commission’s area rate making scheme is upheld. If such a scheme is found constitutional, then the courts are likely to take the further step of upholding the Commission in banning rate increase filings to above-ceiling rates. Such a ruling assumes, however, that the Commission updates its area rate ceilings at reasonable intervals, so as to protect the producers against changed economic conditions.
necessary to offset reduction in other prices to the area level, many of the producer respondents in those proceedings had suggested that it would be necessary for the Commission to do this in order to protect producers against confiscation. Much natural gas is now being sold under contracts made many years earlier at lower rates that are a small fraction of the going field prices for gas today. These contracts often are long-term or even run for the life of the field. Producers that would suffer revenue deficiencies as the result of the reduction of their newer contracts to the area ceilings argue that to avoid confiscation these older, lower priced contracts should be increased at least to the level at which their unit revenues would equal the area ceiling price.

Section 5 (a) of the act provides: "The Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural gas company on file with the Commission, unless such increase is in accordance with a new schedule compiled by such natural gas company." Presumably, the producer would be willing to file a new "schedule," but the pipeline would not necessarily be agreeable to having its gas cost increased, and consequently would be unwilling to enter into a new contract which under the Commission's regulations constitutes the "schedule."

The section 5 (a) prohibition was drafted with pipelines in mind and is clearly intended to prohibit the Commission from eliminating discrimination as between various rates by increasing a particular rate over the objections of the selling pipeline company. Thus, the prohibition historically has little relevance to the producer rate problem. A pipeline seeking to resist an imposed rate increase would undoubtedly rely on the prohibition, however, and it presents a hurdle to the Commission's increasing prices that are below the area ceiling over the objection of the purchasing pipeline.

The Commission could argue, if it decides against a method calling for increasing contract rates up to its area levels, that since the gas found under old contracts does not reflect current producing or exploration costs, the producer is not entitled to receive the going price for such gas, particularly at the expense of the pipeline which has entered into a long term contract in reliance on a specific price. It is unlikely that the Commission will utilize this device in view of the legal difficulties which seem to be involved.

There is a final issue implicit in the Commission's current area proceeding; namely, how far the Commission can or should depart from "costs" in establishing area rates, in contradistinction to the

154 See note 9 supra.
issue of how "costs" are to be determined. The examiner tentatively has concluded that in setting area rates he should give some weight to factors such as the value of service to the consumer, the need for production incentives, and other noncost elements. Since such considerations have always entered into the making of public utility rates, it is likely that the Commission could as a matter of law give them weight in setting area rates. It is more questionable that the Commission could break loose entirely from costs and establish rates wholly on the basis of field prices or other noncost formulae.

Certain of the major producers in the Permian Basin proceeding have argued strongly that since the industry (from the sellers side) is workably competitive the "incentive" price necessary to elicit adequate gas supplies can be determined from a study of current field prices and trends in drilling activity. Since these producers also contend that it is difficult, if not impossible, to ascertain meaningful costs for natural gas, area rates should not be based, even in part, on average cost of service.

Although prediction is perilous, it is likely that the Commission will give lip service at least to area costs in arriving at area rates. Since such rates will undoubtedly reflect many noncost factors, it is by no means clear, however, that consideration of cost data will lead to a markedly different result than if no attempt were made to approximate the cost of finding and producing natural gas.

III. Conclusion

The interest of this subject to the present writer stems from its touching many of the major political issues of the time: public control versus private initiative; the choice of federal or local regulation; the impact of regulation (however enlightened) on the long run capability of an industry to develop resources; and the ability of the unregulated market to provide needed raw materials at fair prices. These are in the best sense political issues, but regretably they are being fought out in the first instance not before Congress, which would seem to be the proper forum, but rather before an administrative agency.

The proponents of field price regulation along utility lines may

155 Bonbright, op. cit. supra note 125, at 82-92.
156 Wisconsin v. FPC, 373 U.S. 294, 309-10 (1963); City of Detroit v. FPC, 230 F.2d 810 (D.C. Cir. 1955).
claim that the underlying issue was settled decisively by the first Phillips decision; if so, the second Phillips decision would seem to have unsettled it. In any case no issue of this kind is ever decided merely by judicial decision alone, since what is decreed must also be realized in practice.

The legislative process thus far has resulted not in a considered decision as to the need for and the form of producer regulation, but rather in an unilluminating stalemate. Hence, the Commission must struggle with what is essentially an unresolved political issue of major importance. The Commission and the industry have come a long way since the initial Phillips' decision in 1954; the question remains whether they will eventually arrive at some form of regulation which will be at least tolerable to the producers, acceptable to consumer representatives, and good for the country. The most that can be said at this point is that the issue is in doubt.