# ENFORCEMENT AND COMPLIANCE OF FEA OIL PRICE REGULATIONS



## HEARING

BEFORE THE

## SUBCOMMITTEE ON REORGANIZATION, RESEARCH AND INTERNATIONAL ORGANIZATIONS

OF THE

## COMMITTEE ON GOVERNMENT OPERATIONS UNITED STATES SENATE

NINETY-THIRD CONGRESS

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# ENFORCEMENT AND COMPLIANCE OF FEA OIL PRICE REGULATIONS

WEDNESDAY, DECEMBER 11, 1974

U.S. SENATE,
SUBCOMMITTEE ON REORGANIZATION, RESEARCH,
AND INTERNATIONAL ORGANIZATION,
COMMITTEE ON GOVERNMENT OPERATIONS,
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 11:07 a.m., in room 3302, Dirksen Senate Office Building, Senator Abraham Ribicoff (chairman of the subcommittee) presiding.

Present: Senators Ribicoff and Chiles.

Also present: Richard A. Wegman, chief counsel and staff director; Paul Hoff, legislative counsel; and Marilyn Harris, chief clerk.

## OPENING STATEMENT OF CHAIRMAN RIBICOFF

Senator RIBICOFF. The committee will be in order.

This hearing has been called because there is a serious question whether the Federal Energy Administration has done all it can to protect the public from illegal overcharges by the oil industry. A report from the General Accounting Office—and I commend you, Mr. Hughes, and your staff for the excellence of your report—concludes that FEA's program to enforce industry compliance with price controls has been inadequate up to now.

The FEA has already announced that it has uncovered overcharges by 13 refineries totalling $194.3 million. It has detected overcharges by retailers and wholesalers amounting to $106.2 million. A report in this morning's press indicates that there has been a substantial overcharge to utilities which has been passed down to the consumers as adjustment costs by the utilities. I know this has been very substantial in my own State of Connecticut and apparently throughout the country.

This only begins to get at the problem. The GAO report states that by FEA's own estimate, oil companies may well have claimed an additional $1 billion to $2 billion in excess costs at the refinery level alone.

It is imperative that FEA conduct a thorough audit at the producer level where the all-important decision is made to treat the crude as old oil, or new oil worth twice as much. Yet, only now is FEA beginning to audit producers.

There is thus no guarantee that the total sum of illegal overcharges is not considerably more than $1 billion to $2 billion.

One fact, though, is perfectly clear. In this time of skyrocketing prices, and very large oil industry profits, the consumer must not be subjected to additional, illegal overcharges by the oil industry.

The disturbing truth is that at this moment the Government cannot assure the public that this is the case.

I hope these hearings today can help reassure the public that in the future at least FEA will have an effective enforcement program.

But even more important, what does FEA intend to do to recapture these multibillion dollars for the consumers of this country and to make sure that the oil companies with their huge profits are not adding to these profits by illegal and unfair additional charges to which they were not entitled.

Mr. Hughes, do you want to start with your statement?

## TESTIMONY OF PHILLIP S. HUGHES, ASSISTANT COMPTROLLER GENERAL, ACCOMPANIED BY DEXTER PEACH, ASSOCIATE DIRECTOR, OFFICE OF SPECIAL PROGRAMS, GAO, AND VERNON TEHAS, SUPERVISORY AUDITOR, GAO, DALLAS REGION

Mr. HUGHES. Thank you, Mr. Chairman. I will be pleased to do that. I would like to introduce my associates here at the table, if I might.

On my left is Dexter Peach, who is an associate director of our Office of Special Programs under the auspices of which this effort was undertaken, and on my right is Mr. Vernon Tehas, supervisory auditor in our Dallas regional office. We did put a good deal of field effort into this and Mr. Tehas has been very important in that effort.

I will mention two other names not here at the table with me, if I might. Mr. Richard Chervenak, who is our onsite audit manager, at the Federal Energy Administration, and Pete Taliancich, who is an audit manager in the Dallas regional office.

We are pleased to receive your kind comments, Mr. Chairman, on our work, and we hope that it will be helpful in achieving the results that I am sure we all seek.

Senator RIBICOFF. Of course, what your report indicates to me is that Congress has a very, very special obligation to exercise its oversight function and of course, its strong arm to accomplish this is GAO. We are dealing with oil which is one of the major causes of inflation. It is estimated that last year alone the additional charges to the American public were about $15 billion, and if you add illegal overcharges, this compounds the problem that we have.

Of course, we will try to bring out what the true situation is and to determine if FEA, and other agencies, through oversight, neglect, or inefficiency, are adding to inflationary pressures and the burden upon the consumers of this country.

Certainly your report indicates that one of the continuing obligations of GAO should be the monitoring and supervision of what is actually happening at FEA. FEA has undergone a number of changes. It is still undergoing changes. Its present head will be leaving. Its new head has not been determined at the present time. But I can say right now as far as the Committee on Government Operations is concerned, we intend to ask you, Mr. Hughes, you and your staff, to continuously monitor FEA to make sure that what has happened in

the report will not happen in the future. There is nothing like keeping an agency on its toes to know that GAO is looking over its shoulder.

Mr. HUGHES. Mr. Chairman, we will do our best to do that in a constructive fashion. We feel that some of the more serious difficulties that are referred to in our report are in the process of being corrected or have been, but we are in the monitoring, the oversight business, and we feel this is a very important area of Government to perform that function in right now.

Senator RIBICOFF. You may proceed.

Mr. HUGHES. Some 10 months ago, Mr. Chairman, you asked the General Accounting Office to monitor and evaluate the operations of the Federal Energy Office and any successor organization and report periodically to the subcommittee on the results of this work. Subsequently, section 12 of the Federal Energy Administration Act of 1974 provided a statutory basis for GAO monitoring and evaluating operations of the Federal Energy Administration.

Accordingly, we have briefed members of the subcommittee staff from time to time and issued reports to you. In July we pointed out that FEA's compliance and enforcement efforts were limited, and perhaps, misdirected. We agree to examine this area in more depth and on December 6 reported to you on "Problems in the Federal Energy Administration's Compliance and Enforcement Effort." My testimony today will summarize the results of our work.

In considering FEA's problems, one should keep in mind that the task of developing and insuring compliance with price regulations involving all elements of the complex petroleum industry is difficult at best. There are over 19,000 producers of crude oil; 250 refineries owned by 200 different companies; 25,000 wholesalers; and 200,000 retail gasoline stations.

Senator RIBICOFF. I am just wondering, the FEA representatives are here, too, are they not?

Mr. MONTGOMERY. That is correct, sir.

Senator RIBICOFF. Is there any breakdown as to the dollar value at each stage of oil production and utilization? What is the value and the sales of the 19 producers, the 250 refiners, et cetera? Is that available?

Mr. MONTGOMERY. Mr. Chairman, I think what you are asking for is a total value of all oil produced domestically. That is available. I do not have it at my fingertips.

Senator RIBICOFF. Will you get it for the purpose of the record?

Mr. MONTGOMERY. Yes, sir.

Senator RIBICOFF. Thank you.

Mr. HUGHES. In addition to these rather large numbers I have mentioned, Mr. Chairman, the difficulty of the FEA task is increased by the vertical integration and the multinational character of major oil companies. GAO's evaluation of FEA's compliance and enforcement program was impeded by FEA's reluctance to allow us full access to information relating to refinery audits. I will discuss our problem of access to information in more detail later. Now, however, I believe we have established a workable framework to insure that such problems do not occur in the future.

Senator RIBICOFF. Was there ever any question in your mind that FEA had the obligation under the law to make this information available to you?

Mr. HUGHES. No, sir.

Senator RIBICOFF. But you were impeded and hampered in your investigation, were you not, by FEA's refusal to comply with the law specifically setting out that these facts and information should be made available to GAO?

Mr. HUGHES. Yes, Mr. Chairman. The circumstances of that are to an extent at least understandable, although we disagreed rather sharply with FEA. FEA was concerned that its administration of the compliance enforcement effort and related litigation not be impeded by our audit efforts. We never, I think, quite reached an impasse but certainly as reflected here, our effort was impeded. Subsequently, and I have made a record of this in this statement, Mr. Sawhill and I met and I believe have achieved a basis for our work proceeding without any impediment in the future.

Information provided us showed significant problems in FEA's compliance and enforcement program at all levels of petroleum industry operations. Our findings—which I will also discuss in more detail—can be summarized as follows:

There was almost no direct audit of crude oil producer operations.

FEA concentrated its audits at the retail level and found numerous violations, however, there was evidence of large violations at the wholesale level where little audit effort was made.

Senator RIBICOFF. In other words, as I understand, there were efforts that were made that if I went into Acme gasoline station and bought 10 gallons of gasoline and was overcharged 5 cents a gallon for a total of 50 cents, they were concentrating their efforts on the 50-cent overcharge instead of going in where the billions are charged in the production of oil, where the old oil comes in at $5.25 and the new oil at $10. It makes a whale of a difference in overall costs if the oil was being billed as old oil or new oil. Is that not correct?

Mr. HUGHES. That is correct, Mr. Chairman.

Senator RIBICOFF. Because the new oil gets passed on in increased cost all the way down the line to the consumer.

Mr. HUGHES. My understanding, Mr. Chairman, is that the range of old to new oil can be somewhat wider than those charges which you referred to. The $5.25 and the $10 are averages and the range can run $3 to $11 or something of that sort, so that there is, as we see it, the opportunity at least, the possibility of substantial violations at the producer and at the wholesale level and I think the article in the morning press that you referred to is some evidence of the potential significance of those.

Audits of refiner operations were not completed. These are very complex audits. The audit program was very substantial and there was not the opportunity with the manpower assigned to complete the audits.

Substantive issues relating to the adequacy of regulations remained unresolved.

Finally, organizational disputes within FEA hindered audit work at refinery operations.

Our work has shown that if petroleum price controls are to be continued, FEA must strengthen its compliance and enforcement program at all levels if it is to have adequate assurance that firms are complying substantially with pricing regulations.

Now, with respect to the compliance and enforcement effort.

COMPLIANCE AND ENFORCEMENT

At the start, compliance and enforcement work associated with petroleum price regulations was performed by the Internal Revenue Service under a memorandum of understanding with FEA. Initially, 300 IRS employees were used while that agency hired and trained employees for eventual transfer to FEA. Two hundred and thirty-six of the 300 IRS employees were assigned to the retail/wholesale level and 64 were assigned to audits of refining companies. By July 1, 1974, 850 employees had been hired and trained to perform compliance and enforcement work and FEA assumed full control of the program. FEA assigned 762 of the 850 employees to the retail and wholesale level and 88 to audits of refining companies.

MONITORING THE OIL PRODUCERS

With respect to producers, neither IRS nor FEA assigned compliance and enforcement staff to audit the 19,000 producers of crude oil.

Senator RIBICOFF. Is this not where it all really starts, in the production end?

Mr. HUGHES. That is a fair statement, I think, Mr. Chairman.

Senator RIBICOFF. And there were no auditors assigned at all to the production end?

Mr. HUGHES. That is our finding.

Senator RIBICOFF. Do you think that this is defensible at all by the FEA?

Mr. HUGHES. The FEA has defended it in terms of what it regarded as the most crucial needs at the time. In our judgment, the manpower was misallocated. We have indicated in this report and continue to feel that a better balance would have been achieved had auditors been assigned to the producing area.

Senator CHILES. On that line, Mr. Chairman, what you are telling us is they spent their manpower going to a filling station operator and checking him and did not check the producer of the well or the wholesaler?

Mr. HUGHES. Generally speaking, Senator, that is correct.

Senator RIBICOFF. Let me ask you—I am curious. These audits and the way they are put together, do they come through computers? Are they then computerized?

Mr. HUGHES. My understanding is that they are not, but perhaps FEA should address that question.

Mr. SMITH. I am Gorman Smith, sir, Acting Assistant Administrator for Operations, Regulations, and Compliance, FEA.

The audits performed—the records of the audits performed by our auditors in refineries are not computerized. However, our auditors at those refineries used the computerized recordkeeping system of the oil companies themselves in checking the data.

COMPUTERS

Senator RIBICOFF. That is very interesting. My office in the Federal building in Hartford received a telephone call this morning which was relayed down to me just a few minutes before these hearings

started and I understand—you can tell me whether this is so or not—that FEA has just given a new contract for its computers to a company called Optimum Systems. Do you know that to be the case?

Mr. SMITH. No, sir. I am not familiar with whether that is the particular company that has been selected. The FEA's data processing activities are centralized in another office other than mine, sir. I will find out for you and provide that information.

Senator RIBICOFF. All right. Now, Dun & Bradstreet's lists say that Clint Murchison is a major stockholder and president and chief executive officer of Optimum Systems. Now, if this is true, that is very disturbing because I believe that Mr. Murchison is one of the biggest oil producers in the United States.

Now, computers—what comes out of one end of the computer depends on what goes in at the other end of the computer. Do you think that it is proper for one of the major producers of oil to also be the head of the computer system that is used by FEA?

Mr. SMITH. I do not know enough about the issues involved in the contract to have an opinion on that.

Senator RIBICOFF. Well, do you not think it is important, and I would like before this hearing is over if one of your staff would call down at FEA to find out whether Optimum Systems has been given the computer contract from FEA and whether Clinton Murchison is the major stockholder, president and chief executive officer of Optimum Systems, because if this is so, it would seem that there would be a conflict of interest and certainly most disturbing for the proper monitoring of FEA and what is going on.

Mr. SMITH. I will get that information, Mr. Chairman.

Senator CHILES. Mr. Chairman.

Senator RIBICOFF. Senator Chiles.

Senator CHILES. Along that same line, I did not know the contract had been awarded but my understanding was that GSA, who has the right to overlook these contracts on computers, signed off on FEA and, therefore, did not exercise an authority that they had to see that competition and price bidding could have taken place. And there was a great concern even by the Government Operations Committee in the House that GSA had surrendered that authority. I think that was before they actually selected who FEA selected. So I think that is something we in this committee should also look into, GSA's role.

Senator RIBICOFF. You may proceed.

### RETAILERS VIOLATIONS

Mr. HUGHES. We were referring, Mr. Chairman, to the absence of compliance and enforcement staff assigned to audit the 19,000 producers of crude oil.

In some instances, producer records were looked at either as part of a refinery audit or on a selected basis; but, as of mid-November 1974, FEA still was in the process of developing its first full-scale review of producer operations.

Audits of producers are important because their operations determine the price of crude oil used in refineries. Under price regulations, oil produced in the United States sells at either a controlled price of about $5.25 per barrel or a free market price—which has been as

much as $10 per barrel. With such a price difference, an adequate program of verification is needed if we want to be sure that purchasers of crude oil and ultimately consumers are not overcharged.

### RETAILER VIOLATIONS

While FEA has identified substantial violations at both the wholesale and retail level, its efforts have been concentrated on violations at the retail level. Basically, FEA officials felt the consuming public was more sensitive to these violations. Also, retail violations can be investigated faster and require less time and work than wholesale violations.

As of September 27, FEA had made 80,137 investigations of the approximately 225,000 wholesale and retail firms. Some firms were investigated more than once. These investigations uncovered 18,034 violations of price regulations and resulted in reports refunds of $51.2 million to the marketplace. Most of the violations occurred at the retail level and individual violations were in relatively small amounts.

### WHOLESALER VIOLATIONS

Investigations of wholesalers uncovered much larger violations. For example, during a 3-month period one FEA region uncovered violations at 132 retail firms totaling $345,000. Violations uncovered at four wholesale firms in the same period totaled $513,000. In the case of propane wholesalers, FEA made a special effort termed "Project Speculator" directed specifically at wholesale firms. So far FEA has determined that 75 companies violated or probably violated regulations, overcharging customers $55 million.

### AUDITING REFINERIES

In the refinery area, FEA's audit program seeks to insure that refiners increase prices only for allowable cost increases. Of a total of 200 companies, FEA considers 125 of enough significance to report regularly. Thirty-one of the companies—which account for over 85 percent of refining capacity—have been placed under audit by FEA.

The refinery audit program is complex and comprehensive. Yet, IRS in its earlier work and FEA to date have assigned only two auditors to each company. Considering that many of the refining companies are billion dollar corporations with numerous subsidiaries and multinational operations it is not surprising that the auditors fell short in completing an ambitious audit program.

For 17 of the 31 refining companies under audit, we examined the audit reports made available to us, reviewed supporting documentation and discussed the audits with auditors assigned to the companies. We found that neither IRS nor FEA completed important parts of the audit program. In general, the scope of work performed was limited. In a number of cases, the auditors agreed that the work was not adequate. For example:

There was limited or no verification or tracing of pertinent cost or other information to basic source documents.

In many instances where problems or discrepancies were noted, follow-up or expanded audit effort was not undertaken.

The failure to accomplish the entire scope of the program and the lack of follow-up where discrepancies were noted can be related directly to the limited number of staff committed to audits at the refinery level.

ADMINISTRATIVE SANCTIONS

Of course FEA has authority to impose administrative sanctions. When FEA believed a provision of the price regulations had been violated, an attempt was made, as a first step, to obtain a voluntary price rollback and a refund of overcharges to customers or the marketplace.

If compliance could not be achieved voluntarily, FEA issued a notice of probable violation—where the violation was likely but not certain—or a remedial order—where the violation appeared certain or repetitive. If the company complied with actions required by FEA, the violation or order was rescinded.

As of September 30, 1974, FEA reported that the refinery audit program resulted in five voluntary rollbacks, six notices of probable violations, and six remedial orders. These violations involved 13 refining companies and amounted to $194.3 million. Four of the six notices of probable violation and three of the six remedial orders were not resolved as of November 1974 because FEA was studying proposed regulatory changes or awating additional information from the company.

In many cases, corrective action involved the firm writing off a portion of the violation against paper-cost increases accumulated under a cost carryover provision of the price regulations. This provision allows refiners to "bank" cost increases which the firm feels cannot be immediately passed on in the marketplace. FEA intended the carryover provision to be a method whereby price increases could be smoothed out.

What has happened, however, is that large accumulations, or banks have been created which represent over 50 percent of the additional costs they claim to have incurred since October 1973. FEA officials tolds us that as of September 30, 1974, the collective banks totaled about $2 billion.

Senator RIBICOFF. Do I understand when you talk about banks that these oil companies put aside *x* amount of dollars which they say they are entitled to use to raise the price of their product and that at any time they can feed out of this bank increased costs to the marketplace?

Mr. HUGHES. That is correct essentially, Mr. Chairman. Of course, they do not put aside the dollars. They put aside a record of the dollars.

Senator RIBICOFF. A record of the dollars.

Mr. HUGHES. Yes.

Senator RIBICOFF. But then they can feed as they choose—they are the ones that decide when that extra amount of money that is in their so-called bank can be fed into the marketplace as additional costs?

Mr. HUGHES. That is correct. There are some interesting—a very interesting collateral question that we have thought about, do not have any answer on, the question of tax treatment of these banks by Internal Revenue. I am not familiar with what they are doing or what thought has been given to it, but the banks pose a rather unusual sort of problem from a tax standpoint, it seems to me.

Senator RIBICOFF. In other words, depending on what their earnings are, they can make the determination when they want to earn more money or earn less from a tax standpoint.

Mr. HUGHES. I think that is possible, Mr. Chairman, but in any event, I think the potentiality of the situation——

Senator RIBICOFF. You gentleman from FEA, any time you want to respond or answer any question I raise or if you want to comment on any statement made by Mr. Hughes, please feel free to do so, gentlemen.

## TESTIMONY OF JOHN SAWHILL, ADMINISTRATOR, FEA; ACCOMPANIED BY GORMAN SMITH, ACTING ASSISTANT ADMINISTRATOR FOR OPERATIONS, REGULATIONS, AND COMPLIANCE, FEA; ROBERT MONTGOMERY, GENERAL COUNSEL, FEA; AND JAY LAPIN, DEPUTY GENERAL COUNSEL, FEA

Mr. MONTGOMERY. Thank you, Mr. Chairman. Let me introduce myself. I am Bob Montgomery, General Counsel of FEA. This is Gorman Smith, Acting Assistant Administrator for Operations and Compliance and Regulations. And Jay Lapin, my Deputy General Counsel. I think we should say at the outset as you know, that John Sawhill called you and explained his inability——

Senator RIBICOFF. He is expected a little later.

Mr. MONTGOMERY. He is attempting to get here.

In our prepared statement which was prepared by and for Mr. Sawhill, we address many of these questions. I think the most logical way of dealing with most of the points raised in the GAO report, many of which are coming up again here, is to address them in the context of this statement. The point I wanted to say——

Senator RIBICOFF. I just want to give you an opportunity to make a timely response.

Mr. MONTGOMERY. I appreciate that.

Now, a couple of questions have been raised so far which we very much want to respond to. We would like to discuss them at this point, if we may.

Senator RIBICOFF. We want to get as much information as we possibly can. We want to be fair. We do not want this to be one sided. We want to give you all the opportunity to explain the situation. These questions are complex, and Senator Chiles and me are trying to understand them. You live and work with these problems; we are trying to understand them; and that goes for the press, too, and in order to clear up some of the special language, we raise the questions as we go along. So if you want to respond, please feel free to do so, in the event you believe Mr. Hughes has not stated it properly or you have another explanation.

Mr. MONTGOMERY. Thank you. May we then discuss briefly the banks?

Senator RIBICOFF. Yes; because that is very complex and we ought to know how this operates and what effect it has on the market cost of petroleum products?

Mr. MONTGOMERY. All right, sir. As you know, the Emergency Petroleum Allocation Act provides for price controls, the central principle of which is that there shall be a dollar-per-dollar pass-through of all additional costs, product costs. This was put in the statute and made a part of our regulations in recognition of the fact that because of the greatly increased cost of crude oil in the Middle East, and the related increase in some domestic crude oil costs, that refiners and producers could not stay in business if they had to eat those costs, that they were authorized and were logically to be permitted to recover those costs but no more. So our regulations essentially provide that a refiner, a marketer, a retailer, anyone in the business can pass through his product cost dollar-for-dollar but cannot expand his profit margin.

Now, the banks come in from the—as a result of the fact that if we were to require everyone to either pass through these costs at the time they were incurred or forgo recovering those costs we would be putting in a very disadvantagous position those members of the industry at various different levels who, because of their special situation, seasonal variations, the contract situation they are in vis-a-vis the people that buy from them, the aggressiveness of their competition, the fact that sometimes they buy once for a 3-month time period and our regulations are on a strictly a month-to-month basis—we would put some people in a position of being unable to stay in business. We would require them to either pass through their costs in a given month, the month in which they pay that additional cost for their product, their crude oil, for example, or forget it, and to do that would greatly injure some, for example, some of the independents, some of the smaller people.

Many people in the business buy only once a quarter. They buy a large quantity of crude oil once and they use it for 3 months. They cannot sell their product during the first month at the prices that would be legally permitted if they were to pass-through the entire cost of their additional crude oil. So they have to have an opportunity to spread the cost of that added crude out over a period of time.

Senator RIBICOFF. But on November 6 you adopted new regulations, did you not, limiting the amount that they could pass through in any month to not more than 10 percent of their bank?

Mr. MONTGOMERY. We did. That was in recognition—the reason we put the banking provisions in the regulations was not to allow oil companies to accumulate massive amounts of allowable cost pass-through which they could then kind of hold over everybody's head in anticipation of a renewed embargo or some kind of a supply shortage which would make the market so tight that anything would go. We recognized in September—we began to see it earlier—that the market was getting sufficiently tight, competition was returning at the retail level and people were accumulating very large sums of costs. These are costs that they are legally entitled to recover. This is not some kind of a windfall. This is a cost that the Congress and the statute said they should be able to recover. But because of competitive conditions many of them were not able to do so or chose not to do so. So these amounts began to get so large that we were concerned that come winter, with the possi-

bility of a supply shortage, these volumes would be passed through and the results on the consumer end, the customer end, would be unacceptable.

So we put out for comment a proposal to eliminate the banks altogether over a period of time, but phase them out over the life of the Allocation Act.

Senator RIBICOFF. Well, in other words, are you telling us that the normal play of market forces does not apply to the oil industry?

Mr. MONTGOMERY. Just the contrary, sir. I am saying it has applied very substantially in the last few months.

PASSING COSTS ON TO THE CONSUMER

Senator RIBICOFF. But the law of supply and demand at any given time makes it advisable for business purposes not to pass on their costs at any one time.

Mr. MONTGOMERY. That is right.

Senator RIBICOFF. And it would in any other business. They could put it on their books and at some future time if the market situation got tight, they could add on that cost which they did not charge even——

Mr. MONTGOMERY. Yes, sir, and this is precisely what businessmen do. In the unregulated markets, before they had these price regulations or any other part of the economy right now a businessman is completely free to increase his costs any time and he does just that.

Senator RIBICOFF. Yes; but you do have a controlled situation.

Mr. MONTGOMERY. That is right.

Senator RIBICOFF. When it comes to old oil and what you can charge.

Mr. MONTGOMERY. What we have here, even with our banks, we have an upper limit on the extent to which they can take advantage of a supply shortage. We say unlike people who sell tomatoes or sugar, if there is a terrific shortage of oil they cannot take advantage of that shortage by increasing their costs except to the extent they have also accumulated allowable costs which are directly related to their increased product cost, their crude oil or whatever they bought, and then as of the most recent regulation change we impose a limit that they can only pass through at the time of that shortage or the time of the market situation that would allow it no more than 10 percent of their total bank.

Senator RIBICOFF. But they never lose. In other words, it is heads I win, tails you lose.

Mr. MONTGOMERY. No. They really do—they do lose.

Mr. Smith.

Mr. SMITH. Mr. Chairman, I think it is important to remember two things. One, the law in terms of the Emergency Petroleum Allocation Act requires that our regulations provide for dollar-for-dollar pass-through of increased costs of petroleum products. So we have no authority whatsoever——

Senator RIBICOFF. That is allowable but let us say market conditions are such and the competition is such that competitively they would not pass it through on January 1, let us say.

Mr. SMITH. Yes.

Senator RIBICOFF. In an ordinary business, whether you sold shoes or trousers or locks, they would not pass it through because they were meeting competition from other lock or shoe manufacturers, right?

Mr. SMITH. Yes, sir.

Senator RIBICOFF. Now, what you do, when you allow them to bank it, if competition at one time would not allow them, or would militate against their raising the price, they can put it aside and when they reach a noncompetitive situation, or a shortage, then they can pass it on. I am trying to think about the fairness of this. How can they lose?

Mr. SMITH. The way they can lose is dependent on the market forces, Mr. Chairman. But the point is that the law precludes this, as I understand it—I have got two lawyers, one on each side—but at least my understanding from the policy side is the law precludes us from writing a regulation that will prohibit an oil company from passing through allowable cost increases. Given that law, we have got two choices. We want to retain a set of price regulations on a month-by-month basis so that we can follow what happens to the costs and so we can audit, doing a better job than we have done already, as Mr. Hughes has pointed out, but so that we can have a basis for auditing a company on the basis of its month-to-month transactions.

Now, under that situation we have got two alternatives. We either say, every dollar of cost you incur, increased cost you incur, in January you have got to either get back in February or not get it at all. And the application, as Mr. Montgomery indicated, of that rule in the marketplace is going to cause wild swings in allowable petroleum prices which serve no useful public purpose and it is going to put different companies at severe competitive disadvantages from month to month based on the particular accident of timing of their transactions, and that serves no useful purpose.

Senator RIBICOFF. But at the present time these oil companies have banks of about $2 billion.

Mr. SMITH. Yes. Now, the other things to keep in mind, Senator, is that those banks—every dollar in those banks is a dollar that has not been passed through to the consumer at the gasoline pump.

### EXAMPLES OF COSTS PASS-ON

Senator RIBICOFF. Yes, but it hit the 10 percent—10 percent in any 1 month could hit the consumer.

Mr. MONTGOMERY. Can I give you a couple of specific examples of the type of thing that Mr. Smith and I have been alluding to here? You take a region in which you have a number of marketers, say, wholesalers, marketing heating oil or some product of that type. Your own State is a good example. You have in that kind of a situation no uniformity as to purchase dates or contract arrangements. You may have one or two suppliers and they may be independents, buying their supplies at date No. 1 and then selling it pursuant to a contract which may be a 1-month contract or a 6-month contract or whatever at a given price. Their competition may have bought their supplies earlier or later. They may be selling it under a different kind of contract.

What we are trying to do is allow these people within limits, flexibility, to compete effectively, given their cost situation which may be vastly different from the cost situation of their competition. The major oil companies, for example, have such resources that they can absorb

time—they can absorb fairly substantial cost increases for almost indefinitely without passing them on. Some of your independent heating oil marketers and terminal operators when they incur an added cost, they put cash down for very high priced imported heating oil or distillate or something. They have to pass it on.

Now, if they have to pass it on immediately they might not be able to sell their product but if they are able to pass it on over a period of months, they may still be able to compete with the majors and may be able to stay in business.

Senator RIBICOFF. As I see the reports of GAO, the problem we have is this. If you have not properly audited the producer, the refinery and the wholesaler, we have no way of knowing whether these banks are proper or improper, whether the consumer is being fairly charged or unfairly charged, and you have got an entire passthrough situation which causes turmoil and a practical revolt from the consumer.

You take, using my own State again as an example, one of the problems that exercise the people of Connecticut the most is the fuel adjustment costs that are added on their utility bills, and yet from what I read in the paper today, and since you are not auditing, the people of the State of Connecticut and other States may be paying much more than they need pay. The utilities are taking the rap and maybe it is not utilities' fault because maybe they are being overcharged for oil.

Mr. SMITH. Senator, this is a no-win game from our standpoint. The article you read in the paper today was a result of an FEA press release. The disclosures were the result of the work of our audit teams and the fact that we are discovering these things is evidence that we are auditing them.

Senator RIBICOFF. Well, this is good.

Mr. SMITH. It is also evidence that we have not every day in every transaction across the entire oil industry audited everybody on a real time basis any more than the Internal Revenue Service issues penalty notices for tax returns within 3 weeks after the 15th of April.

Senator RIBICOFF. No. It is very ironical that you waited for the morning of the hearing to disclose that you had caught somebody with their hands in the till. I am glad that you did. And——

Mr. SMITH. Yes, sir.

Senator RIBICOFF. If we could save those millions of dollars this way for the people of this country, I am all for having a continuous oversight hearing constantly so FEA and other agencies will disclose to the press and the public what is really going on.

Mr. SMITH. Right.

Senator RIBICOFF. I am all for that. I mean I am not criticizing you but maybe we should have somebody holding around-the-clock hearings so you people will come out with the facts.

Mr. SMITH. The only trouble is we would not have any time to do any auditing, then. We would be testifying all the time.

Senator RIBICOFF. I know. But, again, I am glad you came out with this information. I think it has a salutary effect. Stories like this will tend to keep honest the producers, the wholesalers, the refiners, everybody down the line. If they feel that it is being overlooked, they are just going to cheat the American public blind, but if they know that somebody is on the job and they can be audited at any time, it will be a different proposition, and I think the next thing that you have to do is to disclose the names of the people and the companies that are

cheating the American public. I think the people have a right to know which companies are overcharging. I think the utility companies should know which wholesalers are charging them more than proper. The consumer should know who is an honest distributor or dishonest distributor. I think the public has a right to know these facts. The press has a right to know these facts. Congress has a right to know these facts.

Mr. SMITH. Yes, sir, and we will release those as soon as the audits are completed and we are sure that we are not unfairly accusing somebody.

Senator RIBICOFF. This, I do not want you to do at all.

Mr. SMITH. No, sir. That is——

Senator RIBICOFF. I am——

Mr. SMITH. That is why we are going to wait until the audits are completed and we have the bottom line numbers and then at that time when we have no more doubts and the companies have each been given an opportunity to explain, if they can, the practices that we allege are contrary to the regulations, and when those explanations have been considered and found wanting, then the amounts and the companies involved will be made public.

Senator RIBICOFF. You see, reading, let us say, the papers in my own State, when your auditors found that a gasoline station overcharged and should make refunds or lower the price of gasoline, that was a front page story in the Connecticut press.

Mr. SMITH. Yes, sir.

Senator RIBICOFF. A proper front page story, but I have not seen any stories about the producers, the refiners, the basic wholesalers. This has been kept under wraps. So some man who did wrong with a corner gasoline station, he is pilloried on the front pages of the paper for everybody to read but the big boys get carte blanche.

Mr. SMITH. I believe, Senator, we have made a number of announcements about rollbacks at the wholesaler-refiner levels when the work on those cases has been completed and we are sure of the facts and the individual or the company concerned has been given the opportunities that according to the procedural requirements of the law, he is entitled to. We are very careful not to make public accusations——

Senator RIBICOFF. I do not want you to.

Mr. SMITH [continuing]. Involving names until we have gone through all the procedures and the individual has had a right to make his case.

Senator RIBICOFF. So when you have finished your complete audit of what appeared in the press today, you will release to the press those who are responsible.

Mr. SMITH. Yes, sir. We will not wait until we are through with the entire thing but as we nail them one by one, they will be made public; yes, sir.

Mr. HUGHES. Aside, a relevant aside, I hope, Mr. Chairman, I think one of the keys to administrative success in a program of this sort is prompt action. I had some experience in the campaign finance business over the last couple of years and we, I think, suffered substantially from the lag between essentially an administrative finding and legal action and I think prompt followup on these is a very important business. I am sure there is no real dispute about that.

Back to the banks a moment, Mr. Chairman. I think we have no disagreement really, with the comments of the representatives of the FEA. The one sort of summary comment that I would make is that I believe that while we understand and have some degree of agreement with the rationale under which the bank arrangement was set up, it seems pretty clear that there have been some unforeseen consequences as a result of this arrangement. It occurs to us that some of these may well be in the tax area and that it would be appropriate, therefore, for the FEA and for us to scratch our heads some more and make sure that——

Senator RIBICOFF. Have you called in the Internal Revenue for discussion?

Mr. HUGHES. We have not discussed it with Internal Revenue.

Senator RIBICOFF. Let me ask you, if you think you are proceeding in accordance with the law, do you think the law ought to be changed or do you think it is fair to allow these banks?

Mr. SMITH. I think it is essential to allow these banks. As we stated, to disallow them will cause severe disruption and severe market pressures in the industry at the wholesale-retail level and at the refiner level, and it will cause the kind of pressures that the major oil companies are best fitted to endure because of their profits on the production side and it will literally be ruinous to the independent segment of the industry.

Senator RIBICOFF. Let me ask both of you this. The many unresolved issues in the FEA's price regulation of the oil industry lead to a basic question of whether it is possible to conduct an airtight audit of as fungible a substance as oil. How airtight and foolproof can FEA's auditing procedures be when the difference in base cost can be as large as $5.25 for old oil and about $10 for new oil? Can you have effective price regulation when the potential for abuse is so large?

Mr. MONTGOMERY. Senator, the answer is theoretically yes, without any qualification. I am not going to stand here, and neither is Gorman, or sit here and tell you our actual audit procedures have been airtight. The problem with making—the translating the theory into the practice is manpower, skill, numbers of people, the complexity of the industry, the other priorities that we all had to deal with last spring and last winter. We are, I think GAO will concede, breaking new ground here and moving into an industry in a way in which no one in Government has ever tried to regulate an industry. I think we are doing generally speaking, a respectable job of that and we are committed to doing a better job and are in the process of taking steps that will enable that to happen.

Senator RIBICOFF. I would say, the reason this becomes important, with inflation being what it is, it is such a disturbing aspect, forgetting the administration and people in Government, but the average consumer, the two factors which are probably the greatest contributing cause are in the energy field and in food that has the greatest impact on most people at all times, not at any given time. Do you not think that a wise investment would be to have proper, sufficient and well-trained auditors to do this job? We are not talking about nickels and dimes. We are not talking about the 50-cent overcharge at a gasoline station. We are really dealing with billions. Here you are talking about a potential $2 billion overcharge at the refinery level.

Now, let us extrapolate that, at the producer level to the wholesaler, to the distributor, to the retailer, and you are really talking in billions of dollars.

Mr. MONTGOMERY. Mr. Chairman, there is no doubt about that. There is a rough rule of thumb that has been used on a number of occasions and that is that a penny increase in the price of gasoline across the country amounts to about a billion dollars a year. So no one is going to argue with you that the potential for overcharge is immense.

I think going back just for a second, though, to your question that, namely, can we have a reliable airtight audit given the discrepancies or differences in the price of the input, the crude oil selling at between, say, $5.25 and $10 a barrel, the answer is if you do it the way our regulations would provide, you can, because that regulation looks at every step of the way at the increment added by that person in the distribution chain who processes or distributes or sells the product. You take the original cost at the producing levels. It has been pointed out that we have not audited directly the producers, but I think we would like to address that. We did not audit the producers for, I think, some respectable reasons. I think it is time to audit them. I think we admit we should have done more in this area earlier but the opportunities and potential for abuse at the producer level in our view is nowhere near as serious or at least was nowhere near as serious last spring as it was in the retail level.

Senator RIBICOFF. Why do you say that, because it is not a question whether a gasoline station is overcharging you a penny. I go down the road and I will pass five or six gasoline stations and I see a variable of from 1 to 5 cents between adjacent gasoline stations. I have no way of knowing whether one station is overcharging or not, what its costs are, but when you are talking about a differential between old and new oil, between $5.25 and $10, now you are talking about a very, very substantial evasion. Now you are talking in the billions. Now you are talking about the base that goes all the way up the line and that is what bothers me.

You say it was important to get it at the retail level, which it is, but it is important to get it at the producer level. There were some figures here, I think in the beginning of Mr. Hughes' statement, indicating that you have over 19,000 producers of crude oil.

Mr. MONTGOMERY. That is right, sir, but I think the potential for abuse in terms of dollars is no greater at the producer level. To some degree I think it is illusory because you are talking at the producer level about a price per barrel in the first place. You are talking about 42 gallons to a barrel. So if you have a cent a gallon violation at the gas pump you are talking about almost a half dollar violation.

Senator RIBICOFF. You are talking about half a dollar. That is a lot different from $5 a barrel.

Mr. MONTGOMERY. That is right, but realistically the basic reason that the potential for abuse at the retail level is so much greater than at the producer level is the fact that producers sell their oil to other people who are subject to our regulation and subject to our audit. About 30 percent of the domestic crude oil in this country, produced in this country, is sold at arm's length to nonaffiliated refiners. Those refiners in themselves have a very strong incentive to police the sales of the price at which they buy.

Senator RIBICOFF. Yes, but the difference is they can pass it on. If there is a timely shortage, and they are being overcharged, they bite their tongue so they will not lose their source of supply because they know they can pass it on down the line.

Mr. MONTGOMERY. Senator——

Senator RIBICOFF. I think the great problem we have had and the fantastic increase in the price of oil, the OPEC countries have increased the price that has been passed on. And the consumer is the person who has gotten socked with this entire increase.

The refiners have not lost out. What difference does it make? He passes it on. He is unhappy because everybody is kicking him around but he passes it on to the consumer and what disturbs me is the fact that everybody down the line is being taken care of but the consumer pays the ultimate price. So everybody down the line does not suffer.

So when you say the refiner is going to watch the producer, the wholesaler is going to watch the refiner, not at all, because he knows that he is protected because he passes it on to the ultimate consumer, John Q. Public.

Mr. MONTGOMERY. Senator, I am not saying it would not be desirable to audit at all levels but there are 19,000 producers. Most of them, the ones that sell to independent refiners, are small people. They are locked into those purchasers? The refiners, on the other hand, have under our regulations a guarantee that they can continue to buy that oil. There is no possibility at all that they will, by exposing a violation or taking a hardnosed attitude on price, that they will lose their source of supply. We froze those relationships and have since December 1 of last year. There is a fact, you are correct, that they can pass on their costs but the pressures to keep those costs down because of the need to sell their product and their desire at the retail level to have a competitive price are substantial.

Second, 7 percent——

Senator RIBICOFF. But, you see, in other words, the President and the Congress and the country one way or another are going to have to go for rationing or conservation of some kind. So, generally, what you are going to do, you are going to just hold down the supply of petroleum products that are available to the people of this country. So there is basically a virtual monopoly, so there is no competition any more. There will not be any competition. They can sell all they have.

But the question is, At what price is that being sold if you do not have price controls? It makes a lot of difference whether that oil starts out at $5.25 or starts out a $10 a barrel, because if it is at $10 a barrel there is a limited amount, that $4.75 differential. The public is going to pay for it because they have no place else to go. In other words, they cannot go from brand X to brand Y because at that time there is going to be a limited supply and the entire supply will be used by the consuming public.

Now, we are not talking about today but we are talking about tomorrow, because I am positive that the President is going to have no alternative but to go to some sort of rationing. Under these circumstances, if the public has no alternative, the public is entitled to pay the fair price and not an inflated price or a wrong price because the governmental agency in charge of supervising the industry just is not there.

Mr. MONTGOMERY. Senator, I could not agree with you more. It we are talking about tomorrow we would like to talk about our program to implement a system of producer audits because we recognize what you say is completely true. If we return to another type situation, another shortage situation, whether it is by embargo or our own efforts to restrict imports and impose a certain degree of conservation, we are going to have to be very careful about this. In our testimony we address the question at some length and, if you would like, Mr. Smith would explain to you the program of producer audits that we have underway.

Senator RIBICOFF. I think that is a point. Gentlemen, it is not important that you read the statement. That will go into the record. I think it is important to get this out.

There are two things that I see that are important here today. The first is to make sure that those segments of the industry that have violated the law and have taken an unfair advantage any place down the chain should be required to reimburse by penalty, civil action, or otherwise.

PROTECTING THE PUBLIC

Second, how do we make sure that the public is protected in the future? And I look at this as a cooperative basis. I do not see GAO and FEA and the Congress of the United States at cross-purposes with one another. You have not made the overcharge. You have not benefited. GAO has not benefited. But basically, all of us have the objective of protecting the public. I mean, that is why we are supposed to have these laws and why this exercise is taking place.

Now, how will we protect the public from now on?

Mr. SMITH. There is clearly no question about the objectives, Mr. Chairman, and the short answer to how we protect the public is that we learn from the things we did do right and did not do right in the past and frankly, we learned a great deal from the review that the General Accounting Office did and from their people, not only in terms of the general findings set out in the report but in terms of the very specifics of how to get our job done, by having somebody else come in, point up where you can provide areas for improvement and we have welcomed these findings. Frankly, I wish they were a little bit better, but we welcome these and we are committed to doing whatever is required to building the kind of enforcement program that you—that we both want.

Senator CHILES. Mr. Chairman, I just want to say along that line, where we are, it is inconceivable to me that they only have two auditors from IRS that are assigned to audit one of these majors. There is just no way in the world—IRS sends four auditors on a $25,000 tax case, fraud case, if they are going to put some guy in jail. I wonder, you know, where are the problems between IRS and FEA and their assignment of people to enforce this, because their major job, of course, is tax collection and has been and I just cannot understand how we do not have adequate manpower assigned. We now know that finally FEA has had a statement that there is a tremendous possibility of fraud, perhaps in your area, too, but certainly in the Southeast, in the sale of oil that was being counted as foreign oil when it was in fact domestic. It was old oil and being charged at the foreign price, and our people are dying under the electric charges in Jacksonville

and all over the State where supposedly all we were getting was Venezuelan oil and we have been trying to get some kind of an allocation, to try to readjust that.

But now when the people find out that there is perhaps fraud involved, they are out of their minds about that and wanting to know why this had not come to light, what is taking the time. I hope now from yesterday's statement that FEA is going to assign the kind of resource people to it, but prior to that, all that case really was in the hands of our State attorney in the particular area. He is trying to get all kinds of people to trace down the manipulations that would be necessary to try to determine what happened. He does not have the experts on his staff, a county-State attorney and the staff that he has, and he was getting minimal help. FEA just was not in the investigation. I hope they are now.

PRICING SUPERVISION AND COMPLIANCE

Senator RIBICOFF. What is your program now to assure supervision and compliance in the pricing field?

Mr. SMITH. First, in respect to the producer area, we are in the process of redeploying the manpower so that we will have in addition to the refiners that I will come to in a minute, we will have a total by the end of the year of 212 positions in the compliance and enforcement field force devoted exclusively to producer audits.

Second, with respect to the refinery program we are in the process of more than doubling our strength in the refinery program, from 88 currently assigned to 190, and we are revising and expanding the audit guidelines that those refiners will use so that we will have more than twice as many people in the refinery audit program and based on, first, IRS's experience, and then our own, now that we have completed two cycles of audits, we will have better guidelines for those people so they will be able to be more productive, know better what to look for.

Third, in the process of these first two audit cycles also, we have identified a number of ambiguities or a number of needs for interpretation or changes in the regulations. The GAO report refers to these explicitly.

With the exception of one, I believe, that is still outstanding, these have all been resolved and now there are fewer ambiguities. We now know more about what the price regulations mean.

Understand, sir, that during this period of time one of these issues like the double recovery or transfer pricing or any of the others that are mentioned in the report, every time one of these came up it was the first time. It was brandnew. And the industry is so complex that you do not just make an off-the-wall call on a ruling on one of these things. You have got to find out what the law says, what the regulations say, what the facts are and then under the law we are required to study the economic impact of those rulings, hold public hearings and allow period for comments and consider the comments, go through the procedures of changing rules when required.

I am not objecting to that. I think that is entirely proper. But we resolved a number of these one-time issues so now we know more about how to do the job. We know how to do the job better. The regulations are clear. The interpretations have been made, not all of them but a lot more than we had then, so we are going to be able to do our refinery

audits quicker and better and we are more than doubling the manpower assigned to those.

Now, those refinery audits themselves, sir, will incorporate as part of these revised guidelines, a more extensive look at the crude purchase—crude purchases of the refiner. You see, in many cases, since froze the supplier-purchaser relationship as Mr. Montgomery outlined, in many cases the records of what is paid to the producers are in the refiner's own bookkeeping system. In fact, in all the cases, who he paid what for how much oil is in the refiner's bookkeeping system, to include the base period. So we can look right there and find out at the refinery level where there have been any big variations and then we can use those findings as inputs or red flags to have our 212 dedicated producer auditors go out onto the property if required and review the records of the——

Senator RIBICOFF. But that involves where a producer is selling to an independent refiner. How about an integrated operation where the producer, which probably involves more in volume, is also the refiner? Certainly, that is so with the major——

Mr. SMITH. Then the records there—and you are quite right, sir, the major refiners are also the producers of the majority of the oil and there the records delivered from each track they own are in his bookkeeping system and any charges he has made to himself in effect for that oil—you know, we can do right there in the refinery records, we can do the whole producer and refiner audit.

Senator RIBICOFF. That is provided you do it.

Mr. SMITH. Yes, sir.

OVERCHARGE RECOVERY

Senator RIBICOFF. Now, what are you doing to recover for the public the overcharges that have taken place up to now?

Mr. SMITH. Every time an overcharge is established, then some remedial action is taken. The emphasis on that remedial action is getting that money back in the hands of the public. If it has actually been overcharged, passed through to the public, or if it is a part of these banks that we talked about and the money has not passed through yet, then we reduce those banks and thereby reduce the authority of the company to keep its prices up in the future. And if the violation has been a flagrant one and there is the appearance of willful attempt to evade the regulations, in those cases we pursue penalties.

Senator RIBICOFF. Well——

Mr. SMITH. And that is why we——

Senator RIBICOFF. On that basis, have you not now decided that you are going to apply your regulations prospectively instead of retroactively? In other words, are you whitewashing——

Mr. SMITH. No, sir. I think you are referring to the refinery fuel issue, are you not, and there is specific reason for that particular call that we can go into if you would like, but back to the enforcement question, there has been no determination in any case that a refiner who was in fact in violation at some time in the past is forgiven that violation, renfiner or anybody else.

Senator RIBICOFF. When you use the word refiner I am talking all the way down the line and so are you.

Mr. SMITH. Yes, sir. I said refiner or anybody else.

DOUBLE DIPPING

Senator RIBICOFF. Or anybody else. We talk about banking. What are we talking about when we talk about double dipping?

Mr. SMITH. Double recovery, sir, was an issue relating to ambiguity in the regulations so that they were susceptible to an interpretation that a company could charge more for the oil it imported and sold on its—under the crude allocation program than the difference between what it paid for it and what it sold for. I am not sure I understand that either, what I just said, but I will let Mr. Montgomery try it.

Senator RIBICOFF. As an example, use dollars or cents. Or use plain dollars so we will know what it is all about.

Mr. MONTGOMERY. One part of our program is called the crude allocation program. That is the program that requires the large refiners to sell crude oil to the small refiners, in a nutshell.

Now, large refiners who sold this crude were doing so under some regulations which allowed them, pursuant to the statute, to recover the costs of their crude, the increased costs, on a dollar-per-dollar basis. They brought some crude which they refined, sold as product. They bought some which they had to sell under our allocation program to other refiners. One provision in our regulations was interpreted by some refiners, by no means all, who had this obligation to sell to allow them to recover the increased cost that they incurred in buying the crude twice. They would sell it to the smaller refiner and recover the full amount of their cost. They would then add that cost increment into their overall cost base which they would then pass through on the products that they produced.

Now, this was called the double dipping because it allowed them a double recovery.

Senator RIBICOFF. Well, is this right?

Mr. MONTGOMERY. This is wrong.

Senator RIBICOFF. Well——

Mr. MONTGOMERY. This was not a permissible interpretation of the regulations and was never intended to be.

Senator RIBICOFF. All right. Now, how much does this amount to in millions of dollars, this double dipping?

Mr. MONTGOMERY. It amounts in the overall to—by our best estimates—$330 million. Let me emphasize, though, sir, that of this $330 million, as far as we know as a result of very comprehensive audits of this particular issue which we focused on extensively, only about $40 million of that total was actually passed on. The rest went into the banks of the refiners questioned.

We took two actions in September. Action No. 1, we issued a ruling which made it very clear to anyone who had ever had any doubts that this double accounting was incorrect and unlawful. And we directed that the banks of any company, any refiner, be immediately reduced to the extent of any additions to those banks as a result of this interpretation. In other words, in one ruling we wiped out the—well, $290 million of that $330. There was no longer——

Mr. SMITH. And we are going to get the rest of it back in rollbacks.

Mr. MONTGOMERY. On the rest of it we wrote a letter to every refiner. We described the situation and advised them that if they had passed through, in their costs, any increments that were allegedly allowable

in their view because of this interpretation, that they would be forced to roll back their prices or make direct refunds to recoup or reimburse to whoever paid those amounts the $40 million. In other words, when this enforcement effort is completed and it is very much—we are committed to it and it is underway right now—there will be no result whatsoever on the consumers as a result of this provision.

Senator RIBICOFF. Do you want to make any comments from the GAO's position on double dipping?

Mr. HUGHES. I do not believe so, Senator. We understand the problem to be as described by Mr. Montgomery and applaud the resolution of it. It is—this was among a number of unresolved issues that we refer to in our report and again in much briefer form in the statement.

I think the main point that has not been specifically mentioned is that the magnitude of adjustments consequent to these rulings, revisions in rulings, or clarification in rulings or regulations, could approximate $1 to $2 billion and that in some instances, it is on the basis of FEA's judgment, some of the banks of some of the companies would be wiped out by the adjustments of—or more than wiped out by these adjustments.

Senator RIBICOFF. There is a rollcall going on and we will take a short recess to respond to the rollcall. I wish you would get me the answer during the recess as to the Murchison Audit Computer Co. and I would appreciate, too, an estimate from both FEA and GAO, what are we really talking about in overall charges? We talked about $1 to $2 billion on the refinery end. I am curious about the estimate that you have on the overall overcharges all the way down the line.

We will take a 10-minute recess.

[A recess was taken.]

Senator RIBICOFF. Mr. Sawhill, we have been going along in your absence and I think many of the questions we would have asked you have already been responded to by your associates. I am not going to ask you to read the statement. I have read that.

Mr. SAWHILL. I hope we can put that in the record.

Senator RIBICOFF. Your statement will go in the record as if read and that also goes for you, too, Mr. Hughes, because we interrupted you.

Mr. HUGHES. Thank you, Mr. Chairman.

[The prepared statements of Mr. Hughes and Mr. Sawhill follow:]

PREPARED STATEMENT OF PHILLIP S. HUGHES, ASSISTANT COMPTROLLER GENERAL OF THE UNITED STATES, ON THE FEDERAL ENERGY ADMINISTRATION'S COMPLIANCE AND ENFORCEMENT ACTIVITIES

Mr. Chairman and members of the subcommittee, some 10 months ago you asked the General Accounting Office (GAO) to monitor and evaluate the operations of the Federal Energy Office and any successor organization and report periodically to the Subcommittee on the results of this work. Subsequently, section 12 of the Federal Energy Administration Act of 1974 provided a statutory basis for GAO monitoring and evaluating operations of the Federal Energy Administration (FEA).

Accordingly, we have briefed members of the Subcommittee staff from time to time and issued reports to you. In July we pointed out that FEA's compliance and enforcement efforts were limited, and perhaps, misdirected. We agreed to examine this area in more depth and on December 6 reported to you on "Problems in the Federal Energy Administration's Compliance and Enforcement Effort." My testimony today will summarize the results of our work.

In considering FEA's problems, one should keep in mind that the task of developing and insuring compliance with price regulations involving all elements of the complex petroleum industry is difficult at best. There are

over 19,000 producers of crude oil,
250 refineries owned by 200 companies,
25,000 wholesalers, and
200,000 retail gasoline stations.

The difficulty is increased by the vertical integration and multinational character of major oil companies.

GAO's evaluation of FEA's compliance and enforcement program was impeded by FEA's reluctance to allow us full access to information relating to refinery audits. I will discuss our problem of access to information in more detail later. Now, however, I believe we have established a workable framework to insure that such problems don't occur in the future.

Information provided showed significant problems in FEA's compliance and enforcement program at all levels of petroleum industry operations. Our findings—which I will also discuss in more detail—can be summarized as follows:

There was almost no direct audit of crude oil producer operations.

FEA concentrated its audits at the retail level and found numerous violations, however, there was evidence of large violations at the wholesale level where little audit effort was made.

Audits of refiner operations were not completed.

Substantive issues relating to the adequacy of regulations remained unresolved.

Organizational disputes within FEA hindered audit work at refinery operations.

Our work has shown that if petroleum price controls are to be continued, FEA must strengthen its compliance and enforcement program at all levels if it is to have adequate assurance that firms are complying substantially with pricing regulations.

## COMPLIANCE AND ENFORCEMENT EFFORT

At the start, compliance and enforcement work associated with petroleum price regulations was performed by the Internal Revenue Service (IRS) under a memorandum of understanding with FEA. Initially, 300 IRS employees were used while that agency hired and trained employees for eventual transfer to FEA. Two hundred and thirty-six of the 300 IRS employees were assigned to the retail/wholesale level and 64 were assigned to audits of refining companies. By July 1, 1974, 850 employees had been hired and trained to perform compliance and enforcement work and FEA assumed full control of the program. FEA assigned 762 of the 850 employees to the retail and wholesale level and 88 to audits of refining companies.

*Producers*

Neither IRS nor FEA assigned compliance and enforcement staff to audit the 19,000 producers of crude oil. In some instances, producer records were looked at either as part of a refinery audit or on a selected basis; but, as of mid-November 1974, FEA still was in the process of developing its first full-scale review of producer operations.

Audits of producers are important because their operations determine the price of crude oil used in refineries. Under price regulations, oil produced in the United States sells at either a controlled price of about $5.25 per barrel or a free market price—which has been as much as $10 per barrel. With such a price difference, an adequate program of verification is needed if we want to be sure that purchasers of crude oil and ultimately consumers are not overcharged.

*Wholesalers and retailers*

While FEA has identified substantial violations at both the wholesale and retail level, its efforts have been concentrated on violations at the retail level. Basically, FEA officials felt the consuming public was more sensitive to these violations. Also, retail violations can be investigated faster and require less time and work than wholesale violations.

As of September 27, FEA had made 80,137 investigations of the approximately 225,000 wholesale and retail firms. Some firms were investigated more than once. These investigations uncovered 18,034 violations of price regulations and resulted in reported refunds of $51.2 million to the marketplace. Most of the violations occurred at the retail level and individual violations were in relatively small amounts.

Investigations of wholesalers uncovered much larger violations. For example, during a 3-month period one FEA region uncovered violations at 132 retail firms totaling $345,000. Violations uncovered at four wholesale firms in the same period totaled $513,000. In the case of propane wholesalers, FEA made a special effort termed "Project Speculator" directed specifically at wholesale firms. So far FEA has determined that 75 companies violated or probably violated regulations, overcharging customers $55 million.

*Refiners*

FEA's refinery audit program seeks to insure that refiners increase prices only for allowable cost increases. Of a total of 200 companies, FEA considers 125 of enough significance to report regularly. Thirty-one of the companies—which account for over 85 percent of refining capacity—have been placed under audit by FEA.

The refinery audit program is complex and comprehensive. Yet, IRS in its earlier work and FEA to date have assigned only two auditors to each company. Considering that many of the refining companies are billion dollar corporations with numerous subsidies and multinational operations it is not surprising that the auditors fell short in completing an ambitious audit program.

For 17 of the 31 refining companies under audit, we examined the audit reports made available to us, reviewed supporting documentation and discussed the audits with auditors assigned to the companies. We found that neither IRS nor FEA completed important parts of the audit program. In general

The scope of work performed was limited. In a number of cases, the auditors agreed that the work was not adequate.

There was limited or no verification or tracing of pertinent cost or other information to basic source documents.

In many instances where problems or discrepancies were noted, follow-up or expanded audit effort was not undertaken.

The failure to accomplish the entire scope of the program and the lack of follow-up where discrepancies were noted can be related directly to the limited number of staff committed to audits at the refinery level.

## ADMINISTRATIVE SANCTIONS

When FEA believed a provision of the price regulations had been violated, an attempt was made, as a first step, to obtain a voluntary price rollback and a refund of overcharges to customers or the marketplace.

If compliance could not be achieved voluntarily, FEA issued a Notice of Probable Violation (where the violation was likely but not certain) or a Remedial Order (where the violation appeared certain or repetitive). If the company complied with actions required by FEA, the violation or order was rescinded.

As of September 30, 1974, FEA reported that the refinery audit program resulted in five voluntary rollbacks, six Notices of Probable Violations, and six Remedial Orders. These violations involved 13 refining companies and amounted to $194.3 million. Four of the six Notices of Probable Violation and three of the six Remedial Orders were not resolved as of November 1974 because FEA was studying proposed regulatory changes or awaiting additional information from the company.

In many cases, corrective action involved the firm writing-off a portion of the violation against paper-cost increases accumulated under a cost carryover provision of the price regulations. This provision allows refiners to "bank" cost increases which the firm feels cannot be immediately passed on in the marketplace. FEA intended the carryover provision to be a method whereby price increases could be smoothed out.

What has happened, however, is that large accumulations, or "banks", of unrecovered costs have been created. A number of companies have "banks" which represent over 50 percent of the additional costs they claim to have incurred since October 1973. FEA officials told us that as of September 30, 1974, the collective "banks" totaled about $2 billion.

Because of its concern about the growing size of oil company "banks", FEA issued a regulation on November 6 which limits the amount of banked costs which can be added to the consumer prices in any one month to 10 percent of a company's total bank.

## UNRESOLVED ISSUES

On August 28 the then Director of the Refinery Audit Program, in a final report preceding his leaving FEA, indicated that there were a number of pending

complex regulatory issues which are discussed somewhat in our report including recently publicized allegations of "double-dipping" by certain oil companies.

In the case of some of these issues—including the double-dip issue—FEA has issued rulings or regulations which should preclude such practices in the future. However, several issues still are not resolved. Further, FEA has not determined the amount of possible overcharges which might result, nor sustained the legality of retroactively applying the regulations. Substantial amounts of time elapsed between identification of potential violators and regulatory action. FEA refinery audit officials estimated that the magnitude of refineries' potential violations could be between *$1 and $2 billion* and that some of the individual violations are so large that if sustained they would wipe out the previously mentioned "banks" of some companies and thereby result in price reductions.

ORGANIZATIONAL PROBLEMS

Organizational changes and disputes also prevented sustained program direction.

When IRS was performing compliance and enforcement activities, FEA's direction of IRS personnel at the retail/wholesale level was hampered by the lack of key regional personnel. Also, FEA's assessment of the effectiveness of IRS efforts was limited because of the limited amount of information furnished FEA by IRS.

When FEA assumed full responsibility for compliance and enforcement activities, a dispute arose as to whether headquarters or the regional offices were responsible for the activities of the refinery auditors. While FEA headquarters was responsible for program direction of the audits of major refiners, the field auditors were assigned to FEA's regional offices. In some cases, the lack of clear responsibility for the auditor's activities hindered the effectiveness of the refinery audit program.

FEA PLANS TO REDIRECT COMPLIANCE AND ENFORCEMENT EFFORTS

In mid-November, we met with FEA's compliance and enforcement officials to discuss a draft of our report of December 6. We discussed the need to improve the program overall and specifically the need to audit producers and wholesalers and to improve refinery audits.

FEA officials generally agreed with conclusions of our report. They said that a revised staffing plan had been approved which would permit audits of crude producers to begin, increase the audit attention to the wholesale and refinery level, and decrease the audit attention at the retail level. By January 1, 1975, auditors assigned to producer audits will be increased from none to 143. Auditors assigned to refiners will be increased from 88 to 188. FEA officials also stated that

> operating procedures between headquarters and regional offices for compliance activities had been clarified to provide more uniform treatment of violations and to coordinate actions among the regions and the national headquarters.
>
> improvements are planned in FEA's reports and data-gathering procedures aimed at increasing FEA's ability to identify suspicious activities or companies in violation of FEA regulations through the review of information reported routinely to FEA by the companies.

We believe the changes planned by FEA are important steps designed to improve its compliance and enforcement program.

ACCESS TO RECORDS

Earlier in my statement I mentioned problems we encountered in obtaining certain FEA records. During our review, FEA did not authorize us access to records relating to active compliance investigations or audits which had not been completed. Since many of the problems were considered unresolved issues at the time of our audit, we were restricted in evaluating the extent of the problems and the adequacy of FEA efforts to resolve them.

We had numerous discussions with FEA officials during the course of our work regarding our right to access to FEA records under section 12 of the FEA Act. These discussions continued after our audit was completed. I met with the FEA Administrator last week to discuss this.

On December 4, 1974, the FEA Administrator sent a letter to the Comptroller General outlining FEA's position on GAO's right of access to information in FEA's possession. He agreed that the FEA Act contains no explicit limitations

exempting certain classes of data in FEA's possession from access by GAO when such information is necessary for GAO to carry out its statutory responsibilities. He also said that FEA does not intend to contest further GAO's view that the FEA Act allows it "plenary access" to all such data.

The Administrator expressed FEA's concern, however, that methods be developed to enable GAO to carry out its statutory responsibilities without impairing FEA's compliance activities, particularly in situations where investigations have reached the point that FEA is seeking administrative sanctions for violations of its regulations or where litigation is involved.

We believe the Administrator has proposed a workable approach for GAO access to the information we require to fulfill our responsibilities under the FEA Act. We plan to work with FEA to make sure that access problems do not occur in the future.

Mr. Chairman, that concludes my prepared testimony.

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PREPARED STATEMENT OF JOHN C. SAWHILL, ADMINISTRATOR, FEDERAL ENERGY ADMINISTRATION

Mr. Chairman and members of the subcommittee, I appreciate the opportunity to present to this Subcommittee FEA's comments on GAO Report B–178205, "Problems in the Federal Energy Administration Compliance and Enforcement Effort." On the whole, the report submitted to this Subcommittee is fair and objective—even with respect to those findings criticizing some of our work. In addition, we have derived substantial benefit from the many helpful observations and suggestions made by the GAO staff during the short life of our enforcement effort.

The report sets out GAO's findings in five major subject areas: producers, wholesalers and retailers, refiners, administrative sanctions, and unresolved issues. I will make some points regarding the overall effort that are essential to a proper perspective on the report's findings; then state our position on each set of findings. As I discuss each area, I will describe the actions taken and planned to correct the deficiencies noted in the report.

First, we must remember the conditions under which the agency was created. It was pulled together overnight by combining numerous segments of other government offices, adding large numbers of detailees from other departments and agencies, and hiring a number of new employees. It confronted an entirely new problem with which none of us had any direct experience. Most of the people involved had little direct knowledge of the industry's complexity, and we were cautious about bringing in people with industry ties because of the nature of our work. We were in a true emergency situation, with a premium on decisive action.

Given this setting, I am proud of the agency's overall record. It met the challenge confronting it and brought us through a trying and dangerous period with minimum disruption of our economy and our society.

There were, of course, mistakes made in this period. In retrospect it is clear that we probably should have done some things differently, although I might add that it was much less clear at the time the hard decisions had to be made. We have learned from these mistakes. Many of them have already been corrected, and others are now being corrected. As we have gained experience, we have learned how to do our job better, and we will continue to improve our performance.

While we welcome constructive criticism of our efforts, we do believe it important to evaluate those criticisms in light of the agency's overall performance of a difficult task under trying circumstances.

Turning now to the subject of the GAO report, I think two specific points need to be made.

While it is only implied in the GAO report, the fact is that FEA's compliance program, coupled with widespread voluntary compliance with our price regulations at all levels of the petroleum industry, has provided and will continue to provide the American people with assurance that the prices they must pay for petroleum products are equitable and within the law. The amounts represented by all the violations or possible violations identified to date represent a small fraction of the total lawful costs passed through to the American consumer, and the number of violators is dwarfed by the number of firms who have scrupulously attempted to comply with the letter and spirit of the law. Leaving aside the "double-up" issue which arose from a disputed interpretation of our

regulations, our second refinery audit cycle uncovered $145 million of possible violations during a period when over $13 billion in lawful costs was available for pass-through. Even at the outside, the percent of unlawful costs is less than 1 percent.

The fact that, as reported by GAO, FEA has uncovered violations involving potentially many millions of dollars does not mean our compliance and enforcement program is not working. It means that our program is working. Once a formal finding is made that any portion of these sums has in fact been illegally passed through to consumers or illegally used to create "banks" of as yet unrecovered costs on a firm's books, FEA has taken and will continue to take whatever action is appropriate to rectify the violation.

The key point here is that despite any violations of our regulations that may have occurred, no permanent damage to consumers' interests has been done. Every member of the industry—producer, refiner, wholesaler, and retailer—is still liable for any overcharges that may have occurred. The FEA has all the authority it needs to cause any overcharges, whether detected yet or not, to be refunded to consumers. You may be sure that we are going to use that authority to the full extent required.

It is also important to understand that only a relatively small fraction of the total amounts which we suspect may be involved in possible violations has, in fact, been passed through to consumers in the form of prices higher than would have been allowable under our regulations. The "banks" of unrecovered costs now on the books of refiners and sellers represent potential price increases—or potential delays in price reductions—that have not yet been passed through to the marketplace. To the extent that past violations did not actually result in overcharges to consumers, FEA possesses the quick and effective remedial device of reducing the amount of the current "banked" costs by the amount of the past violation. Of course, if an overcharge actually occurred, FEA will take whatever action is required to make the overcharged purchasers whole, including refunds and rollbacks to the marketplace through price reductions.

While there may have been some deficiencies in our compliance and enforcement efforts in the past, I believe these must be kept in perspective. Our achievements have been substantial, and we retain the authority to take both preventative and corrective action with respect to past violations to assure that the American people pay no more than they should for petroleum products.

We are now taking the actions we believe to be required to correct the deficiencies noted by the GAO. We are committed to the goal of a vigorous and effective compliance and enforcement effort, and if the actions now underway are not fully effective, we will take whatever additional measures are required to attain and sustain the level of effort required to get the job done right.

PRODUCERS

Turning to the specific findings of the report, I will begin by discussing the question of producer audits. We now have underway a major program of auditing the prices paid for domestic crude oil.

You might ask why we took so long to begin this effort. Initially, the retail sector was the source of the overwhelming majority of the complaints received by the agency. We felt a clear responsibility to be responsive to those complaints, not only as a direct service to the public, but also because in a tight market situation such as prevailed during the first part of this year, the opportunity for price gouging at the retail level was perhaps the greatest. The whole issue of providing fuel to truckers at reasonable prices was one example of how crucial the retail sector was in the program's beginning. Initially, then, the major focus of the compliance program was at the retail level.

We were not unaware of the producer problem, of course, and we took steps to assure ourselves of an acceptable level of compliance in this segment of the industry. The refinery audit program itself included a review of prices paid by refiners for their crude oil supplies. Since the regulations had frozen supplier/purchaser relationships, refiners' books would show any major shifts in the prices paid for crude to individual producers. Also, a certification requirement was included in the regulations for the sale of any crude oil not subject to price controls. This was done both to promote compliance and to create a permanent record that would be subject to audit at any later date.

We also watched the trends in the overall composition of total domestic crude production from month to month. Had there been persistent and widespread

violations of the crude oil price rules, the percentage of "old" or price-controlled oil would have dropped sharply and the percentages of oil reported as exempt from price controls would have risen sharply. The data we had did not show any such trends.

Accordingly, it did not seem justifiable during the shortage period to divert our limited investigational capability from the refiner-retail-wholesale area, especially in light of the great number of complaints received by the agency in the early part of 1974 and the high rate of violations relative to complaints we were finding at the refiner, wholesale, and retail levels. During the period May through October 1974, a total of 7371 investigations (mostly in response to complaints) disclosed 3675 violations, for a violation rate of 49.9 percent. With one out of every two investigations turning up a violation, we were reluctant to divert manpower from this area to crude producers, where we had no reason to believe that there were major and persistent violations in progress.

In retrospect, you might argue that we should have instituted a number of spot-checks throughout the producer area and advertised them widely, just to let everyone know we were not ignoring the potential for violations at this level. The GAO report describes the redevelopment of manpower we have underway and the staffing level of 143 targeted for the crude producer area as of December 31, 1974. During the last half of fiscal year 1975, we intend to further strengthen our program in this field and will have by June 30, 1975, a total of 212 positions dedicated to crude producer audits. In addition, the refiner audit guidelines have been revised to place additional emphasis on this area. Results of the refiner audits will be used as leads to see that the efforts of the producer auditors are directed at those producers most likely to be in violation. I believe this action will, when completed, correct the deficiency noted in the GAO report.

WHOLESALERS AND RETAILERS

The GAO report criticized the allocation of our compliance and enforcement resources as between the retail and wholesale level. The report noted that larger violations at the wholesale level were uncovered and that FEA should have redeployed its compliance efforts to "capture" these more substantial overcharges, rather than concentrate on the retail level.

Let me state at the outset that FEA did not ignore the wholesale level. Most wholesaler investigations were initiated in response to retailer complaints. But, many investigations that led to the wholesale level started as routine retail investigations or audits. Because the wholesale/retail distinction is not always a clear one (many wholesalers also operate retail outlets), we did not initially classify investigations at the different distribution levels separately as we are now doing.

I believe the reasons for FEA's initial concentration on the retail level were sound. Given a shortage situation, consumers were willing to pay whatever they had to pay to get petroleum products. While individual violations may be small, the aggregate amount of such violations to the consuming public could be very large indeed. We also felt that retailers were less likely to sit by quietly and accept an overcharge from a wholesaler. For a wholesaler, a violation is more visible, more likely to provoke a complaint, and therefore less likely to occur.

In this kind of situation, a highly visible enforcement effort aimed at retailers not only catches actual violators but also deters other potential violators, thereby saving consumers from potential overcharges in amounts no one can ever estimate, but which are clearly of major significance.

Put another way, Mr. Chairman, I believe it would have been irresponsible not to have concentrated the majority of our enforcement effort at the retail level during this period. Given the situation that existed during the early months of the program, even if we had an airtight system from the producing well to the gas pump and no enforcement of the pump prices, consumers could have lost billions of dollars in unauthorized charges. We are confident that our vigorous retail compliance program prevented such an outcome.

Moreover, many of these would never have been recoverable. The turnover in retail operators is far higher than any other segment of the industry; wholesalers, refiners, and producers turn over at much slower rates.

In a shortage market, the retail level was the most likely—not the only, but the most likely—level for violations, and if they were ever going to be

caught or deterred, they had to be caught and deterred quickly. Clearly, there have been violations at the wholesale level; we have found a number of them, and we will find more as our review of this sector continues. Obviously, when one finds a violation at the wholesale level, it is likely to be larger than a retail violation because larger quantities of product are involved. However, we dispute the GAO contention that the wholesale level was a source of disproportionately greater violations than the retail level. GAO's reliance on our experience with propane pricing violations to project the magnitude of wholesale violations for all products fails to reflect the realities of the petroleum products marketing and distribution system.

The report states, "We recognize that the propane situation was somewhat unique but believe that Project Speculator illustrates the magnitude of violations at the wholesale level." In fact, the propane situation was truly unique in that, for a variety of reasons, the supply-demand gap at allowable prices was far wider for propane than for any other petroleum product. Nearly 70 percent of all domestically produced propane is extracted from natural gas. As natural gas production has leveled off and curtailments have increased, the demand for propane, the best substitute for natural gas, has soared at precisely the same time its supply has been restricted by that same natural gas production. Moreover, the distribution is irregular with substantial quantities moving horizontally at the wholesale level to meet regional supply imbalances. This situation of tight supplies and irregular wholesale transactions created unusual opportunities for price gouging, and a number of firms did just that. As reported in earlier testimony on several occasions, Project Speculator was initiated to stop this practice and to get refunds for actual overcharges. It has done so. We have already issued orders for the refund of $43 million in 31 completed investigations and expect to issue orders for refunds of some $25 million in the remaining 44 cases still open. Again, the propane market is unlike the gasoline market in that specific records of deliveries to each customer are maintained. These records provide a basis for refunds to individuals who were overcharged, and these refunds are now underway.

To take this situation as representative of the entire wholesale distribution system in all petroleum products is a gross overstatement of the opportunities for and probable extent of any possible overcharges.

Two other considerations supported the emphasis of our compliance and enforcement effort on the retail sector. The first, frankly, was to be responsive to the public. It was almost as important to reassure a consumer quickly that he was not being overcharged as it was to catch a violation when he was. We were responsive to individual complaints. I think we should have been and that we will continue to be so. The taxpayers deserve a responsive answer to their requests for assistance.

The second reason was that we could mount an effective retail effort quicker than we could put in a complete, across-the-board program. Retail investigators required the least training, and the complexity of the price regulations was minimal at the retail level.

All of these considerations taken together convince me that we started the program in the right way, and nothing in the GAO report is contrary to this conclusion.

However, we have begun shifting emphasis from retail outlets to wholesale levels, with the proportion of wholesale investigations rising by about 50 percent in the last few months.

Still, the major emphasis has remained on retail enforcement. Why, when there have been adequate supplies of gasoline available in the market for several months and we actually see price wars breaking out again in several areas?

The answer is the two-tier pricing system for crude oil. Because of the complexities and conflicting interests involved, it has taken us longer than we expected to formulate the final regulations for largely removing the effect of the two-tier crude price system on the average cost to refiners. This has meant that some refiners with more than average ratios of old oil in their refinery runs have had a substantial competitive advantage over other refiners with higher costs.

In this situation, a continued major effort at the retail distribution level has been required to keep those with supplies of low-priced product from unlawfully raising prices to match those of sellers supplied by higher cost refiners.

Even now, though, with increasing supplies available, we see the effects of competition causing almost all sellers to charge below their maximum lawful

prices in the gasoline market and, to a lesser but still significant extent, in the markets for other petroleum products, propane excepted. For propane, supplies will remain tight, and we will have to maintain a vigorous enforcement effort at all levels of the supply and distribution chain.

With this exception, we believe that as crude cost equalization becomes effective, we will see even greater price competition in the markets for products. This will drive prices generally below maximum allowable levels, as it is already beginning to do in substantial segments of the market. As this develops, we believe that a shift of manpower from retail and wholesale levels to refiner and producer levels is not only possible, but also mandated by considerations of responsible management. Once we restore the conditions under which competition can exist in product markets, we should let it work.

Because competition at the retail level and, to a large extent at the wholesale level as well, is already driving prices down to levels below those authorized by the regulations, fewer total people will be needed to attain a satisfactory level of coverage. People shifted from the retail level where there are over 200,000 outlets will be moved to the producer level where we estimate there are some 19,000 producers. Thus, we believe we can improve substantially our enforcement efforts and operate within our personnel ceilings because of the major shift in our workload. With a net strength reduction of only 71 and a far greater reduction in the compliance workload in the retail and wholesale sectors, the producer and refiner areas can be covered adequately. The remaining compliance personnel will be free to concentrate on an expanded audit of wholesalers. These audits will, of course, cover the entire period during which our regulations have been in effect.

REFINERS

Turning now to the area we all agree is the key to our enforcement effort, I would like to describe our plans with respect to refiner audits. Clearly, this is a very difficult and complex job, as we have learned, first from IRS experience on the first audit cycle covering the months August 1973, through January 1974; and second from our own experience in the recently completed second cycle covering the months February through June 1974.

It is clear that we need more manpower as well as better guidelines. We are more than doubling the size of our audit staff, from 88 to 190, and are revising our audit guidelines. Moreover, the auditors we do have are now more experienced and will be more productive in their future work. Adding to this core of trained and experienced people will make the new people more productive than if they had to start out on their own as the present group did.

In addition, we are adopting the GAO suggestion for a "strike-force" approach that would develop experts in particular facets of refinery audit issues. Not only could they expedite the actual audit work, but also they would be available to the on-site auditors as a source of ready technical expertise that could enhance their productivity. We now have underway a thorough analysis of our second-cycle audits from which we seek to identify special areas of emphasis or indicators that would give us "early warning" of violations. Using the results of this analysis, we then intend to develop a modification to our current reporting systems so as to get the required data from refiners, if we are not already getting it.

Our goal is to computerize this data and subject it to the detailed analyses that would disclose any irregularities or sharp changes in cost trends. These would then become the targets for "strike-force" audits to determine whether violations had occurred. The concept is essentially the same one applied by the IRS to individual and corporate tax returns.

Again, Mr. Chairman, I believe it important to recognize that in the event and to the extent costs have been overstated, they have by no means all been passed on to consumers. I also want to assure this subcommittee that we will pursue this effort until we are convinced that each refiner has charged only lawful prices or has refunded to the marketplace any overcharges that have been passed through to consumers.

ADMINISTRATIVE SANCTIONS

The GAO report speaks to the time required for imposing administrative sanctions once a probable violation had been discovered. Under our procedural regulations, the companies concerned are allowed to submit data contesting a Notice of Probable Violation. These data must be evaluated before a final determination is made. With litigation on each case an ever-present possibility, we

must be meticulous at every stage in building our case and we must adhere strictly to our own procedural regulations in dealing with a suspected violation. This is by its nature a time-consuming process. The deployment of additional manpower to the refinery audit program and the increased experience level of our core group will serve to expedite this aspect of the sanctions program.

Moreover, the process of adjudicating violations has been inevitably burdened by the fact that every major issue was a "first." There have been no precedents to look to for guidance. Some issues have called for developments of rulings as to the exact meaning of our regulations. Others have called for additional rule-making, itself a time-consuming process that affords adequate opportunity for all interested parties to comment, and requires extensive evaluation of those comments. Again, as we are now building up a body of precedents, rulings, and guidelines, we already see an acceleration in the processing of sanctions.

Finally, the GAO report alluded to confused lines of authority with respect to the refinery audit program. This may have caused confusion and delay in resolving issues. Again, this has been corrected, with the National Office of Compliance and Enforcement in clear charge of the overall effort. This, too, has resulted in speeded-up resolution of outstanding issues.

UNRESOLVED ISSUES

Of the major unresolved regulatory issues identified in the GAO report, all but one—price differentials required by regulations among different classes of customers—have been resolved by formal rulings or rulemakings. The one remaining issue should be resolved in the near future with a ruling now being developed by the General Counsel.

With regard to the implied criticism in the GAO report that FEA generally has taken too long to plug loopholes in, or otherwise clarify, existing regulations, I would like to make the following points:

First, as the GAO report recognized, ambiguities or gaps in the initial January 15 regulations promulgated by the Federal Energy Office were inevitable, given the novelty and complexity of the task assigned to us by the Congress and given the extremely short time-frame mandated by the Allocation Act in which to put these regulations into effect. Certainly, the perceived ambiguity of the so-called "double-dip" provision is traceable to the chaotic atomsphere of those early days of the program.

Second, the GAO criticism completely overlooks the fact that almost immediately after promulgation of the January 15 regulations, FEO began to issue amendments designed to clarify existing regulations, fill in regulatory gaps, and make the program work in an atmosphere of constantly changing market conditions. A cursory review of the daily *Federal Register* issues since January 15 reveals over 60 separate instances of FEO, and later FEA issuing clarifying correcting, or substantive amendments to the allocation and price regulations. In addition, 26 formal rulings have been issued by the FEA General Counsel clarifying the application of various aspects of the regulations. This is hardly a record of sloth or insensitivity to unresolved regulatory issues. We have been working very hard, Mr. Chairman, to learn from our experience—even from our mistakes—and to constantly improve our regulations to achieve the mandate of Congress.

Finally, following adoption of the Federal Energy Administration Act of 1974, the process whereby FEA can amend its regulations, except to cure the most technical and obvious errors, has been made substantially more burdensome and time consuming. Under Section 7(i) of the Act, FEA must publish virtually all rule changes for comment before adoption and must hold public hearings on any change that has a substantial impact on large numbers of individuals or businesses. Moreover, Section 18 imposes upon FEA the duty to insure, to the greatest extent practicable, that the potential economic impacts of proposed regulatory actions are carefully considered and evaluated. In other words, Congress has established procedures for FEA which are designed to assure that its decisions are fully informed, carefully considered, and not made in haste. These procedures apply to regulation amendments involving existing programs as well as to regulations creating new programs. Accordingly, when FEA discovers a gap or ambiguity in its regulations, it cannot act precipitously or thoughtlessly in seeking to plug what some may regard as a loophole. Indeed, the issues which have required clarification or amplification of existing price regulations—transfer pricing, refinery fuel, "double dip," natural gas liquids, and competitive dis-

counts—are extremely complicated issues requiring careful legal and factual analysis before the most appropriate corrective action can be implemented.

Finally, I would like to address the reference in the GAO report to problems experienced by GAO auditors in securing access to certain information in FEA files concerning its compliance and enforcement activities. While I believe that the magnitude of this problem in practical terms has been somewhat overstated, I acknowledge that there have been a number of misunderstandings and even differences of view between GAO and FEA staff personnel over the most appropriate manner in which GAO can fulfill its statutory obligation to monitor and evaluate the activities of FEA in this area.

Let me reassert what has always been the position of FEA that we not only respect GAO's responsibilities and duties under the Federal Energy Administration Act of 1974, we welcome GAO's oversight role as a means to increase public confidence in FEA's efforts to carry out the mandate of Congress. We took the initiative in inviting Mr. Staats and his staff over to a good working relationship right from the outset. If there have been problems, they were the result of an unfortunate, if understandable, misunderstanding as to the best means to implement this novel relationship between an agency of Congress and an agency of the Executive Branch. I am confident that as we move beyond the start-up period, we will see a smoother and more harmonious working relationship.

If there were any differences of principle between GAO and FEA during this initial period, they were quite narrow. Basically FEA took the position that while there was no limit to what GAO could see in FEA files, there ought to be certain reasonable groundrules under which the timing of GAO access could be regulated so as to respect certain significant legal and practical considerations. Specifically, FEA was concerned that GAO's access to investigate files relating to active compliance proceedings and enforcement litigation could raise a real or apparent problem with regard to outside interference in the exercise of what are essentially FEA's law enforcement responsibilities. We were concerned that inadvertent release of information from such files, even if the name of the company involved were deleted, might jeopardize our ability to enforce our regulations.

Let me emphasize that we were at all times prepared to permit full GAO access to such files after they were closed so that GAO could monitor and evaluate the job FEA had done. Moreover, we were prepared to make, and did make on several occasions, exceptions to this general rule where GAO could show us that it needed more current access to information in such files. Throughout our dealing with GAO, we have been assured by them and by representatives of various committees of the Congress that they were sensitive to FEA's concerns in this area. GAO's firm position, however, was that it was up to GAO, not FEA, to decide whether it should exercise restraint in the timeliness of its access to any materials in FEA files.

Accordingly, on December 4, in a letter to Comptroller Staats, FEA set forth its acquiescence in GAO's view of its unrestrictive right of access to FEA files. I have no reason to believe that there should be any further differences of view with regard to this issue, and I fully expect that the GAO-FEA working relationship will be maintained in an atmosphere of openness and cooperation.

In summary, Mr. Chairman, we are convinced that the major direction of our program was the appropriate one under the conditions that existed when it was begun; we acknowledge that based on what we have learned in its initial stages, it needed some substantial redirection to enhance its effectiveness; and we have that redirection underway. Applying the lessons we have learned from our own experience and the findings of GAO's review, we will vigorously pursue the strengthening of this program.

While it is, of course, the GAO's role to point out areas that need improvement, I believe it is important that the record reflect that FEA's overall compliance and enforcement effort has been effective in securing a substantial degree of compliance with the agency's price regulations, detecting a large number of the violations that have occurred, securing individual refunds—or price rollbacks to the marketplace where individual customers cannot be identified—and preventing the pass-through to customers of unjustified costs.

Mr. Chairman, that concludes my prepared statement. I will be happy to respond to any questions the Subcommittee may have.

Senator RIBICOFF. In your opening statement you say that the "GAO's report is fair and objective even with respect to those findings criticizing some of our work." Do you feel that it is fair to conclude

that the compliance and enforcement procedures that FEA will require of everybody in the oil industry and the energy industry will be strengthened?

Mr. SAWHILL. Absolutely no question about it. We work very closely with the GAO, Mr. Chairman, and I think they have done a creditable job here in developing, showing us areas where we could improve and frankly, we appreciate the work that they have done and have tried to respond I think quite well to their criticism.

As a matter of fact, I was just reviewing their report on the plane down from New York this morning and I noticed at the end that they indicated that there had been a meeting with us and that they were pleased with several of the things we had done in response to what they were asking us.

There is no question in my mind that this Government needs a very credible, strong and well-managed compliance program and we in FEA certainly do intend to provide that. I think there is dedication up and down the line in the FEA to making sure that our regulations are carried out effectively, that in areas where there are ambiguities or strength needed in our regulations that they will be carried out. We are—there is just a great deal of commitment in the organization to this.

I think we have got good people now, whereas maybe initially when we had to recruit so rapidly—as you know, we built an organization from zero to about 3,500 people in a very short period of time, in a 60- to 90-day period, and admittedly there was some confusion as we began the process of regulating this terribly complex industry, but I believe now that with Gorman Smith and Bob Montgomery you have a team of people in FEA that are probably unmatched for their skills, administratively and legally, and their dedication to getting the job done. There is just no question in my mind that these are pretty dedicated individuals and they have built under them a very strong team.

### AUDITING WHOLESALERS

Senator RIBICOFF. Now, the Project Escalator that you announced yesterday that made the morning press indicated the need for continuous auditing on the wholesale level. Yet, the GAO report states that as of December 31, 1974, you plan to reduce the number of auditors at the wholesale and retail level from 762 to 363, with another 90 working in the propane area. Do you think that by almost halving the number of auditors you can do the job?

Mr. SAWHILL. Well, what we have done is to have shifted the emphasis of our resources at FEA, shifted the emphasis toward the refiner and toward the wholesaler and away from the retailer. We will handle in the future retail audits on an exceptions basis rather than having a large field force dedicated almost exclusively to retailers as we had in the past.

I think with the market conditions the way they are today that by and large we can handle the retail program with a much reduced force and thus permit us to use our expertise where it is really needed, in the wholesale area and particularly at the refinery level where I think it is just terribly important. So this really does not in my mind, represent a deemphasis of our program but a shift in emphasis, if you will,

toward a very significant and important area which I think the GAO agrees is important for us.

One of the things this will enable us to do will be to concentrate higher talent people in an area which is more complex, where more higher talent people are needed.

Senator RIBICOFF. I posed a few questions to you gentlemen before I left the room for a vote. Have you estimated how much is involved in overcharges in the entire oil industry?

Mr. HUGHES. We have not, Mr. Chairman. We do not have the basis for doing that. Some of—I am not sure what FEA's capability is. Our problem is we are in any event, once removed from this kind of estimation. Our access problems in the past played some part in that. I do not want to overestimate that, but we simply are not able to do that. They are substantial.

ESTIMATION OF OVERCHARGES

Senator RIBICOFF. But on the refinery level it was estimated by FEA to the auditors, GAO, that it was anywhere in the range between $1 and $2 billion?

Mr. HUGHES. That is right.

Senator RIBICOFF. If those are the overcharges in the refinery level, what would the overcharges be overall from the producers on through the retailer?

Mr. SMITH. Mr. Chairman, we have the basis for reviewing our historical records and the rates of violations and the amounts of the findings associated with each of those violations and I simply am not equipped right now to give you anything like an accurate estimate. I would much prefer, if we could, to provide the best estimate we could for the record. I would point out, however, that the very thing that we have been criticized for in terms of the emphasis at the retail level we believe has served to detect and correct a substantial number of violations at that level and at the same time, to deter violations.

Now, clearly we can—you know, we cannot place any dollar value on the amount of the overcharges that were deterred, but because of our major emphasis at this level, we believe that the sum total of the undetected violations at the retail level is relatively small and that at the wholesale level, we will go back, look at the extent of the coverage we had in that area, what kind of violation rates we found, generate an estimate for you there and provide it. But I am just not equipped to give you the number that——

Senator RIBICOFF. You have no guess—you have no figures or estimates on the wholesale level?

Mr. SMITH. No, sir. I have not prepared one, although as I say, we do have the basis for doing that.

Senator RIBICOFF. Where did you get the $1 to $2 billion figure on the refinery level?

Mr. SMITH. That was made up of a number of components, Senator, each related to some of the issues. For example, $750 million of that related to the determination of the refinery fuel issue. Had a determination been made that refinery fuel costs were not allowable as product costs, our estimate was that the amounts involved were $750 million. Another $330 million of that was in the double recovery issue

that we discovered earlier. So this put the total somewhat over a billion dollars.

The question of how far over that billion dollars it was was the next element and here we were counting on the experience of our two audit cycles and in the first of those audit cycles we found something like $194 million of violations in other than the issues that I have mentioned. So this would have accounted, then, for some $1.2 billion.

The second cycle, the figure was $164 million of violations in other than these issues. So that would have run it up to about somewhere in the neighborhood of $1.4 billion.

HOW DO YOU RECAPTURE $1.4 BILLION?

Senator RIBICOFF. Let me ask you, what do you propose to do to recapture that $1.4 billion?

Mr. SMITH. The specific—well, we will either require refunds as we stated earlier, sir, either refunds to the marketplace, to the extent that these costs have been passed through to consumers, or we will require reductions in bank costs to the extent that the charges have not yet been passed through the consumers.

Mr. MONTGOMERY. Mr. Chairman, if I may, let me clarify the nature of that estimate. The $1 to $2 billion figure, and there have been variations on that up and down, was a ball park guess by our auditors as to what the total volume of violations might turn out to be if all the unresolved questions in their minds concerning the legality of certain practices that they were encountering were resolved against the refiners.

For example, this was—this estimate was made before we had our double-dip investigation and took the actions I discussed earlier with you to eliminate the impact of that. People are—our auditors confronted with what looked to them as though there was a double accounting, double recovery, said if this is found to be a violation this could be worth, you know, $300, $400, $500 million.

They said similarly they noticed that some refiners were treating refinery fuel as a product cost under our regulations. They said if it is not properly treated as a product cost this could amount to violations equaling maybe $750 million.

The fact of the mattter is that on the double-dip question we did make a determination against the refiner. There was never any question in our minds that that was not a legal interpretation and a proper interpretation of our regulations. So we have taken the actions we described to either recover or to set in motion enforcement proceedings to recover that amount of money.

Refinery fuel is an entirely different situation. In our opinion, having looked at the matter exhaustively in the agency, in the legal office and elsewhere, refinery fuel could legitimately be treated as a product cost and we have issued a regulation in which we have said prospectively we think that it makes more sense to treat it as a nonproduct cost but the treatment of refinery fuel as a product cost during the first 9 months of the program was not in violation of the regulation. It did not allow any kind of illegal overcharge or anything else, so there is no question of any effort being made now to recover those amounts. And they do not represent violations or illegal overcharges.

POWER COMPANY OVERCHARGES

Senator RIBICOFF. Let me ask you, in this morning's story about Project Escalator, you mention that one single power company may have been overcharged as much as $15 million. Have any Connecticut companies, power companies, been overcharged?

Mr. SMITH. Senator, we do not know at this point. The particular power company referred to was not in Connecticut but——

Senator RIBICOFF. They were overcharged as much as $15 million?

Mr. SMITH. That is right, sir.

Senator RIBICOFF. Did that power company know it was being overcharged?

Mr. SMITH. I do not know, Senator. It is not clear.

Senator RIBICOFF. There would have to be quite a variable, would there not, for one single power company to be overcharged over a period of a year to the extent of $15 million? Did they know they were being overcharged or were they indifferent to the overcharge because they were passing it on to the consumer through adjustment fuel costs?

Mr. SMITH. Under our regulations, Senator, the maximum allowable selling price clearly differs among different suppliers. Each of the major power companies involved has several suppliers. It is not a question of buying all these products from just one. And even under, you know, legal prices there would be substantial variations and month-to-month variations in the prices of the fuel sold by each of those suppliers. So it is not all clear at this point that the power company itself would have been in a position to recognize that the charges it was paying for the fuel were in fact illegal or contrary to the regulations.

Senator RIBICOFF. Now, the power companies, of course, if they were overcharged, contrary to law, could recapture these sums of money, could they not, from those who overcharged them?

Mr. SMITH. Yes, sir. In fact, the result of our enforcement action will be to mandate refunds from the people guilty of the overcharge to their customers and in this area, unlike the retail gasoline area, in this area there exist explicit records of quantities and prices charged to the various customers and, therefore, we will be able to get the refunds back in the amount of the overcharge to the utility or customer who was overcharged.

Senator RIBICOFF. Yes. So if the charge went back—if the refund went back to the utility and they had charged their customers a fuel adjustment charge, then the customers would be entitled to get that money back, would they not, from the utility?

Mr. SMITH. I would clearly think so, sir, although clearly the utility comes under the jurisdiction of the State regulatory commission, but I am sure they would.

Senator RIBICOFF. Do you have an estimate of Project Escalator overcharges? What would you estimate there? Now, you have done a lot of preliminary work that is indefinite. What do you think that amounts to in total?

Mr. SMITH. Again, sir, the investigation is still in such an early stage that we do not have any sound basis for protecting. It depends on how far it goes, how many people we find involved, that kind of thing, but it is clear on the basis of what we do have that we are

talking in the neighborhood of something over $50 million. And it could be as much as $100 million.

Senator RIBICOFF. So somewhere between $50 and $100 million covering a period of 1 year, but it could be more.

Mr. SMITH. Yes, sir, and I want to impress upon you, Mr. Chairman, that is just—you know, that is a guess at this point. It is a guess based on what we have found so far. But we just have not progressed far enough in it to be able to do any calculations or hard estimates.

Senator RIBICOFF. Let me ask you, let us say a utility company felt it was overcharged. Could they come to FEA and get from you the information and figures of your audit and study so they could use that as a basis of a lawsuit against those people who overcharged them?

Mr. SMITH. Bob, I will let you—as far as the availability of the information, the utility will not need to take any action on its own. We will be responsible for taking the action to get the amount of that overcharge back to them. We would be reluctant, unless we are required to, to release that information before the audit is completed for the reason——

Senator RIBICOFF. I understand. Once the audit is completed, would those figures be made available to a State public utility commission or a utility that was overcharged?

Mr. MONTGOMERY. Senator, we do not normally make them available but if there were a lawsuit in progress and if the data were needed in the context of that lawsuit I think we would.

Senator RIBICOFF. You complete——

Mr. MONTGOMERY. Let me say, sir, that the question would be whether we would make them available or whether the respondent in the case would make them available. If the utility had reason to believe that it was being overcharged and that was a violation of the law it does have a right of action in the courts under the law directly. It does not have to rely on FEA. If it were to do that, it would be entitled, in my view, to discover in the context of the litigation the cost figures that were necessary to establish the violation.

Senator RIBICOFF. Let us say you complete your audit. When you complete your audit, as I understand at this hearing, you will make these figures and those responsible public, to the press.

Mr. MONTGOMERY. Sir, if we complete our investigation, part of which is an audit, and determine that there has been a violation, we will take enforcement action which would be in the form of a notice of probable violation and/or a remedial order directing the company in question to make a refund or take appropriate remedial action, and that would be public—the name of the company, the size of the violation, and so forth. The cost data on which we established that violation would not necessarily be made public because it would not be necessary to accomplish what we were intending to accomplish. And it would be competitive information which the competitors of the supplier could use to their advantage.

Senator RIBICOFF. I know, but if there has been a wrong committed against a utility company that has passed it on to its consumers and you have not proceeded and the utility company wants to proceed, are they not entitled, either through discovery or voluntarily to get those figures from you as to what your audit shows? Would not the seller and the buyer both be entitled to those figures from you?

Mr. MONTGOMERY. Sir, I think in a way the question is moot because if our figures do show a violation, then under the law we are required to take enforcement action. If they do not, then the question is would we then make them available so that the utility could second-guess us or undertake its own litigation. I would hesitate to give you a final answer because I have not really considered the question but I think that we would have trouble doing that. Not——

Senator RIBICOFF. Why?

Mr. MONTGOMERY. Not trouble as a matter of discretion but because the statute does require that we do not disclose this kind of information and I think that we would have to look very carefully at the rationale of the statute and the nature of the need in this case and see whether there is a legitimate basis on which we could make an exemption.

Senator RIBICOFF. But, if you think a wrong was committed and, let us say, you do not move, how can a utility get you to move or how can a utility bring an action? I am not only thinking of the utility. I am thinking of the hundreds of thousands of consumers of electricity or gas who might have suffered because of the overcharge.

Mr. MONTGOMERY. Senator, I recognize the dilemma. It is a problem. But again——

Senator RIBICOFF. If there is a question in the law that you think there is a doubt, I want to know that because then I would like to put in an amendment to change the law.

Mr. MONTGOMERY. Sir, let me say this, that what the Congress did when it established this program was to create a Federal agency with a specific responsibility to collect the data, under appropriate safeguards, evaluate it, in the context of price regulations, and then take enforcement action where the facts justified that.

Now, what you are saying is should we have a statute or should we interpret the statute so as to provide that data to the public or selected members of the public so they can make their own judgments. I think that the Congress did not intend for that to happen. There are substantial problems with that because every customer of every supplier could be interested in looking at the cost data of its supplier. There may very well be, you know, thousands of people out there who think, gosh, my prices are too high. I would like to myself go audit this oil company and determine whether they are violating the law. But I think you can see readily——

Senator RIBICOFF. They do not ask for the audit. They want copies of your audit.

Mr. MONTGOMERY. That is right, but if we make this available to them, then we are putting it into the public domain and we have antitrust laws and other considerations which would preclude us, I think, or at least provide the Congress with a very good reason for not wanting this information to go out.

Senator RIBICOFF. I am really puzzled. Let us say you make an audit of a Connecticut utility company and let us say that Connecticut utility company willingly overpaid the price of the oil that they received because they wanted to get it at any price, and the utility company passed that charge on to a couple of hundred thousand customers in their jurisdiction, and the utility company or you did not move.

Mr. MONTGOMERY. OK. Well, that——

Senator RIBICOFF. Would there not be a class action or could not the public utility commission in the State of Connecticut move? In other words, somebody ought to have the right, if there were complicity, to recover these overcharges for the benefit of the public. We are talking about billions of dollars.

STATUTORY RESPONSIBILITY

Mr. MONTGOMERY. But, Mr. Chairman, I think that the answer in a nutshell is that that is FEA's, not only FEA's right but I think it is our statutory responsibility and I think the possibility that you keep suggesting, that we would find the violation but not move, is unrealistic. If we find the violation, we do move.

Senator RIBICOFF. You say it is unrealistic but yet we had a situation where it was unrealistic but you have failed over a period of time to make audits that you should have made. So why would it be unrealistic to feel that you might neglect your duty again?

Mr. SMITH. Sir, for various different reasons we have not done a perfect job auditing but I think the fact of the matter is that the Congress did not only give us the responsibility but in the FEA bill they designated GAO to have a continuous responsibility to monitor and evaluate what we are doing.

Senator RIBICOFF. Yes, but for months you refused to allow GAO to evaluate and monitor the facts even though the law specifically gave GAO the right to get those facts from you. Yet, you refused GAO the facts.

Mr. SMITH. I hestitate——

Senator RIBICOFF. In the future you say you are going to give it to them but GAO is handicapped because they could not monitor and audit the facts because of the refusal of FEA.

Mr. SMITH. Mr. Chairman, may I add one thing on the nonlegal side, sir, and that is that it may well be, and in fact in some cases we have reason to believe, that it was not the final seller to the utility who is responsible for the overcharges. In other words, the wrongdoing, the illegal overcharges may be several steps behind the final seller. So that——

Senator RIBICOFF. That is right.

Mr. SMITH. So that that is why I think the broad scope of our own authority, giving us the right to go anywhere we want to in the chain from the time it comes out of the well until it gets to the utility, the final consumer, is the time that is required to effectively pursue these kinds of things and I do not believe I am mistaken but I do not believe that the GAO commented anywhere on the place where we had identified a violation, resolved the issue, that we had not in fact taken corrective action. Am I right?

Senator RIBICOFF. I think the problem is the GAO found that you just did not audit properly, period, so it is not a question that you did not take action. You did not proceed in such a way to find out if there was a violation and if you should take action. I think this is what is bothering us and bothering the GAO and ought to be bothering you, too.

Mr. SMITH. Yes, sir, but I am speaking to your point that the possibility might exist that we would find the violation and then do

nothing about it, and the utility would have to go sue and get its money back, and that has not happened yet, and I will guarantee you that it will not happen, sir, that in every case where we have established one, we have taken remedial action and clearly will continue to do so.

Senator RIBICOFF. Let me ask you, Mr. Hughes, I would like you to continue your monitoring of the entire auditing program to the end when their audit is completed to make sure that action is taken to recapture for the customer or in the public interest the overcharges wherever they are from the producer all the way up the line to the ultimate consumer. Could you continue your audit at the request of this committee?

Mr. HUGHES. We certainly intend to continue. I guess it is fair to say, with or without your request, Mr. Chairman, to monitor this area because we think it is quite crucial.

The problems that the FEA people have had are varied, and I think I would agree in general that where they have found violations, they have proceeded.

Again, I would come back to the comments I made earlier, that fast action is extremely important for administrative purposes. It is not a question of ultimate justice. We are talking about an ongoing program, and if the cause and consequence relationship does not take place in fairly prompt fashion, much of the value of the action taken is lost. So we would urge faster action.

One other comment I would make is that I think manpower is just extremely crucial here and as the agency engaged in the monitoring and oversight, I think we have some responsibility to place emphasis on that fact.

These are audit guidelines for refineries. It is a pretty formidable document. You cannot do it on a shoestring, as we have referred to before, and this kind of a problem is multiplied in other areas that FEA has to contend with.

STAFFING

Senator RIBICOFF. How many people do either of you gentlemen believe FEA or GAO should have to do a proper auditing job?

Mr. HUGHES. I doubt we have an estimate, Senator. We certainly applaud the steps that they have taken to increase the manpower at the producer and refinery level. I would question personally whether there is yet adequate manpower, assuming we continue with this sort of program.

Senator RIBICOFF. What do you think in FEA, what your personnel should be?

Mr. SMITH. Sir, in our judgment, the allocation that we now have in mind, which is 212 dedicated to the producer area by the end of the fiscal year, 190 in the refiner area, the balance concentrated primarily on the wholesale area, the special group watching propane because of its sensitivity and because it is still the product in the shortest supply situation relative to the demand for it, and the remainder in the——

Senator RIBICOFF. You think that is sufficient?

Mr. SMITH [continuing]. Retail area. Yes; I believe this to be sufficient.

Now, let me go ahead and say that that is on the basis of the best estimates we can now make about the manpower involved, and that as soon as I find that is not sufficient, I will be beating the tub for additional people to the extent required to get the job done right.

COMPUTER CONTRACT

Senator RIBICOFF. Let me ask you, during the recess did you check upon Optimum Systems and Clinton Murchison as to whether they have received the computer contract?

Mr. SMITH. I will let Mr. Montgomery respond to that, sir.

Mr. MONTGOMERY. Mr. Chairman, part of your answer I can deal with. Part of the question I can answer. Namely, Optimum Systems did recently become the successful bidder in a procurement data system, management contract.

The situation, as I understand it, is this. We had about 26 small computer management contracts, ADP contracts. We wanted to consolidate those contracts under one contractor and thought by doing so we would save about $3 million on a total contract cost of about $8 million. We decided to proceed to do this through competitive bidding under the Government procurement regulations.

The appropriate notice of procurement was made. We had a number of bidders. We reviewed the proposal and the handling of the whole thing with both OMB and GSA, got their concurrence, and awarded the contract to Optimum Systems.

I do not know, although I have—we have inquired as to whether or not anybody did know or did find out in the context of that procurement whether or not Clint Murchison was the owner of Optimum Systems or whether we have any information on the ownership of Optimum Systems and we will provide that for the record and we can probably do so today.

Senator RIBICOFF. But let us assume that you have a major oil producer whose producing company would come under supervision in auditing. Do you believe it would be proper to award the computer contract, to get all the facts and data, to the person who is supposed to supply you with the information?

Mr. MONTGOMERY. Mr. Chairman, I think we should address these questions in a comprehensive way and I think we can do that very quickly. Can I just—off the top of my head let me say this. I do not believe there is any responsibility under this contract to generate data, to go out and, you know, have an input. I think this is a contract to provide FEA not only in its regulatory area but as regards its full across-the-board energy policymaking responsibilities with the data base necessary to keep the agency, the administration and the Congress informed of what is going on here. But I think that this particular contract deals only with the management of ADP machinery and is not a contract such as a consulting contract or a contract where the nature of the ownership of the bidder is a legitimate consideration in making an award. If that is the case, then we certainly should review the contract and indeed a protest has been filed and the award is under review. But this award was handled under very, very detailed specific procurement regulations. The request for procurement had to have certain kinds of elements in it and the bids had to be considered

in a certain way. The ownership of the bidders was or was not a legitimate consideration under the regulations and it is not really too much discretion involved.

So I think that your question is a very valid, good question. I think we have to look at it but I am not at all sure that the ownership of the company, especially if it is a publicly held company and this is simply stock ownership, is legally a valid consideration in deciding whether or not to award it.

Senator RIBICOFF. Yes, but if Clint Murchison is the major stockholder, president and chief executive officer of Computer Systems——

Mr. MONTGOMERY. If he is——

Senator RIBICOFF [continuing]. And he is one of the major oil producers in this country——

Mr. MONTGOMERY. That would give——

Senator RIBICOFF [continuing]. Should he have the contract to get all the data and the material that is being used by FEA?

Mr. MONTGOMERY. That would give me serious concern if that were the fact.

Senator RIBICOFF. Then I am assuming you are going to check back on this.

Mr. MONTGOMERY. Yes, sir.

Senator RIBICOFF. Now, a general question, Mr. Sawhill. You are leaving FEA. Willingly or unwillingly I do not know.

I would be interested in your appraisal of the energy policies now being pursued in this country.

PROJECT INDEPENDENCE

Mr. SAWHILL. Well, as you know, Mr. Chairman, we recently concluded a report on Project Independence, which I think has been widely praised in both the press and by many Members of Congress as taking the first comprehensive integrated look at the energy situation in this country.

This report will form the basis, I believe, for an energy policy and it draws several conclusions which I think we should all pay careful attention to.

In the first place, it shows that there is very little we can do to increase our energy supplies over the next few years. Oil production will continue to decline from now until 1977 and perhaps longer in this country. It shows that there are considerable difficulties in bringing nuclear plants on line and opening up new coal mines. Therefore, our energy budget will continue to get further out of balance in the sense that our demand for energy will continue to grow more rapidly than our demand for imports will probably increase.

If this is the case, it seems to me, and if you agree with this assessment then I feel very strongly we need to move to estabish some strong conservation measures, to bring energy supply and demand back into better balance.

As we look at the world economic situation today, we find examples of weakening economies in both the industrialized countries and in some of the underdeveloped countries and by and large, the economic problems they are experiencing are directly related to the high cost

of oil that they are having to pay Italy is a good example of this. But there are many other examples as well.

The only way we can bring pressure on prices to come down is by developing tough conservation measures in this country and setting an example for the rest of the world so that not only is consumption reduced here but in other countries as well and I believe this can bring pressure on prices to come down.

So I feel strongly, as has been widely reported, that we need to adopt these measures, that we need to face up to the fact that we have been consuming energy at too rapid a rate. The goal that President Ford has set of reducing energy consumption by a million barrels a day is certainly an admirable one but the fact is we do not have any measures in place yet to achieve that goal. I do not feel that the voluntary programs that have been proposed will be effective and I think so far the evidence bears that fact out.

### WHAT CONTROLS WOULD YOU RECOMMEND?

Senator RIBICOFF. Well, what compulsory or mandatory controls would you recommend?

Mr. SAWHILL. Well, there are really three important areas in the economy where energy is consumed. In the industrial sector, in the residential and commercial buildings, and in transportation.

In the industrial sector, I believe that we have gotten off to a good start by requiring voluntary submission of data to the FEA to monitor the improvement in energy productivity by the six major energy-consuming industries in this country. It may be that we need some legislation requiring the development of a conservation program in larger companies. But that program I think is well underway and the only requirement might be for additional reporting requirements to insure that we are getting access to the facts.

Second, in the industrial sector, we need to beef up our spending for conservation technology, if you will, for research and development in areas to show us and show American industry how it can use energy more efficiently. Clearly we compare our utilization of energy with other comparable countries in the world, we are wasting a great deal of energy and it is not just in one sector. It is across the board and some of it is in the industrial sector. So we need to improve our basic industrial processes to reflect more efficient energy consumption.

Second, in the residential and commercial sector, it seems to me we need to do two things. First, we need to require that all new buildings are built in a more energy-efficient way than buildings have been built in the past. So we need to establish some national standards, perhaps developed and implemented at the State level, to insure that new buildings are built in an energy-efficient way. And then we need to do something about existing buildings, and I believe we need to provide tax incentives for people to retrofit existing buildings with insulation and storm windows and other energy-saving devices.

Finally, because tax incentives do not reach certain segments of the population, I think the Government should seriouly consider a program of subsidization to very low-income people to enable them to retrofit their homes with storm windows and insulation and other energy-saving devices. It is particularly in this low-income category where

people have been hard hit by the escalating costs of energy that they need help and they will not get it through some kind of tax credit. They need something over and beyond that.

Last winter in Maine there was a very successful demonstration project that was sponsored by OEO, I believe, to provide subsidies for low-income people. I think the average subsidy was about $95 and it did quite a bit of good.

Third, we come to the transportation sector and here I think it is well known that we waste considerable amounts of energy. The basic things we have got to do is to get people to stop using their automobiles as much as they have in the past and make greater use of public transportation, so we have to provide incentives to get people onto public transportation and that involves developing better facilities and perhaps decreasing the charges for utilization of public transportation. The Congress has already made a step in this regard and perhaps greater subsidies will be needed in the future.

And then we have got to provide disincentives to the use of the automobile. I have talked in the past about a gasoline tax, that is, making gasoline more expensive, so that people would be less inclined to use their automobiles or if they did, they would use them in a more efficient way by either carpooling or buying smaller automobiles.

Now, there is an obvious problem with a gasoline tax and the problem is that it does fall more heavily on lower income groups and, therefore, any time that I have advocated a gasoline tax I have always talked in terms of a tax with a refundable feature, that is, a tax which would be refunded to at least lower income groups, either through the withholding system or by having people that are not part of the withholding system present evidence that they paid the tax and thereby be entitled to a refund.

Finally, I think to encourage the automobile manufacturers to build more energy-efficient cars we probably need some kind of either regulatory mechanism or tax to penalize people who buy the less efficient automobile. One program that we have looked at very carefully would be a program which would provide a tax credit to people that bought small, efficient cars, and a tax penalty to people who bought larger, less efficient cars. This way we would stimulate automobile sales which are certainly needed right now but we would do so in those areas which are important from an energy standpoint; that is, the smaller efficient car.

So in summary, those are the kinds of conservation measures——

Senator Ribicoff. You do not consider rationing for automobile users.

Mr. Sawhill. Well, I felt myself that a refundable tax would be preferable to rationing because it would not require the large bureaucracy that rationing would require and over the longer term I think it would be easier to implement and administer in a fair way.

One thing I found is that the American people demand a sense of fairness. They want a policy that is applied in an evenhanded way across the board. That is the trouble with voluntary programs. Some people do without, others do not. I think in order to have a sense of fairness you need to follow a policy that is applied in an evenhanded way and I am afraid my experience last winter when we talked so much about rationing and so many people came in and asked me for excep-

tions, that I think it would be tough to administer a rationing program in as fair a way as we could a gasoline rationing program.

Senator RIBICOFF. Thank you very much, gentlemen. I think this hearing has had some salutary results. I am confident that FEA will be doing their auditing much more carefully, effectively, and efficiently. To make sure you do, we will have GAO looking over your shoulder constantly.

I want to thank all of you gentlemen for your cooperation and I would like the privilege of submitting additional questions both to FEA and GAO for your response.

The committee will stand in recess subject to further call by the Chair.

Mr. SAWHILL. Thank you.

Mr. HUGHES. Thank you, Mr. Chairman.

[The responses to the questions submitted in writing to Mr. Sawhill and Mr. Hughes follow:]

RESPONSES TO QUESTIONS SUBMITTED IN WRITING TO THE FEDERAL ENERGY ADMINISTRATION BY SENATOR RIBICOFF

*Question No. 1.* Could you please explain in more detail the reasons which led you to conclude that the new rulings to transfer pricing should at least in part be applied retroactively, while your new regulations on refinery fuel costs were not applied retroactively?

Answer. When the Cost of Living Council adopted its Phase IV petroleum pricing regulations in August of 1973, it established a standard for intra-corporate transfer pricing of crude oil which required a U.S. company to compute the "landed cost" of crude oil acquired in transactions between affiliated entities "by use of the customary accounting procedures generally accepted and consistently and historically applied by the firm concerned." 10 CFR 212.83(b). This standard is the measure by which "violations" of FEA price regulations must be measured during the period this standard was in effect.

On October 31, 1974, FEA published new rules governing transfer pricing of crude oil which adopted a self-executing "representative price" standard to which all future transfer pricing decisions must conform. 10 CFR 212.84. This new standard was *not* applied retroactively in the sense that FEA can now find that a firm was in *violation* of the representative price standard during the period when the "customary accounting procedure" standard was in effect.

Notwithstanding the foregoing, FEA can use the criteria of the "representative price" standard to disallow certain costs resulting from past transfer pricing decisions because of a unidue provision of FEA's price regulations which has been in effect since the Cost of Living Council adopted the Phase IV rules. That provision, 10 CFR 212.83(e), provides:

> Whenever a firm uses a landed cost which is computed by use of its customary accounting procedures, the FEA may allocate such costs between the affiliated entities if it determines that such allocation is necessary to reflect the actual costs of these entities or the FEA may disallow any costs which it determines to be in excess of the proper measurement of costs.

Thus, under this subsection, FEA may disallow costs even though a firm complied with the "customary accounting procedure" standard during the period in question. FEA is free, then, to apply any reasonable criteria in disallowing costs under Section 212.83(e), and the Agency has announced its intention to utilize the criteria involved in the "representative price" standard for purposes of disallowing costs for prior periods under that section.

With regard to the refinery fuel issue, there is no comparable "savings clause" in the regulations under which FEA can disallow costs which were otherwise properly booked for passthrough under existing regulations. Accordingly, if refinery fuel was a permissible "product cost" under then-existing regulations, it would have been of questionable legality for FEA to have retroactively amended its regulations to disallow such cost passthroughs. (See also, Answer to Question No. 2, below.)

*Question No. 2.* The attached memo dated July 18, 1974, from Mr. Sklar to all cases analysts states that "fuel costs that have been passed through under § 212.83 must be reversed." Did FEA subsequently change its mind on this point and, if so, why?

Answer. Mr. Sklar's memorandum of July 18, 1974, reflected his view that the cost of crude oil acquired for use as refinery fuel should be considered as "allowable non-product cost attributable to refining" as set forth in Sections 212.82 and not an allowable product cost available for passthrough under Section 212.83. Ultimately, the Agency adopted this position in a recently concluded rulemaking proceeding in which the pertinent provisions of FEA's price regulations were amended, effective December 1, 1974, to treat the increased cost of crude oil which is used as refinery fuel as a non-product cost increase which can be passed through in higher product prices subject to profit margin limitations.

FEA determined that prior to the amendments made effective on December 1, 1974, Section 212.83 permitted refiners to passthrough increased refinery fuel costs as increased product costs. Accordingly, any effort to amend the regulations "retroactively" to sustain a contrary conclusion would have been of questionable legality. Moreover, the FEA field audit guidelines which were prepared for the use of FEA's RARP teams clearly stated that refinery fuel should be treated as a product cost. Finally, unlike the so-called "double-dip" issue, there was never any question that FEA lacked authority to treat the cost of refinery fuel as a product cost or that such treatment under prior regulations was contrary to the Emergency Petroleum Allocation Act of 1973. For all of these reasons, the Agency was constrained to limit its new rule on refinery fuel to prospective application.

*Question No. 3.* How large are the past overcharges which you think you will be able to correct by applying the new rules on transfer pricing retroactively?

Answer. As stated in response to Question No. 1 above, FEA is not applying the new transfer pricing regulation retroactively. Accordingly, it is inappropriate to characterize costs which may be disallowed under Section 212.83(e) as "overcharges". Moreover, until data necessary to compute representative prices has been collected, processed, and analyzed, it is impossible to determine the total amount of the costs which may be disallowed.

*Question No. 4.* How large are the past overcharges which you would have been able to correct if the new refinery fuel rules had been applied retroactively?

Answer. FEA estimates that refiners booked approximately $750 million in increased "product costs" that were attributable to the increased costs of refinery fuel. It would be misleading, however, to characterize this amount as representing "overcharges" to the consumer. First, since the amount of banked costs has grown significantly over the past six months, the treatment of refinery fuel as a product cost has not necessarily resulted in higher prices to consumers.

Secondly, if FEA had determined that refinery fuel was not allowable product cost prior to the new regulations, refiners would nevertheless have been able to pass through a significant portion of the increased costs of refinery fuel as a non-product cost. The total amount of such non-product costs that could have been passed through would have depended upon the ability of individual refiners to satisfy the FEA profit margin limitation described in the response to question No. 28.

*Question No. 5.* Does FEA really plan, as suggested in the GAO Report, to only investigate retail pricing practices if it receives complaints about a particular retail company's prices?

Answer. Complaints about a retailer's pricing practices received from customers or from competitors will continue to be a major source of investigational targeting. The volume of complaints received from the public has dramatically decreased from a high of 18,000 recorded for the week of February 22, 1974 to 74 for the week of October 25, 1974. However, FEA will continue to conduct investigations based on its own analysis of market conditions and areas of possible noncompliance.

The decision to decrease enforcement emphasis in the retail gasoline area followed the general reduction of prices below the maximum lawful due to competitive market pressures. As a result of such competition, companies have not been able to pass through the entire amount of increased costs permitted under the regulations. Under these conditions, FEA determined to use its limited resources in areas where price competition is absent.

*Question No. 6.* Does the uncertainty about the future of the price regulations affect the ability of FEA to hire the staff and organize the enforcement and compliance effort that is necessary to assure compliance with the regulations?

Answer. We have found that the unique challenges of FEA's enforcement work have continued to attract many talented applicants for positions with the enforcement program. The current tight labor market, and the valuable experience to be gained from participation in the government's energy program, insure a continued source of qualified personnel. The organizational planning for achievement of FEA's compliance goals must be flexibly geared to cope with an evolving regulatory mechanism and an unsettled statutory duration.

*Question No. 7.* The GAO Report describes how the oil company's banked costs have grown from a total of about $386 million in March, to about $2 billion by the end of September. These costs have not yet been passed on to the consumer. If the government adopts next year new mandatory allocation rules, or in some other way limits the available supply of gasoline, do you think there is a danger that the oil companies will use 10% of their total banked costs each month to increase oil prices?

Answer. At the present time, the 10% limitation should prevent any inordinate passing through of unrecovered costs. If the price control program is extended beyond its present expiration date, or if market conditions change dramatically, the statutory requirement to permit the passthrough of increased costs can be satisfied by a further limitation on the monthly utilization of banked costs.

*Question No. 8.* Could you provide for the record individual figures showing how much each major oil company on the one hand, and all the independents combined on the other hand, have collected each month in banked costs and what the increased costs were that justified the banks costs? I would appreciate it if you could also provide for the record what portion of the banked costs have been accumulated because of a seasonal build-up in inventory.

Answer. Individual company "bank" figures are in the process of being cumulated from the reporting forms FEO–96 ad will be made available to the GAO. These banked costs represent increased costs to the companies that have not been passed through to customers as permitted by FEA Regulations.

We do not presently have data enabling us to measure the portion of banked costs attributable to a seasonal buildup in inventory.

*Question No. 9.* When companies violate the price regulations FEA could seek to impose fines as well as ordering a rollback in prices. FEA has already detected price violation by 13 refining companies amounting to $194.3 million. Have any of these companies been fined for these violations, and if not, why not?

Answer. To date, the only fine paid by a refining company was the $300,000 penalty which Union Oil Company of California agreed to pay for alleged violations of the state injection program. FEA does not have statutory authority to impose fines, but can seek to recover statutory penalties in a civil or criminal penalty action brought by the Department of Justice. The nature of past pricing violations on the part of refiners has not been sufficiently substantial or serious to warrant such penalty proceedings. Many of these violations did not actually involve overcharges to customers, or were the result of erroneous interpretations of novel and complex regulations. Under these circumstances, it was deemed preferable to remedy the violations by the medium of price refunds or pricing adjustments.

*Question No. 10.* The GAO Report criticizes the first refinery audit because of its limited scope, its failure to verify figures, and its failure to follow up on problems uncovered by the auditors. I realize that you have been trying to improve the program. In this connection what specifically have you done to follow up on the discrepancies which IRS uncovered during the first audit, but which it failed to resolve?

Answer. All refinery audit teams have been instructed to follow up on the results of the IRS audit. Errors discovered will be corrected for periods covered by past audit cycles, including errors in calculating base period pricing.

*Question No. 11.* What have you done to increase the auditor's use of basic source documents such as shipper's invoices, to assure independent verification of the figures on the books of the refineries?

Answer. Basic source invoices for marine costs, inspectors' fees, insurance, pipeline charges, purchased costs of finished product, purchased costs of crude are part of the audit requirements. Such items are included in FEA's audit guidelines to all teams, and these items are stressed during periodic RARP training courses.

*Question No. 12.* Under the new transfer price regulation, what way will you have to independently verify the data oil companies give you relating to the foreign sale of crude to nonaffiliated third parties?

Answer. Under FEA's new transfer pricing rules, the permissible price of crude oil acquired in transactions with overseas affiliates does not depend solely upon data submitted by the American company claiming a right to pass through such costs. Rather, the maximum allowable prices for such crudes are determined by reference to aggregate data collected from a variety of sources. Thus, FEA has ample opportunity and authority to cross check and validate the integrity of such information.

*Question No. 13.* Your refinery audit program only covers 31 of the 125 firms that own refineries. What plans do you have to audit the other 94 firms that you have not yet looked at?

Answer. A number of non-major refiners are currently being audited. When the expansion of RARP to its authorized 188 staff level has been accomplished, all refiners will be audited.

*Question No. 14.* The study this subcommittee asked GAO to makes of your enforcement and compliance effort was handicapped by GAO's inability to gain access to information within your possession. Section 12 of the FEA Act states GAO shall have exceptionally broad access to all information your agency possesses. Your letter of December 4th to the Comptroller General states that you have directed your staff "to assure that GAO's request for access to data necessary to carry out its statutory responsibilities will be promptly and completely honored." It is FEA's agreement that GAO, and not your agency, will be responsible for determining whether GAO needs certain information to carry out its statutory responsibilities?

*Question No. 15.* Am I correct in concluding that it will be up to GAO, and not FEA, to decide what steps GAO should take to protect the sensitivity of certain information so as not to impair FEA's statutory responsibilities?

*Question No. 16.* Will any procedure you work out with GAO to inform them of the sensitivity of particular data requests be used to delay or frustrate GAO's access to the information?

*Question No. 17.* In short, am I correct that FEA will fully honor the right GAO has under Section 12 of the FEA Act to see all the information within your possession?

Answer. The attached FEA directive makes clear (1) that GAO, not FEA, will determine what information is required to carry out GAO's statutory responsibilities; (2) that GAO, not FEA, will decide what steps it (GAO) should take to protect the sensitivity of certain information so as not to impair FEA's statutory responsibilities; and (3) that FEA's procedures to inform GAO of the sensitivity of certain requested information will neither delay nor frustrate GAO's access to such information. In short, FEA will fully honor the right of access to FEA files which GAO has under Section 12 of the FEA Act.

FEDERAL ENERGY ADMINISTRATION,
*Washington, D.C., December 24, 1974.*

Memorandum
To: FEA Regional Administrators.
From: Acting Assistant Administrator for Operations, Regulations, and Compliance.
Subject: GAO access to compliance files and records.

As you will note from the attached December 4, 1974 letter by John Sawhill, FEA has revised its policy regarding the manner in which GAO will carry out its oversight responsibilities pursuant to Section 12 of the Federal Energy Administration Act of 1974.

In the future, GAO personnel are to be permitted free and complete access to any documents or other records that they request. As a matter of orderly procedure, all GAO requests should be made in writing and should specify the nature of the information requested. Wherever possible, at the same time GAO secures access to the requested data, FEA should provide GAO with a brief written memorandum setting forth the nature of the materials being made available and referencing the written request for access to such materials.

When information requested by GAO involves an open Compliance case or involves other data, the public disclosure of which would contravene any law or regulation, such factors should be pointed out to GAO in the memorandum responding to the request. Such memorandum should also respectfully request that GAO take appropriate action to preclude release of such data to unauthorized persons and to preclude any action that would prejudice the successful

completion of any potential enforcement action. It should be noted that FEA will merely request that GAO take such protective action, and that the responsibility for assuring that such action is taken rests with GAO exclusively.

Copies of all GAO written requests and of FEA memoranda in response to such requests should be forwarded to my office for our files.

You are also requested to notify my office of any instance where it is felt that the manner in which GAO has utilized material which it received from your office has interefered with your operations. We will undertake to bring any such instance to the attention of appropriate officials at the GAO.

A copy of this communication has been sent to the GAO. Your cooperation in furnishing GAO personnel with data requested pursuant to the procedures outlined above in a timely manner will be greatly appreciated.

*Question No. 18.* Will your audit of producers include a review of the records kept since the beginning of price controls, so that violations that may have been occurred any time in the past will be detected and any overcharges refunded to the consumer?

Answer. Investigations of producers will cover any overcharges back to September 1973, the date when Phase IV controls were implemented.

*Question No. 19.* How large do you think the past overcharges in the producer level have been?

Answer. We have not yet completed a sufficient number of cases to estimate the potential magnitude of pricing violations among producers.

*Question No. 20.* Would you please describe in some detail the procedures you intend to follow to audit the producers?

Answer. FEA has initially targeted 125 crude producers across the country for audit. These audits will determine whether or not the producers are complying with FEA price rules through a detailed examination of records maintained by the producers themselves, pipeline companies who gather and transport the producers' crude oil, the purchasers of crude oil, and the state and local bodies responsible for maintaining independent crude oil production records. These audits will examine (a) base production control levels (crude oil produced and sold from a property in 1972), (b) current production and sales from the same property, (c) price levels as of May 15, 1973, and (d) current prices charged and received.

Review of all these figures will allow FEA to test producing firms' compliance with rules applicable to "new" and "old" oil, correct application of the Congressionally-mandated "stripper well" exemption, and to detect improper use of practices designed to evade the FEA price rules.

After experience is acquired through the examination of these initial 125 producers, the number of producers audited will be expanded to allow FEA to adequately monitor compliance levels across the entire producing sector of the petroleum industry. By June of 1975, there will be 212 full-time positions allocated to this aspect of the enforcement program.

*Question No. 21.* Mr. Sawhill's opening statement says that GAO's report is "fair and objective—even with respect to those findings criticizing some of our work." (p. 1). Is it fair to conclude then that FEA agrees with GAO's ultimate conclusion expressed twice in its report, that ". . . FEA will have to substantially strengthen its compliance and enforcement program at all levels if it is to have adequate assurance that firms are in substantial compliance with pricing regulations." (p. 3; p. 13)?

Answer. We agree that a substantial strengthening of our enforcement program is needed, and we have taken various steps to accomplish this goal. First, we have taken steps to bring greater balance to our compliance effort by devoting more resources at the producer, refiner and wholesaler areas. Second, we have begun a shift in the location of our regional Compliance personnel so as to be able to put greater emphasis on areas of the industry where we have done an inadequate job of policing in the past. Third, we have undertaken a comprehensive program of redesigning our forms and making better use of the data contained therein so as to more quickly and swiftly identify compliance problems. It is felt that a substantial strengthening of the enforcement program can be accomplished without expanding the size of the compliance staff at this time.

*Question No. 22.* FEA's prepared testimony indicates the agency will develop a modification of its current reporting systems (p. 16). How much money, how many computers, and how many people have you devoted in the past to collecting and assembling this information?

Answer. In the past we have used about ½ man year on our computerized reporting system. Since we are on a time-sharing basis with the rest of the agency, we cannot estimate how many computers we use, but we do know that we use only a tiny fraction of the computer time and space available to FEA. Cost is minimal, under $1,000 a month.

*Question No. 23.* How big will the program be after the reorganization?

Answer. We intend to expand our usage of data services significantly during the balance of FY '75. We are currently letting a contract for the examination and revision of our current reporting forms and the adaptation of our data systems to systematically target cases of possible non-compliance. The reports will be designed so that the computer will be able to scan the data from the reports and compare it with programed formulae consistent with the regulations. We may include certified supporting schedules so that we can determine how the firms arrived at their figures. We will then be able to immediately identify those cases having a high violation potential.

*Question No. 24.* How many times in the past, has the possibility of price violations been spotted by people reviewing the reports and other data received from oil companies?

Answer. The reports were used extensively in identifying propane firms to be investigated under Project Speculator. In almost every case, the information on the reports proved accurate and, to date, approximately 44 million dollars in violations, mainly from the wholesaler/reseller class, have been uncovered with the potential for an additional 25 million coming from cases still being investigated.

More recently, the Office of Compliance and Enforcement used these reports in selecting 125 crude oil producers to be investigated initially under Project Manipulator. These investigations will determine whether producers are selling more crude oil as "new" and "released" oil than is actually allowed under the FEA regulations.

*Question No. 25.* How will the efforts of the auditors and the people responsible for new regulations, be closely coordinated in the future with people reviewing this data?

Answer. As indicated in No. 23, we intend to develop an integrated reporting system, whereby we program the computer with the current regulations and revise the reporting forms for facilitating use of the computer for identifying aberrations. The results of the computer run would be turned over to our auditors for an in-depth audit of areas of possible non-compliance. This system can also be used for a printout of prices being charged by all segments of the industry, allowing the regulations people to get a firm grasp on the impact of the regulations.

*Question No. 26.* Have you had difficulty collecting the necessary information from the oil companies?

Answer. In general, company responses to requests for information have been satisfactory. There have been occasions when information, was not furnished as rapidly as the auditors would have liked, but these delays have not materially affected the conduct of the auditors. In certain cases, companies have been warned a failure to supply cost certification data in a timely manner could result in the issuance of compulsory processes or other enforcement action.

*Question No. 27.* Have you ever required oil companies to keep a portion of their accounts in a certain way to increase FEA's ability to understand and monitor what the oil companies are doing?

Answer. FEA has not undertaken to impose a comprehensive accounting system on the companies, subject to its regulatory jurisdiction. However, companies are required to explain and justify changes in their historical accounting methods. In addition, the regulations do not always follow generally accepted accounting principles, e.g., the 30-day delay in reflecting cost increases, the 10% monthly limitation in passed through "bank" costs, and the profit margin limitation applicable to non-product cost pass through. Companies are required to keep their records in a manner reflecting compliance with these regulatory areas which deviate from the normal method of maintaining public records.

*Question No. 28.* Are you considering changing the definition of profit margins so that it is no longer based on a percentage, and how much difference could this make to the consumer?

Answer. The Cost of Living Council introduced the profit margin limitation in Phase II, November 1971. It was designed to prevent a firm from charging prices that would result in a yearly ratio of operating income to sales in excess of the firm's base period ratio of operating income to sales. Accordingly, by limiting

the percentage that a firm's operating income could be to its total sales, the CLC had an effective overall control over the prices a firm could charge. Thus, in addition to its regulations controlling the specific prices a firm might charge, the CLC also had an overall control over prices through its control over the profit a firm could make.

The profit margin limitation applied to all segments of the economy, including the petroleum industry. Thus, when the Council established special regulations for the petroleum industry, which were later adopted by the FEO, it decided to continue the profit margin limitation. Increased product costs were, however, permitted to be passed through without regard to a firm's profit margin.

Firms in the industry were familiar with the profit margin limitation and how it was calculated, and the Council had already collected the firms' base period profit margin data. Consequently, the existing profit margin definition provided an immediate means of implementing a profit margin limitation regulation for the oil companies.

However, because the profit margin is stated as a percentage of sales, the sharply increased cost of crude oil has led to much higher sales revenues for refiners and a corresponding increase in the permissible dollar amount of profit margin. The FEA is studying alternative profit margin limitations to replace the present definition of profit margin. One of the suggestions being given consideration is an absolute dollar profit margin for each unit (*e.g.*, each barrel) with an adjustment factor for inflation. The impact of any such change on the incentive for construction of new refinery capacity is an important consideration which must be taken into account in this analysis.

It is difficult to estimate how much difference such a change could make to the consumer in the future because the ability of firms to qualify for a non-product cost increase under a revised definition and their ability to pass through any such increase in higher prices to consumers are highly speculative.

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RESPONSES TO QUESTIONS SUBMITTED IN WRITING TO THE GENERAL ACCOUNTING OFFICE BY SENATOR RIBICOFF

*The testimony FEA has prepared for these hearings contends the GAO report is inaccurate when it states that the level of wholesale violations in the propane area "illustrates the magnitude of potential violations at the wholesale level" as a whole. What is your response to FEA's criticism?*

In using FEA's special effort in the propane area termed "Project Speculator" as an example, we intended to show that individual violations by wholesalers have a potentially greater value than individual violations by retailers. We did not intend to indicate that the high incidence of violations found through Project Speculator is representative of the entire wholesale level. Our report (pp. 6–7) stated:

> While there appeared to have been many violations at the retail level, the individual violations were in relatively small amounts. On the other hand, wholesaler investigations found much larger violations. For example . . . Project Speculator . . . illustrates the magnitude of potential violations at the wholesale level.

*What special enforcement problems do the new transfer pricing and crude entitlement regulations raise? Do you think that FEA's enforcement and compliance effort, as it is operating today, is adequate to assure compliance with these new programs? Do you believe that the plans FEA has announced and the actions it has taken to date will be adequate to assure that the agency's enforcement and compliance efforts, in connection with these new rules, will be effective?*

The transfer pricing regulations clarify the manner in which oil companies must record intra-corporate crude oil sales and, therefore, should actually ease enforcement problems in this area. Previously FEA had to judge the reasonableness of such transactions based upon historical industry practice which it found was not being consistently followed by some companies. The problem should be resolved since the new regulation adopts a common standard called the "representative price" to judge the reasonableness of historical and current transfer transactions.

The crude entitlement regulations expand FEA responsibilities. Effective implementation of the program required by the regulations will require additional administrative and enforcement effort. Enforcement efforts will be complicated

because the basis for issuing entitlements should be verified, certifications of refinery capacity should be varified, and sales of entitlements among refiners should be monitored.

The exact direction of an effective enforcement program for both of these areas is now under study at FEA. Undoubtedly, further changes to the FEA's refiner audit guidelines will be required. For its crude entitlements program, FEA is hiring a consultant to prepare the additions needed to the refinery audit guidelines. Until the guidelines are revised and audit work implemented, FEA cannot be assured the industry is complying with the crude entitlement regulations.

*Do you see any problems common to both the allocation and price regulations that you think has been hampering FEA's effectiveness generally?*

The complexity of the petroleum industry is a basic problem that has hampered FEA's effectiveness. Their regulations seek to control supply and prices in an industry that is not completely understood. In addition, changing market conditions have added to the already complex industry interrelationships.

Also, the haste with which FEA had to finalize their initial regulations following the 1973 oil embargo, lead to loopholes and varying interpretations by industry. These types of problems have required constant attention and regulatory revisions, thus decreasing FEA's effectiveness and increasing their enforcement problems.

Manpower limitations and organizational problems within FEA have also hampered FEA's operations. These two problems can also be directly related to the haste with which the agency was created and staffed. The problems we noted in FEA's compliance and enforcement program illustrate the effect of these difficulties.

*According to page 4 of Mr. Sawhill's prepared statement, the GAO report implies that FEA's compliance program, coupled with widespread voluntary compliance, has provided the American people with assurance that the prices they must pay for oil are within the law. Do you agree that this is what your report implies?*

We do not agree. We believe FEA will have to substantially strengthen its compliance and enforcement program at all levels if it is to have adequate assurance that firms are in substantial compliance with the pricing regulations. With its limited program-to-date, FEA has uncovered violations estimated at over $1 billion at the refinery level. Numerous violations have been found at the retail level and the producer level has received only minimal attention by FEA. In addition, a special effort, "Project Speculator," was established to detect violations in the propane industry. Recently, FEA has found that some utilities have been overcharged by residual fuel oil suppliers and has begun another special enforcement program called "Project Escalator." We do believe the changes FEA has planned are important steps designed to improve their compliance and enforcement program.

[Whereupon, at 1:30 p.m., the subcommittee was adjourned, subject to the call of the Chair.]

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