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CRUDE OIL PRICING COMPLIANCE PROBLEMS

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HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY AND POWER

OF THE

COMMITTEE ON

INTERSTATE AND FOREIGN COMMERCE

HOUSE OF REPRESENTATIVES

NINETY-FOURTH CONGRESS

SECOND SESSION

ON

ACTIONS TAKEN BY THE FEDERAL ENERGY ADMINISTRATION
TO IMPLEMENT THE PRICING REQUIREMENTS OF THE ENERGY
POLICY AND CONSERVATION ACT

NOVEMBER 11, 1976

Serial No. 94-162

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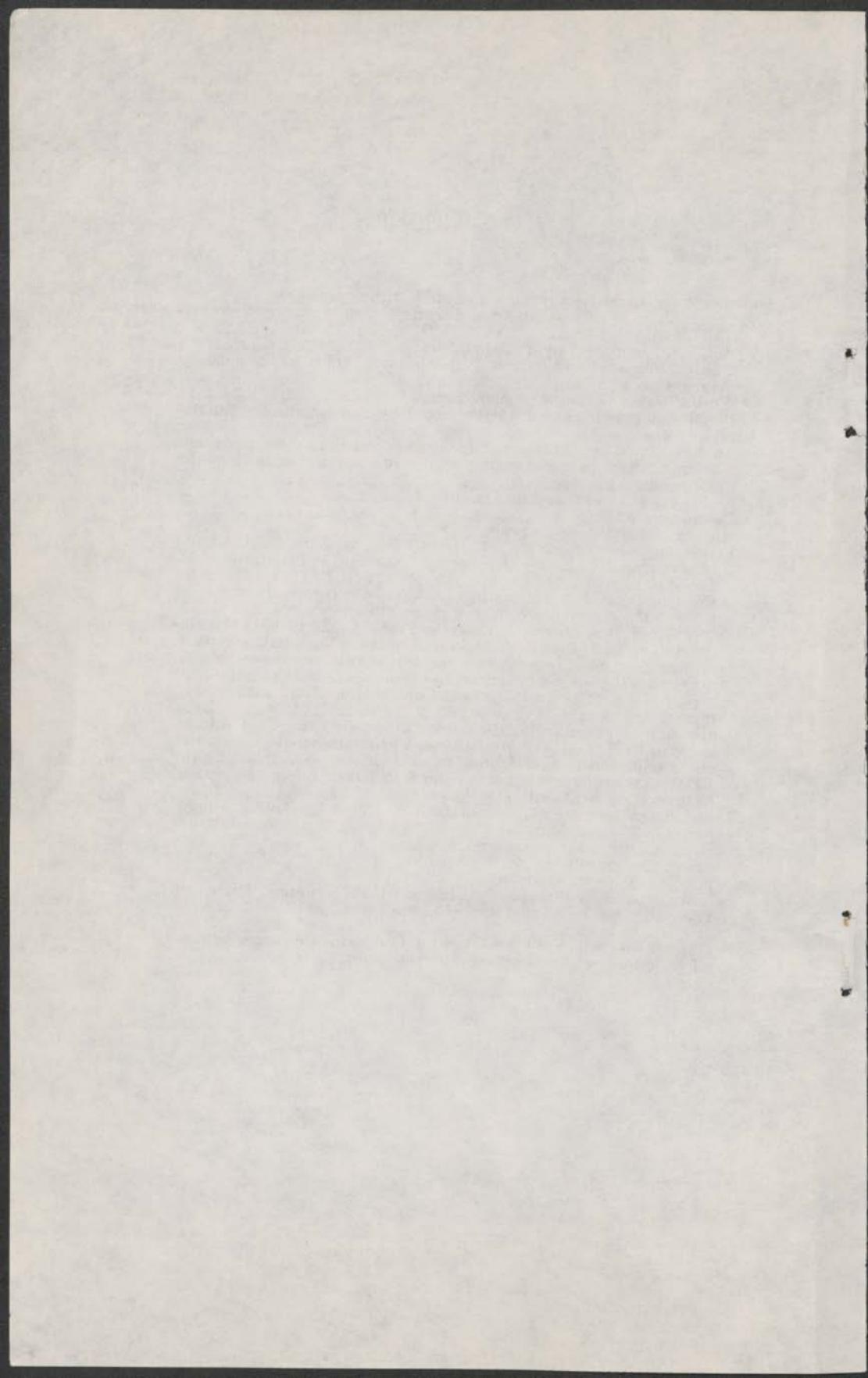
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CRUDE OIL PRICING COMPLIANCE PROBLEMS

THURSDAY, NOVEMBER 11, 1976

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
SUBCOMMITTEE ON ENERGY AND POWER,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2123, Rayburn House Office Building, Hon. John D. Dingell, chairman, presiding.

MR. DINGELL. The subcommittee will come to order.

Today the subcommittee will examine actions taken by the Federal Energy Administration to implement the pricing requirements of the Energy Policy and Conservation Act (EPCA) as part of its continuing oversight on matters under its jurisdiction. In its essential terms, that act provided a 40 month program which gave recognition to the justification and need for future price increases tempered by a procedure which allows these increases to be absorbed by the economy without undue economic disruption.

The underlying policy was to provide a means of weaning the Nation from a low cost energy based economy to one based upon substantially higher cost energy. The mechanism selected was to establish as the benchmark for regulatory purposes a "weighted average" or "composite" price initially set at \$7.66 per barrel for domestic oil production.

The President was authorized, within certain limits, to increase the composite price to account for inflation—and thereby maintain the composite price in real dollar terms—and to provide an incentive to increase production. Within that framework, the President was to have regulatory flexibility to craft and administer a price regulatory program which optimizes the incentives for investment in domestic production within the constraints of the composite limitations. Our hope was that a stable regulatory structure would evolve upon which both producers and consumers could rely and employ as a basis for economic planning.

The pricing regimen of EPCA has now been in effect for roughly three calendar quarters. In general, I believe the act has worked well to retard the inflationary spiral which had beset the economy in 1975 and had been a considerable cause of the recession. Prices of energy and other consumer goods began to stabilize during the first quarter of 1976. Correspondingly, the gross national product rose at an annual rate of 7.2 percent, evidencing broad-based economic recovery.

While many factors contributed to the improvement in our economic circumstance, it is abundantly clear that the stabilization of domestic crude oil prices played a major role in helping to restore this Nation's

economic health. That this was accomplished without retarding domestic production, drilling activity or exploratory development evidences the merit of the program.

Nonetheless, although the basic objectives of the oil pricing policies of EPCA appear to have been accomplished, that is not to say that the program has proceeded without difficulty. As the testimony we hear today will indicate, significant problems have evolved. The Federal Energy Administration badly missed the initial composite requirement of \$7.66 a barrel, and to repair the mistakes of the first several months of the program FEA has imposed a freeze on the upward adjustment of domestic oil prices since June of this year.

Current estimates indicate that the freeze will be required to remain in effect at least until February of next year to recover fully the overcharges which occurred in the first 6 months of the program. Moreover, regulatory actions taken in August have exacerbated the compliance problem and may compel the continuance of a freeze on prices until October of 1977.

Alternatively, FEA has told us that a price rollback in upper tier oil may be required to restore the regulatory program to compliance with the statutory requirements of EPCA. Significantly, we are also told that the data upon which such a decision must be based will not be complete until the end of this calendar year. Thus, the decision of what corrective action is to be taken will pass to the new administration.

The Chair is very much concerned that, by that date, the data will show that the program is so far out of compliance that only Hobson's choices are available and congressional relief may be necessary. I am concerned that the new administration will inherit a compliance program badly in need of repair.

FEA has only begun to inquire into producer compliance with price regulations, after over 3 years of price controls. If the preliminary indications reflect the norm, violations appear to be pervasive and the aggregate amount of overcharges which have occurred may be measured in the hundreds of millions or even billions of dollars.

Let me add parenthetically that I do not wish to start this hearing on a contentious note. I fully appreciate that this industry is complex and dynamic. Any regulatory program will encounter significant problems. Our effort today is not to place blame or find fault; rather it is to fully set out on the record the steps which have been taken by FEA and their effects as a means of gaining from their experience a measure of the legacy which this administration will pass on to the next.

Now I am pleased to recognize Mr. John Hill, Deputy Administrator of FEA, to proceed with his testimony. I welcome those who accompany him at the witness table.

Mr. Hill, if you would identify yourself and your associates for purposes of the record, we will be most pleased to receive your statement.

STATEMENT OF HON. JOHN A. HILL, DEPUTY ADMINISTRATOR, FEDERAL ENERGY ADMINISTRATION, ACCOMPANIED BY JOHN D. CHRISTIE, ASSISTANT ADMINISTRATOR, OFFICE OF ENERGY INFORMATION AND ANALYSIS; GORMAN C. SMITH, ASSISTANT ADMINISTRATOR, OFFICE OF REGULATORY PROGRAMS; AND DAVID G. WILSON, DEPUTY GENERAL COUNSEL

Mr. HILL. Thank you, Mr. Chairman.

On my left is John Christie, Assistant Administrator, Office of Energy Information and Analysis. On my immediate right is Gorman Smith, Assistant Administrator for Regulatory Programs and on his right is Mr. David Wilson, Deputy General Counsel of FEA for Regulatory Programs.

We appreciate the opportunity, Mr. Chairman, to appear before the subcommittee today to review for the subcommittee FEA's implementation of the Energy Policy and Conservation Act and the Energy Conservation and Production Act crude oil pricing provisions. In my brief statement I will describe our initial implementation of the EPCA pricing provisions, the results of that initial implementation, the effects of the provisions mandated by the ECPA enacted in August, our current projections as to the extent of compliance with EPCA provisions as of January 31, 1977, and our options with respect to the compliance issue.

Before I read my statement, Mr. Chairman, I would like the record to show my resignation from FEA has been announced effective tomorrow and I have discussed my appearance before this committee with our General Counsel and with you and it was agreed that my departure from FEA would not in any way bear on either the quality of my comments or the sense in which they are taken. I would like for the record to show that.

Mr. DINGELL. I would like to join you in having the record demonstrate that. We have had a lengthy discussion on the matter and at no time did I indicate other than full approval of your appearance here. As a matter of fact, I am satisfied that you are a man of sufficient integrity that questions of conflict of interest would not in any event arise.

I might also add that it is with a measure of sorrow that as your friend and admirer I see you leaving government service. I must confess that, given all the circumstances that afflict those who serve in government today, I can well understand your departure and I only express to you my warm personal good wishes as you go into employment in the private sector. I wish you success.

Mr. HILL. Thank you, Mr. Chairman.

Mr. Chairman, you will recall that during the deliberations of the Conference Committee that led up to enactment of the EPCA there was extensive consideration of the data on which FEA estimates of crude oil prices and production were based. The statutory composite

price was, in fact, ultimately derived from such estimates. The sources of the data, the assumptions used in the calculations, the basis for those assumptions, and the resulting estimates were described in detail in a series of letters to the appropriate committee chairman.

In particular three letters treated these issues in substantial detail. They were a letter of November 18, 1975, from Administrator Zarb to Chairman Staggers and Vice Chairman Jackson of the Conference Committee, and two letters from Administrator Zarb to the Chairman of the Senate Committee on Interior and Insular Affairs dated December 6 and December 15, 1975, responding to letters from the Chairman dated November 24 and December 8, 1975, respectively. Copies of these letters have been provided separately to the committee and with your permission could be included in the record at this point.

Mr. DINGELL. I think that is entirely appropriate and without objection the documents referred to will appear in the record following your statement [see p. 13].

Mr. HILL. In summary, Mr. Chairman, this correspondence stated FEA's best estimate that the composite price of domestically produced crude oil under regulations in effect prior to implementation of the EPCA in January 1976 would be \$8.75 per barrel. This estimate was derived from four other estimates:

First, 60 percent of domestic production was at that time subject to price controls at the \$5.25 level;

Second, price controlled crude oil sold for an average price of \$5.25 per barrel;

Third, the remaining 40 percent of domestic production was not then subject to price controls; and

Fourth, uncontrolled domestic production would have sold for an average price of about \$14 per barrel in January 1976.

It was also pointed out that:

First, prior to enactment of the EPCA, FEA collected data on its form 90 only from producers of new and released crude oil;

Second, prices for this production were not subject to controls and were rising during the period in question in response to the imposition of the import fees and OPEC price increases;

Third, there were significant lag time in collecting and evaluating the data; and

Fourth, while estimates of January 1976 uncontrolled prices were necessarily based on projections of trends and could not have been expected to be precise, nevertheless these estimates were the best available at the time.

FEA's implementation of the EPCA pricing provisions was approached in three stages from this data base. The first stage, effective February 1, 1976, as required by the EPCA, was to establish price controls on all domestic production in a manner that was intended to result in a weighted average first sale price—composite price—for February 1976 of \$7.66 per barrel nationally. The second stage provided for escalation of that composite price beginning in March 1976 according to the applicable EPCA provisions. The regulatory provisions adopted in both of these stages were applicable to all domestic crude oil production. The third stage was intended to consider the need for additional production incentives for certain unusually high-cost domestic production such as that from tertiary recovery, deep horizons, offshore leases and the like.

After publication of a proposed rulemaking and extensive evaluation of the comments received on that proposal, FEA adopted a two tier crude oil pricing system applicable to all first sales of domestic crude oil, designed to achieve a weighted average first sale price of \$7.66 per barrel in February 1976. This action was known as the first stage and became effective February 1, 1976. Lower tier crude oil was comprised of what had been previously price-controlled domestic production—old crude oil—and was estimated to be 60 percent of all domestic production. The February 1976 prices for the lower tier were continued at their January 1976 levels, then estimated by FEA to average \$5.25 per barrel nationally.

Upper tier crude oil was comprised of domestic production that had been free of price controls prior to February 1, 1976—new, released, and stripper well crude oil—and was estimated at that time to account for 40 percent of total domestic production. To achieve compliance with the statutory composite price of \$7.66 per barrel in February 1976, FEA adopted a pricing mechanism designed to result in an average upper tier price in February of \$11.28 per barrel nationally. To establish the upper tier price in a manner that permitted easy reference to publicly available data so as to facilitate both voluntary compliance and FEA audits, we decided that the price should be set with reference to the highest posted price in the applicable field as of September 30, 1975.

FEA did not have available direct information on the highest posted price in each field and the associated volumes of upper tier crude oil from each field that would have been required to calculate the necessary adjustment with any precision. Therefore, FEA estimated the average of the highest postings in each field by computing the arithmetic mean of actual transaction prices for uncontrolled crude oil for the months of September and October 1975. As pointed out earlier, prices for uncontrolled domestic production were rising during this period and the procedure described was deemed the best available to estimate the average of the highest postings in each field on September 30, 1975.

The average of actual transactions for September and October 1975 for new and released oil as reported to FEA on its form 90 was \$12.60 per barrel. Thus, the price of upper tier crude oil for February 1976 was established by regulation as the highest posted price in the field on September 30, 1975, minus \$1.32 per barrel as a means of achieving an average upper tier first sale price of \$11.28 for February 1976.

In sum, FEA used the best estimates available to it at the time and the same ones used in the Conference Committee deliberations to try to achieve an actual composite price for the first sale of domestic crude oil in February 1976 of \$7.66 per barrel.

In its second stage rulemaking, effective March 1, 1976, FEA applied the maximum escalator available under the EPCA provisions equally to both upper and lower tiers, again after publication of a proposed rulemaking and evaluation of all the comments received thereon. In conjunction with this rulemaking FEA published a schedule of projected increments to upper and lower tier ceiling prices established in the first stage rulemaking. Again, the estimates of 60 percent lower tier and 40 percent upper tier ratios for total domestic production were used in the computation of this schedule.

The implementation of the EPCA pricing provisions required for the first time that FEA collect and maintain precise first sale data for all volumes and prices of domestic crude oil production. Accordingly, FEA developed and promulgated form P-124-M-O and began to collect data from the first purchasers of crude oil on the quantities sold and prices paid for the first sale of domestic production. Data from this system gave FEA for the first time the capability to measure rather than to estimate the quantities sold and prices paid so that FEA could fully comply with the EPCA crude oil pricing requirements.

There is, however, a 90 day lag involved in the collection, analysis, and final certification of the data. Sixty days of this lag are for the certification of quantities and prices of crude oil as upper tier or stripper well oil as allowed for in FEA regulations. This delay enables first purchasers to accumulate information on all of their transactions for the month of measurement with sufficient precision to be able to certify accurately the necessary data to FEA. The remainder of the time or 30 days is consumed in collecting and processing the data.

In early June preliminary data for February disclosed actual share of lower and upper tier domestic production and actual prices for both lower and upper tier production that differed from the estimates used in establishing the lower and upper tier ceiling prices in the first stage rulemaking. The specifics of these variations are set out in my letter of June 16, 1976, to you, Mr. Chairman. With your permission I would also like to include a copy of that letter in the record.

Mr. DINGELL. Without objection, so ordered [see p. 68].

Mr. HILL. These preliminary data disclosed that the actual first sale price for domestic crude oil for January 1976 prior to the implementation of EPCA regulations had been \$8.63 per barrel and the February 1976 composite price for domestic production was \$7.80 per barrel, or 14 cents per barrel higher than the target of \$7.66 intended by the new regulations. Actual prices were \$5.07 per barrel for lower tier domestic production—as opposed to the earlier estimate of \$5.25—and were \$11.47 per barrel for upper tier production—rather than the estimated \$11.28. Also, the share of lower tier domestic production was actually 57.1 percent in February rather than the estimated 60 percent, while the share of upper tier production was 42.9 percent instead of the estimated 40 percent.

The combination of these variations resulted in an actual composite price for February that exceeded the statutory composite price of \$7.66. In my June 16 letter I stated that we would make compensating adjustments for this overage as required by the EPCA but that we were reluctant to do so on the basis of a single month's data, especially since our early experience pointed to the possibility of significant variations in the relative shares of lower and upper tier volumes from month to month.

Later in June, after more complete data for February were available, FEA learned that the actual composite price for February 1976 had been \$7.87. Also in late June preliminary data for March became available. These indicated a decline in the composite price to \$7.79 per barrel but also made it clear that corrective action had become necessary to assure compliance with the EPCA provisions.

Consequently, effective July 1, 1976, FEA froze prices at their June 1976 levels for the months of July and August. Our intention was to collect additional data during those months before making a decision

on whether a continuation of the price freeze would be sufficient to assure compliance with EPCA or whether a price rollback would be required.

In August 1976, after collecting and evaluating the additional data for April and May, FEA extended the crude oil price freeze through November 30, 1976. Before discussing that extension, though, I would like to point out some other factors which have recently affected the composite price. In August the Energy Conservation and Production Act (ECPA) became law. With respect to crude oil pricing the ECPA exempted stripper well production from price controls and called for an imputed price for stripper well production of \$11.63 per barrel—escalated of course according to explicit provisions in ECPA—to be used in computing the actual composite price.

The ECPA also provided FEA with the authority to escalate the composite price at a full 10 percent per year, regardless of the actual value of the GNP deflator. This provision was included to give FEA the flexibility to deal with certain crude oil pricing issues—for example, certain low-gravity crude oil and certain high-cost crude oil—that had been contemplated in FEA's third stage rulemaking. Accordingly, effective September 1, 1976, FEA exempted stripper well production from price controls and, effective October 1, 1976, FEA adopted upward adjustments in the gravity price differentials for certain heavy crude oils.

The ECPA also changed the basis for qualification as a stripper well property from the preceding calendar year to the preceding 12 months. This resulted in an immediate one time shift from lower tier to exempt status for a number of properties for which the 12-month period had expired during the first 9 months of 1976. Under the previous law all of these properties would have been required to wait until January 1977 to qualify for stripper well status. Moreover, a number of other properties qualified effective September 1 that had maintained marginal production levels during consecutive 12-month periods that did not happen to correspond to a calendar year.

Finally, on August 20, 1976, the FEA issued a Notice entitled "Clarifications to Mandatory Petroleum Price Regulations Applicable to Domestic Crude Oil" setting forth FEA's conclusions with respect to a number of issues that had arisen in connection with our implementation of the crude oil pricing policy of the EPCA.

Perhaps the most significant issue which FEA sought to resolve was the proper application of the definition of property which, for purposes of FEA price regulations, is the basic building block of the two tier price system. As conceived by the Cost of Living Council (CLC) in August 1973 and carried forward by FEO and FEA, the two tier price system is designed to reward producers that increased production levels over base period volumes with higher price levels for incremental production.

Determinations of incremental production are made on a property by property basis. Thus, for example, if a producer has a property which produces 500 barrels of crude oil in the current month and if that property produced and sold 350 barrels of crude oil in the base period, the producer may sell in the current month 150 barrels of crude oil as new crude oil at a price not to exceed the upper tier ceiling price.

Depending upon what is determined to be the property, the volume of increased production from that property might vary significantly. It is imperative, of course, to use the same concept of property for both the base period and the current period in order to measure accurately increased production levels.

Since the definition of property was first adopted by CLC in August 1973, it has provided that property is the right which arises from a lease or from a fee interest to produce domestic crude oil. This definition remains substantively unchanged today. However, in the rulemaking proceeding which culminated in the August 20 notice, FEA attempted to accomplish basically two objectives.

First, FEA sought to clarify for producers what the proper interpretation of the definition should have been for the past 3 years. Second, FEA sought to reevaluate the definition itself in order to insure that the incentives intended under the two tier pricing system operate more effectively during the remainder of the program mandated by EPCA. Let me be a little bit more specific about these two objectives of the rulemaking.

FEA believes that the property definition needed clarification because it became apparent in the implementation of the EPCA that producers had adopted many differing interpretations of the definition. This is probably due in our mind primarily to the extremely complex nature of the interests under which oil and gas have traditionally been produced. Accordingly, when producers were required in a short period of time in August 1973 to make property determinations in order to adapt to the then unfamiliar two tier price system, it is not surprising that many producers made those determinations according to systems that closely fit their historical and traditional methods of accounting, or I might add methods that corresponded to State regulatory requirements.

In setting forth the clarifications, FEA sought to arrive at the most reasonable interpretation that did not frustrate or take advantage of the incentives of the two tier system and in a manner that FEA believes was equitable to as many as possible of those concerned. Moreover, the clarifications of past interpretations are limited only to those classifications made by producers on a traditional and historical basis—no others. Since these clarifications concern historical treatment of properties for purposes of determining new and old crude oil, the effect of these clarifications on the composite price was expected to be minimal.

On the other hand, had FEA insisted upon a very strict, mechanical interpretation of the definition with regard to historical industry practice and to the primary purpose of the definition as the foundation of the two tier price incentive system, it is certain that recalculations by so many producers would have undermined the basic assumptions of the composite price structure itself. For example, the preliminary estimates of 60 percent old crude oil were based, of course, upon FEA reports from property classifications made, for the most part, upon the historical methods approved by the clarifications.

With respect to the amendments to the property definition which became effective September 1, 1976, FEA concluded that while the concept employed by the Cost of Living Council may have been well suited to achieve the incentives offered under that temporary program,

the longer term program contemplated under EPCA called for a reevaluation of the CLC incentive system. Specifically, the natural rates of reservoir decline make it difficult over the long term to provide adequate incentives unless production increases, like economic decisions, can be measured on a reservoir-by-reservoir basis.

In sum, FEA endeavored by this action to clarify a definition which, because of the complexity of the situation it was intended to address, had become confused and was difficult to apply, let alone enforce, without further clarification. This was done, we believe, in the most equitable manner possible under the circumstances. At the same time, effective prospectively from September 1, 1976, FEA provided an optional method for making property determinations to insure that the maximum incentives to domestic production would be preserved throughout the remainder of crude oil price controls.

As I have said, Mr. Chairman, in late August FEA had available data on actual production and prices through May 1976 from its new reporting system. These data disclosed that the actual composite price for April had been \$7.86 per barrel and for May had been \$7.89 per barrel. They also disclosed an unexpected decline in the production of upper tier crude oil and a larger than expected decline in the production of lower tier crude oil. These figures varied from month to month by amounts that precluded the identification of any reliable trends. Moreover, as they covered only the first 4 months of the program, they were insufficient as a basis for reliable projections of future changes in the ratio of upper and lower tier production.

Accordingly, based on the best estimates we could make with the available data, FEA projected that continuation of the freeze on crude oil prices at least through November was required. In fact, while projections at that time indicated that excess receipts could have been eliminated by December, the variability in the data was such that the recovery could have occurred one month earlier or some months later. Thus, given the status of the information available, there was not a firm basis at that time for extending the freeze through December 1976.

Accordingly, on August 31, FEA extended the freeze on domestic crude oil prices through November 30, 1976, at which time data through September would be available to provide the basis for a decision as to what further action, if any, would be required to assure compliance with the EPCA.

At present we have available only preliminary data for September 1976. Complete data for September will not be available until later this month, and reporting first purchasers have until the end of December to make final adjustments to it before they certify it. Thus, final September data will not be available for more than a month from now. Based on our experience to date, final price data for a month can vary from preliminary results by several cents per barrel.

The preliminary September data disclose that the combined effects of the change in stripper well qualification included in the EPCA and the change in the property definition issued by FEA on August 20, 1976, are on the order of a 2.3 percentage point shift from lower tier to upper tier and stripper production. The share of upper tier crude oil is 1.2 percentage points higher and the share of stripper well crude oil is 1.1 percentage points higher than it was for August.

It also appears, based upon a preliminary review of historical data, that 0.5 to 1 percentage point of the total shift may be attributed to the reclassification to stripper oil and about 0.2 percentage point to the normal decline in production of old oil. Thus, about 1 to 1.5 percentage points may be attributable to the redefinition of property in terms of the shift from lower to upper tier oil.

I must emphasize that we are not yet in a position to conclude that this will be the final magnitude involved and that we will not know for sure what the exact shift was for September until sometime in late December. Thus, extreme caution should be used in drawing any conclusions from such preliminary data.

Our current projections, subject to revision as more data are available, disclose that if the 2.3 percentage point shift from lower tier to upper tier production occurs and the existing price freeze is continued, estimated cumulative excess receipts as of January 31, 1977, would approximate \$230 million which is less than 1 percent of the total dollar volume of transactions involved in the first sale of crude oil during the period since February 1, 1976.

We do have available to us three principal options which we believe may be appropriate to deal with this issue of excess receipts. First, we could impose a price rollback of the required amount, estimated on the basis of 1 month's data that are not yet final, on upper tier production for the months of December and January to eliminate excess receipts by January 31. The rollback would probably most appropriately be imposed on upper tier prices because producers of upper tier crude oil have been the recipients of the excess receipts. Equity considerations argue against taking revenues from lower tier producers to eliminate excess receipts that have gone to upper tier producers.

Even if there were no decline in upper tier production as a consequence of the price rollback, the rollback would have to be about \$1.40 per barrel for this two month period. In fact, since this rollback would represent about 15 percent of the revenues of the producers affected during that period, the most likely consequence would be a substantial decline in production as producers waited for the price freeze to expire and for price escalations to resume with February 1977 production.

Moreover, the larger the rollback imposed, the greater is the incentive to withhold production for the rollback period, and the more disruption would occur in domestic production activities. For example, if upper tier production were to decline 10 percent in response to such a rollback, the amount of reduced production would be about 270,000 barrels per day for the 2 months involved. We are, of course, reluctant to take such drastic action on the basis of preliminary and incomplete information, especially in view of the fact that any decline in domestic production would be made up by increased imports at substantially higher prices.

A second alternative is to propose to the Congress an energy action under the provisions of the EPCA that would grant a one-time increase in the composite price for January 1977 sufficient to account for the excess receipts projected to exist at that time and to continue the freeze on actual prices through the end of January. This would amount to requesting a one-time increase in the legal composite price for January 1977 only of about 90 cents per barrel.

Dealing with unforeseen developments of this sort was one of the principal reasons as you will recall, Mr. Chairman, for including in the

EPCA the authority for the FEA Administrator to propose to the Congress changes in the escalator provisions every 90 days. During the Conference Committee deliberations, there were extensive discussions concerning the need for such flexibility in trying to administer a complicated regulatory program of the magnitude involved in the EPCA. This approach would have the advantage of avoiding any disruption to domestic production but would also prevent consumers from gaining the benefits afforded by recovery of the excess receipts.

A third option would be to extend the current price freeze through December 1976 to accumulate as much actual data as possible on the qualities involved and then to impose whatever rollback on upper tier prices would be required for the period January 1977 through July 1977 to assure the recovery no later than July 31, 1977, of all excess receipts. At present it would appear no such rollback would be required if the preliminary September results are confirmed by later data. Under these conditions, a continuation of the freeze through January 1977 should result in the recovery of some \$70 million more than excess receipts after accounting for the impact on the composite price of the stripper well exemption and the October 1, 1976, adjustments to heavy crude oil gravity differentials.

However, it would be extremely unwise to make a decision now on the basis of preliminary results for 1 month. More complete data for September and data for subsequent months could well show that a rollback over the period in question would be required.

In any event, this approach would have the advantage of assuring collection of excess receipts as contemplated in the EPCA and would avoid any disruptive effect on domestic crude oil production. The sole disadvantage would be the delay of some 4 months beyond January 1977 in recovering all of the \$152 million of excess receipts accumulated during the period February through July 1976 and a delay until June or July 1977 in the recovery of those excess receipts accumulated during the period August 1976 through January 1977. This delay could be accepted, however, in recognition of the:

Small magnitude of the excess receipts currently projected to exist on January 31, 1977, compared to the total volume of transactions involved (less than 1 percent);

The difficulty involved in projecting the numerous quantities that affect this magnitude with precision;

The intent of the EPCA pricing provisions; and

The benefits of avoiding the disruptive effects of a large, temporary price rollback.

Any excess receipts accumulated during the period since July 1976 would be fully eliminated in the next corresponding 6 month period as required by the EPCA were this approach to be selected.

One other consideration, Mr. Chairman, is that even with no action the projected excess receipts as of January 31, 1977, are less than half of the projected refunds expected from crude oil producers for the year ending on that date. Based on our experience to date in audits of crude oil producers, we expect to recover over \$500 million in overcharges for the period in question. We have been unable to complete many of these audits pending the clarification of the property definition, but they are now in process.

While this amount represents only about 2 percent of the volume of transactions involved, it is nonetheless greater than the projected amount of excess receipts as of January 31, 1977. Thus, one could argue that the appropriate way to protect consumers' interests is to get refunds from those producers who have violated the regulations. If they had not violated the regulations, we would not be out of sync with the composite price. While it still will be some time before the amounts involved are collected, our remedies include refunding not only the amount of the violation but interest thereon for the period in question. Thus, consumers' interests would be protected by this approach.

It is our current intention to review later this month the most recent data available to us and to make at that time a decision on the appropriate course of action.

Mr. Chairman, this concludes my formal statement. My colleagues and I would be pleased to answer any questions that the subcommittee may have

[Testimony resumes on p. 73.]

[The letters and attachments referred to follow:]

written by J. Hill, no control.

EXCC COMMUNICATIONS



FEDERAL ENERGY ADMINISTRATION
WASHINGTON, D.C. 20461

OFFICE OF THE ADMINISTRATOR

November 18, 1975

Honorable Harley O. Staggers, Chairman
Honorable Henry M. Jackson, Vice-Chairman
Conferees on S. 622 (H.R. 7014)
Washington, D.C. 20510

Dear Mr. Chairman:

There appears to have been a misunderstanding about the basis for the figures used in calculating the domestic composite crude oil price in the recent conference deliberations on the energy bill. I regret any confusion and would like to clarify the figures used.

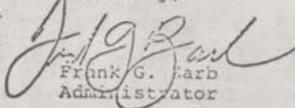
FEA staff worked closely throughout the conference with Committee staff and attempted to use the same price assumptions as the Committee. The current domestic energy crude oil price supplied by FEA to the Committee was \$8.75 per barrel. This price is also the price assumed by FEA in all internal calculations and evaluations of alternative pricing proposals.

While it is recognized that \$8.75 is only an estimated composite price, we believe that it is the best estimate to use for planning and assessing alternative policies. The \$8.75 figure depends upon a number of assumptions including the prices of old oil and presently uncontrolled oil, and the present ratio of old oil to new oil. Because of the lag time in data collection, FEA can only estimate current prices rather than utilize actual figures. The actual current domestic price could be as much as twenty cents different from the estimated \$8.75 figure in either direction depending on the estimates used. However, we consider the \$8.75 price a valid price for purposes of calculation and it was used by our staffs consistently on all the alternatives evaluated.

I should also point out that while a rollback of \$8.75 to \$7.66 per barrel is a reduction of \$1.09 per barrel in the composite domestic crude oil price, such a reduction will not necessarily occur in retail product prices due to a variety of market and regulatory conditions.

I have appreciated the opportunity to work with you as we try to finalize an energy compromise and look forward to continued close cooperation.

Sincerely,



Frank G. Barb
Administrator



FEDERAL ENERGY ADMINISTRATION
WASHINGTON, D.C. 20461

December 6, 1975

OFFICE OF THE ADMINISTRATOR

Honorable Henry M. Jackson
Chairman, Committee on Interior
and Insular Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your letter of November 24, 1975, regarding the numerical parameters of the domestic oil price policy agreed to by the Conference Committee as a part of the "Energy Policy and Conservation Act." This letter answers the questions you asked.

You state that questions have arisen concerning the price levels for crude oil which currently prevail in the United States and the relationship of those price levels to the oil pricing policy adopted by the Conference Committee. In my view, these questions have arisen because the news articles you refer to have not adequately dealt with the distinction between the price figures that have consistently been used for policy planning purposes and the various and understandably different price figures that are estimated to prevail on any given day.

The fundamental point in this regard, and one that has been well understood by all concerned with the detailed consideration of alternative oil pricing policies, is that for purposes of evaluating such alternatives a crude oil average price figure representing FEA's best judgment as to what an average crude oil price would be, assuming continuation of the present program, has been used. This approach is obviously the only rational basis upon which to base a policy decision on whether an alternative to the present program should be adopted.

The actual daily average price for domestic crude oil, on the other hand, has been in a continuous state of transition since February 1, 1975, in response to a \$1.00 per barrel increase on that date in the fee applied to imported crude oil, a further \$1.00 per barrel increase in that fee on June 1, 1975, and the increase in OPEC prices that was announced in October, 1975.

Thus, the projected domestic crude oil average price for purposes of policy planning has remained essentially the same throughout the period of time that alternative price policies have been analyzed and debated, while the actual daily average price (which is not available except as an estimate), has undoubtedly been increasing from month to month. This is illustrated, for example, by the October 30, 1975 document that you refer to in your letter, which listed a domestic crude oil price of \$8.75 in a table under a column headed "Average Current Price/bbl." That this was a price expressly intended to be used for policy planning purposes as the price that would obtain assuming continuation of the current program is demonstrated by the November 10, 1975 document, also referred to in your letter, which compared the projected price effects of alternative price policies and which listed the domestic composite price under "current controls" at the end of January 1, 1976 as \$8.75 per barrel.

It is therefore important to note that the extent to which the oil pricing policy adopted by the Conference Committee will result in price rollbacks at the crude oil level cannot be determined exclusively by reference to what the actual daily average price was in November or is in December (if those figures were presently known), or by reference to the price used for policy planning purposes by FEA. Rather, the actual amount of any rollback under the oil pricing policy adopted by the Conference Committee would be determined by the difference between the actual crude oil average price being charged in the month prior to the month in which the requirements of the new legislation were implemented, and the average price charged pursuant to those requirements. For the reasons set forth in detail below, we are confident

that the figures that have been used for policy planning purposes represent a reasonable and conservative approximation of the price levels that would obtain for domestic crude oil in the proximate future, were the present program to be continued.

Let me also respond as a preliminary matter to the general issue, raised throughout your letter, of the reliability of the data provided the Conference Committee by FEA. As this letter will set out in considerable detail, all the information provided the Conference Committee was without exception what we regarded to be the most reliable information available to FEA at the time. It was the same information in every case that FEA was using internally, with other Federal agencies and with the White House for purposes of policy evaluation.

You correctly refer to the highly complex nature of this issue. I believe that this complexity, together with some unfortunate statements made by persons apparently unaware of the complexities involved, is responsible for the apparent misunderstandings to which your letter refers.

One key element in this complexity is the possible failure to distinguish between estimates of "current" data and the latest, or "current," published series of data collected several months earlier than the date of publication. As in any similar endeavor (e.g., measurement of the Gross National Product), actual measurements of recorded experience are simply not available on a real time basis. As set out in detail below, there is typically a lag of at least 90 days in most of FEA's data series between the time a particular price is charged in the marketplace and the time it is reported to FEA, processed, tabulated, and made available for use.

A second key element is that the FEA's data series were developed for the administration of existing programs and to fulfill FEA's reporting responsibilities under existing legislation. The implementation of a weighted average price concept for domestic crude oil like that adopted by the Conference Committee will require more precise data series tailored to that program.

Accordingly, any estimates of "current" prices must necessarily be just that--estimates. We attempted to make this fact clear to the Committee staff on numerous occasions, and, indeed, thought that it was obvious to everyone concerned in any event. I regret any misunderstandings that may have arisen in this regard and sincerely believe that throughout this entire process FEA has made every effort to be completely open and candid with all concerned, as it has been in all of its dealings with the Congress.

Finally, your letter refers to information supposedly supplied to the press by unnamed "FEA sources" which tends to contradict the FEA-supplied estimates on which the Committee relied. I do not know who those alleged sources were or how they arrived at their figures. They were not acting under my authority or direction. I have no idea of what data they were relying upon or how reliable that data was. I can only say that I tend to discount the reliability of those figures because they do not agree with the figures arrived at by the professionals on my staff who have access to the most recent information available and in whose judgment on such matters I have complete confidence.

Your letter posed six sets of questions, more detailed answers to which are as follows:

- "I. Information and data currently in possession of FEA with respect to
 - "A. the percentage of domestic crude oil production sold at controlled and uncontrolled prices;"

(See Enclosure 1 for a detailed response.)

Briefly, FEA collects information on this question from two FEA data systems, which information is supplemented by other data. As the basis for its published data series, FEA obtains data monthly from the Bureau of Mines on total crude oil production in the United States. It also collects monthly data on FEA Form 90, directly from producers of "new" and "released" oil, on the amount of oil produced by them and the prices at which it is sold. FEA also obtains annually an estimate of total stripper well production made by the Interstate Oil Compact Commission and the National Stripper Well Association.

Using these three data series, the sum of new, released, and stripper production is subtracted from the Bureau of Mines report of total production to generate an estimate of crude oil production subject to price controls.

Since November 1974 FEA has also collected from refiners, on a slightly different time sequence, similar information as part of the data collection necessary for the administration of FEA's old crude oil entitlements program. Each refiner reports monthly its crude oil receipts for the preceding month in three categories: price controlled "old" oil; new, released, and stripper crude oil (i.e., domestic production not subject to price controls); and imported crude oil. This data is then tabulated during the following month for use in calculating that month's entitlement list.

The data available from these two series are shown at Enclosure 1.

An important point that emerges from an examination of Enclosure 1 is that the two FEA measurement systems generate slightly different results on a monthly basis. This is to be expected as they are measuring slightly different quantities in a differing time sequence (production at the lease vs. crude oil receipts at refineries) by different methods. Nonetheless, the two methods do generate results that correspond quite closely, lending added confidence to the validity of the data.

As indicated by both methods, the ratio of controlled to uncontrolled production varies slightly from month to month. However, it is clear from Enclosure 1 that the planning figure of 60 percent of domestic production being price controlled that has been used in all FEA's calculations supplied to the Conference Committee is approximately the median within this month-to-month variability. The most recent data available to the agency (i.e., the most recent four months of entitlements data) confirms this belief.

It should also be noted, based on the discussion contained in Enclosure 2, that this 60 percent figure would most likely prove to be a conservatively high estimate of what the percentage of price controlled crude oil will be in January or February of 1976, when the weighted average

price program adopted by the Committee would go into effect. This is so because during the first quarter of 1972 there existed certain production constraints in major producing fields which were removed during the second quarter of that year and which resulted in significantly higher production for the balance of the year. Assuming, therefore, a continuation of our current crude oil pricing regulations, the percentage of old oil during the first quarter of the next two years can be expected to average between four to six percentage points below the percentage of old oil produced during the last quarter of the preceding years. This, combined with what appears to be a gradual downward movement in the domestic old oil ratio, resulting from natural production decline, demonstrates that the estimate of 60 percent used by FEA is a reasonable and conservative method of reflecting current domestic crude oil pricing trends and produces a weighted average price estimate that is conservatively on the high side for the purposes for which it was used by the Committee.

"B. domestic crude oil prices at the wellhead
(controlled and uncontrolled crude oil)"

First sale prices for old crude oil are fixed by regulation at the highest May 15, 1973, posted price for that grade of crude oil at that field plus \$1.35 per barrel. See 10 C.F.R. §212.73. Some low-quality price-controlled oil sells for as little as \$3.50 per barrel; other high-grade crudes sell for as much as \$7.00 per barrel, depending on the May 15, 1973 posted price.

The estimate of an average price of \$5.25 per barrel for price controlled crude oil was made by the Cost of Living Council, which first promulgated the old oil ceiling price rule, in the manner described in Enclosure 2. Since legal maximum prices have not changed, this estimate has been carried forward and used consistently by FEA in all its estimates of average prices. FEA's published data series have shown this average price for each month since their inception.

There has never been any legal, regulatory, policy, or planning requirement to have an exact measurement of the average "wellhead price" of price-controlled crude oil. The FEA Form 90 collects data from producers of new

and released oil, and, incidental to that collection, also obtains information on controlled oil prices for properties that also produce new and released oil, but the reliability of this data has never been checked, nor has it been used by FEA for any purpose.

Prices of domestic crude production not subject to price controls are collected monthly by FEA on the FEA Form 90 from producers of new and released oil. These average prices are then compared with advertised postings of major purchasers and prices reported in trade journals. Average prices ranging from \$9.82 per barrel in January 1974 to a preliminary estimate based on incomplete reports of \$12.46 per barrel in September 1974 (prior to the announcement of the OPEC price increase, which of course influences the price of domestic uncontrolled oil) are shown at Enclosure 2.

- "C. the refiner acquisition cost of crude petroleum (average cost of domestic crude petroleum, imported crude petroleum, and a composite acquisition cost);"

(See Enclosure 3 for detailed answer.)

FEA obtains a monthly report from each refiner on the acquisition cost of both domestic and imported crude oil. This report, which is subject to FEA audits, is the basis for the refiner's allowable cost pass-through under FEA's price regulations. The latest month for which full data are available, August 1975, prior to the October OPEC price increase of ten percent, reflects a reported average cost of domestic crude oil of \$8.48 per barrel, an average landed cost of imported crude oil of \$14.25 per barrel, and an average composite cost of \$10.81 per barrel.

- "D. the estimated landed cost of crude petroleum from selected countries."

(Detailed data are shown at Enclosure 4.)

It is important to note that the data at Enclosure 4 do not include any supplemental fees (\$1.00 per barrel from February 1975 through May 1975, and \$2.00 per barrel from June 1975 to the present).

"II. Estimates of current price levels"

Detailed estimates are provided at Enclosure 6 together with the assumptions underlying those estimates. Estimates of "current" prices depend on two major considerations: the rate at which OPEC posted price increases are reflected in actual prices charged for imported oil and the rate at which prices for domestic crude production not subject to price controls increase to reflect increases in the cost of imported crude oil.

The key point is that under a set of entirely reasonable assumptions, prices for imported and uncontrolled domestic production could well go higher than figures used in FEA's policy planning, which were provided to the Conference Committee staff. FEA has in every instance, however, used what in its judgment was the best available estimate of the relevant price levels.

"III. FEA estimates transmitted to the Conferees"

The assumptions associated with and bases for estimates provided the Conference Committee staff are set out in detail in Enclosure 5 in answer to the previous questions. As stated above, they were in every instance the best estimates FEA was able to make given uncertainties involved. Moreover, these were the same estimates being used by FEA to evaluate the impact of different proposals and being provided by FEA to other elements of the Executive Branch of the Government.

Briefly, the estimates provided the Conference Committee staff all derive from four key parameters:

- (1) Price-controlled oil represents 60 percent of domestic production.
- (2) The average price of price-controlled domestic production is \$5.25 per barrel.

(3) The average price of domestic production not subject to price controls would be \$14.00 per barrel by January 1976.

(4) The average price of imported crude oil would be \$15.00 per barrel by January 1976.

The basis for the first two parameters is set out above and in more detail in Enclosures 1 and 2.

The basis for the third parameter is the fact that uncontrolled domestic crude oil sold at an average of \$11.28 per barrel in January, and although prices have been in transition since that date, they can reasonably be assumed to reflect at present, or in the proximate future, the \$2.00 per barrel supplemental fees imposed since then, plus 81 cents per barrel as an estimate of the effect of the October OPEC price increase for a total of \$14.09 per barrel. This estimate was then rounded down to \$14.00 per barrel for use in calculating the estimates provided the Conference Committee staff. Although 81 cents per barrel was attributed to the OPEC price increase, that increase, if fully effective, would range from a low of \$1.13 per barrel to a high of \$1.58 per barrel, with an estimated average of about \$1.25 per barrel.

Please note that a different set of assumptions could therefore have produced an entirely reasonable estimate of as much as \$14.53 per barrel (\$11.28 + \$2.00 fees + \$1.25 OPEC increase). For reasons detailed in the enclosure, we used what we believed to be a more nearly correct and lower value.

The fourth estimate was generated in the same way--to the January 1975 average price of \$12.77 per barrel for imported crude was added \$2.00 per barrel to account for the impact of the supplemental fees and 81 cents per barrel as an estimate of the effect of the October OPEC increase. This figure was even more conservatively rounded down to \$15.00.

January 1975 values were used as the starting point for these last two calculations because these are most recent actual data values free of the influence of (1) the supplemental

fees first imposed on February 1, 1975, and (2) the effect of the October 1975 OPEC price increase. We have learned that the price of uncontrolled domestic crude responds slowly--over a period of four to six months--to the price of imported crude. The landed price of imported crude also changes monthly in response primarily to changes in tanker rates and the mix of imports by quality and country of origin.

Accordingly, the price series for uncontrolled domestic production from February 1975 forward is a "moving target" that is clearly going in the direction of imported crude prices but with lags in timing that cannot be measured precisely nor estimated with any precision.

While later data were available for the landed price of imported crude (see Enclosure 4), the same methodology for estimating the \$15.00 price was used for consistency and to assure that comparisons made in using the parameters would be based on truly comparable estimates. Moreover, the latest available data were checked to assure that they were not inconsistent with the approach used in generating the estimates. Since they were not, the estimating procedure outlined here was used.

"IV. Administration of the Energy Policy and Conservation Act"

FEA views the "average domestic composite price" or "national weighted average price" for crude oil as the sum of all domestic crude oil production multiplied by the first sale price of that production divided by the total amount of domestic production. In the case of inter-affiliate transfers rather than arms-length transactions, regulations would specify the method for establishing a price that would be used as the equivalent of the first sale price.

FEA recommends that the legislation specify a "first sale" price (with discretion in the President to impute, in a manner to be specified by regulation, an equivalent price for inter-affiliate transfers), rather than a "wellhead" price, because of the lack of precision in the latter term. The first sale price, which is currently the price to which FEA's current ceiling price rules apply, is the price

charged in the first transfer for value by the producer or royalty owner, which transfer usually but not always occurs at or near the wellhead. The term "wellhead price," on the other hand, while sometimes loosely used as a synonym for first sale price (including in one of FEA's published data series), is not currently a precise regulatory term. The injection of this new term into the statute could result in its being construed as requiring that, for purposes of calculating the weighted average price, the President would have to impute a price at the wellhead in all instances where the actual first sale does not occur at that point. Any such requirement that a price different from that to which ceiling prices must necessarily apply be used to calculate weighted average prices would create an administrative nightmare for no apparent purpose.

It should be noted that use of an imputed "wellhead" price for purposes of making the weighted average price calculation would not result in lower product prices than would result if the first sale price were used. Indeed, the effect is likely to be the opposite. The first sale price for crude oil may in some instances include costs for transportation and other services (which presumably would be excluded from "wellhead" prices). If only imputed wellhead prices were used in arriving at the maximum weighted average price, these transportation and other costs would be added to the maximum, thus increasing the input costs to refiners and allowable product prices to consumers.

Finally, it should be noted that the estimates that were before the Conference Committee in its deliberations were all based on first sale, rather than imputed "wellhead," figures.

FEA is now considering three alternative data systems for directly measuring first sale prices for domestic production and has not yet decided which would be most appropriate. An expanded discussion of the alternatives now being evaluated is at Enclosure 7.

"V. Recent estimates by 'FEA sources'"

As set out above, I have no way of knowing the basis for the estimates attributed to such "sources," or even if such sources actually provided the estimates attributed to them. I do know that no responsible FEA official who was authorized to speak for the agency has provided such estimates and that at no time has FEA used for policy planning purposes any estimates other than those provided the Conferees.

"VI. Consumer benefit of a rollback in crude oil prices"

There have been some apparent misunderstandings on the part of some people on the amount and timing of the potential product price reductions that would be generated by the rollback. I am happy to have this opportunity to attempt to clarify the matter.

One estimate of the amount by which the bill would cause a rollback in prices to the consumer that was often quoted at the time of the Committee's deliberations was approximately 3.5 cents per gallon. While that estimate is fairly close to our estimate of what the total potential reduction would be if only products refined in U.S. refineries were considered, it did not take into account product imports, natural gas liquids production or volume expansion through the refinery process. Based on prices of \$5.25 for the 60 percent of domestic production that is price controlled, \$14.00 for other domestic production, and \$15.00 for imported crude, the composite price for domestic production is:

$$.6 (\$5.25) + .4 (\$14.00) = \$8.75 \text{ per barrel}$$

The composite price for all crude runs to refineries (8.5 million barrels per day of domestic production and 3.9 million barrels per day of imports) is approximately:

$$[8.5 (\$8.75) + 3.9 (\$15.00)] \div 12.4 = \$10.72 \text{ per barrel}$$

If domestic crude is rolled back to \$7.66 per barrel and the import fee is removed, the new composite price of crude runs to refineries would be about:

$$[8.5 (\$7.66) + 3.9 (\$13.00)] \div 12.4 = \$9.34 \text{ per barrel}$$

This represents a reduction of \$1.38 per 42 gallon barrel, or about 3.3 cents per gallon for products refined in U.S. refineries.

In the period August 1974 through July 1975 the U.S. consumed an average of 16.6 million barrels per day of refined products. However, only 12.4 million barrels per day of that amount involved products refined in the U.S. The remainder was made up of product imports, natural gas liquid products produced at gas plants, prices of which

will not be affected by lowering domestic crude prices, and refinery volume expansion. Accordingly, when these considerations are included, as they must be, the maximum effect on domestic product prices will be about:

3.3 cents per gallon (12.4 ÷ 16.6) = 2.5 cents per gallon

The question of how fast this decrease will flow through to ultimate consumers depends more on market conditions than on law or FEA regulations. Under Section 4(b)(2)(A) of the Emergency Petroleum Allocation Act companies are authorized to pass through to consumers increased costs of crude oil, but FEA regulations interacting with market conditions have prevented them from doing so on a current basis. As of November 1, 1975, refiners collectively had unrecovered crude oil cost increases of about \$1.4 billion that they were authorized to recoup in higher prices but had as yet been unable to recoup because of the competitive pressures of the marketplace.

These "banks" of unrecovered costs are not equally distributed among all refiners. Most are held by refiners who had higher than average feedstock costs before FEA's old crude oil entitlements program began operating. Accordingly, some refiners who currently have little or no banked costs because they have been passing through increased crude oil costs on a current basis will be required to pass on immediately in product prices any reduction in their average crude feedstock costs caused by this bill. In a market characterized by plentiful supplies of product, this mandatory reduction in prices by some refiners will place substantial competitive pressures on other refiners to meet these lower prices so as to preserve their market shares and their volumes of sales.

The exact timing and extent of price reductions therefore simply cannot be predicted with any degree of confidence. They depend on the individual business decisions of literally thousands of refiners, distributors, and retailers of petroleum products. Each is caught between two conflicting motivations: trying to collect as much as possible of any increased costs not yet recovered, versus the need to meet competition so as to keep volume and market share up. Profit-maximizing behavior for each company will be different depending on its own circumstances.

The general direction of the forces at work is clear. Currently, product markets are characterized by plentiful supplies and prices below those allowable under existing law and regulations. For those refiners without "banks" of unrecovered product costs, regulations will force lower prices early, thereby imparting downward pressure on all market prices. How fast that flow-through will be, on which products it will occur and in what amounts will be determined entirely by the interaction of supply and demand in the marketplace so long as prices are below legal limits.

Regardless of the rate at which the cost reductions flow through in lower prices to consumers, the Conferees may rest assured that their actions, if enacted by the Congress and signed by the President, should result in a savings to consumers of about 2.5 cents per gallon on petroleum products. These savings, however, will not necessarily be evidenced by actual and immediate decreases from current product price levels at the point of final purchase. They will also be evidenced by a reduction in prices in future months as a result of the immediate reduction in the amount of costs that refiners and resellers will have available for passthrough to consumers in those future months. Thus, prices will be less in future months than they otherwise would have been under a continuation of the present program. The combined effect of the operation of FEA regulations and competition in the marketplace should assure that consumers will reap the full benefit of the rollback one way or the other. What cannot be specified with any precision is exactly how that benefit will be distributed over time and among the products covered by price regulations.

The analysis set out above is consistent with that developed by FEA in its evaluation of the President's 39-month decontrol proposal, as set out in more detail in Enclosure 8. This proposal spoke of a range of expected reductions in overall product prices below what they would have been in the absence of the proposal, and was made before the recent OPEC price increase. The uncertainties set out above caused that range to be stated as "between -0.5 cents and -1.5 cents per gallon."

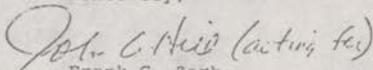
FEA was careful to point out in its evaluation of the 39-month decontrol proposal the contingent nature of the extent and timing of crude oil costs being reflected in

market prices, and the reasons for the uncertainties necessarily associated with the estimates. Our motive was to avoid giving rise to expectations that might not be fulfilled.

In the case of the Conference Committee Agreement, we would expect the range of price reduction to be from -1.0 cents to -2.5 cents, depending on particular market forces operating for each product and each company involved. Although it is impossible to predict with any degree of certainty, it seems likely that these reductions would begin to appear noticeably in the marketplace within several months after the effective date of the rollback in domestic crude oil prices.

I trust this letter is responsive to your questions. If I may be of further assistance, please let me know.

Sincerely,


Frank G. Zarb
Administrator

Enclosures

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PERCENTAGE OF DOMESTIC CRUDE OIL PRODUCTION
SOLD AT CONTROLLED AND UNCONTROLLED PRICES

The data are derived from four sources: (1) Form FEA-P-102, (2) Form FEA-90, (3) Bureau of Mines, Mineral Industry Surveys, and (4) The National Stripper Well Survey.

The most current source of this data comes from FEA's entitlements program (Form FEA-P-102). The purpose of the entitlements data is to assure that old oil is equally distributed among all domestic refiners in such a fashion as to minimize the cost disparities caused solely by the two-tier pricing system and to permit a more competitive environment within the refining, wholesale and retail sectors of the industry. These reports detail the volume of all crude oil used by refiners, of old oil, uncontrolled domestic oil and imported oil. This is a census figure in that all refiners are required to report all crude oil receipts. The old oil receipts percentage of total domestic oil at the refinery is:

November 1974	65.3%
December 1974	66.2%
January 1975	58.4%
February 1975	58.4%
March 1975	58.5%
April 1975	59.9%
May 1975	60.5%
June 1975	60.1%
July 1975	60.2%
August 1975	60.7%
September 1975	61.8%

Additionally, FEA maintains another data base which captures similar information from producers as opposed to refiners. This data lags behind entitlements data. Data applicable to new and released oil is derived from FEA Form 90. This form collects data on a lease basis from over 600 respondents which produce new oil. This is not a census figure, since not all producers report, but the companies that do account for approximately 87 percent of total production in the United States. Stripper well production data is estimated from an annual survey conducted by the National Stripper Well Association and the Interstate Oil Compact Commission. Volumes of oil in each of the three categories are then compared to the total domestic production during the relevant period in order to produce the percentage splits. This is the source of the data which is included in FEA's Monthly Energy Report. The most recent month for which this information is available is

March, 1975, and the percentage of old oil to total domestic production is 60%. Specifically, this data is:

		Controlled Old Oil	Uncontrolled New Oil	Released	Stripper
1974	January	60	17	10	13
	February	62	15	10	13
	March	60	16	11	13
	April	60	16	11	13
	May	62	15	10	13
	June	63	15	9	13
	July	64	15	9	12
	August	66	14	8	12
	September	67	13	8	12
	October	66	14	8	12
	November	67	13	8	12
	December	66	14	8	12
1975	*January	58	19	10	12
	*February	61	17	9	12
	March	60	18	10	12

*Total does not add to 100 due to rounding.

DOMESTIC CRUDE OIL PRICES AT THE WELLHEAD
(CONTROLLED AND UNCONTROLLED CRUDE OIL)

The estimate of \$5.25 per barrel as the average wellhead price of controlled oil was derived from an examination of representative crude oils by the Cost of Living Council and has been carried over to the FEA and is generally used in all its published data. More specifically, in March 1973, crude oil prices for 34° API crudes were approximately \$3.65/bbl. In the following four months typical market prices for that quality of crude increased twice by increments of about \$.25 and \$.35, respectively, bringing the total to about \$4.25/bbl when the Cost of Living Council issued its Phase IV regulations in August of 1973. At that time the Cost of Living Council established the maximum price at which old oil could be sold as the May 15, 1973, posted price in the applicable field plus \$.35 per barrel. It then adjusted the price of all old oil upward by \$1.00 on December 18 of that year, which accounts for the current \$5.25 per barrel estimate. A precise average controlled oil price, on the other hand, has never been determined by the FEA, because old oil prices have remained frozen since December 18, 1973 and because there has been no regulatory need for a more precise figure. While the FEA Form 90 collects some data on old oil prices, that form covers only those producers that also produce new and released oil.

The price of old oil varies from field to field, depending on the May 15, 1973 posted price in that field for the grade and quality of crude oil concerned, and may be as low as \$3.50 a barrel and as high as \$7 a barrel. These price differentials reflect the different values of crude oils depending upon their yield characteristics and other relevant factors. It is important to note that although the ceiling price of controlled oil has been frozen for nearly two years, the average price of all controlled oil undoubtedly varies slightly from month to month as a function of the mix of types of crude oil selling at controlled prices.

In conjunction with the second reporting system outlined in Enclosure 1, FEA requires reports on its Form 90 of pricing data from all properties which have produced new and released oil. In addition to being subject to FEA audits, the

reliability of these price reports is tested by comparison with advertised price posting of selected crude oil purchasers and prices reported in trade journals (i.e., Platts Oilgram).

The FEA's best estimate, determined in this manner, of domestic crude oil prices per barrel at the wellhead since January 1974 is:

		<u>Old</u>	<u>New and Released</u>
1974	January	\$5.25	\$9.82
	February	5.25	9.87
	March	5.25	9.88
	April	5.25	9.88
	May	5.25	9.88
	June	5.25	9.95
	July	5.25	9.95
	August	5.25	9.98
	September	5.25	10.10
	October	5.25	10.74
	November	5.25	10.90
	December	5.25	11.08
1975	January	5.25	11.28
	February	5.25	11.39
	March	5.25	11.47
	April	5.25	11.64
	May	5.25	11.69
	June	5.25	11.73
	July	5.25	12.30
	August	5.25	12.38
	September	5.25	12.46*

*Preliminary figure based on early reports.

REFINER ACQUISITION COST OF CRUDE PETROLEUM

Refiner acquisition costs are derived from mandatory reports (Form FEO-96) submitted directly to the FEA by all refiners (155 reports). These figures represent the average cost of crude oil purchased by refiners which they may pass through to their purchasers in the form of price increases. Refiners report their purchases of domestic and imported crude oil separately. These costs include not only the acquisition cost but the cost of transporting the oil into the refiner's inventory and the supplemental import fees. These data are subject to audit by full-time onsite FEA auditors at the largest 30 refiners to determine whether there have been violations of FEA pricing regulations. However, the FEA's data on average crude oil costs, which is normally published 30 days after the end of the reporting period, is usually based upon FEO-96 reports that have not yet been audited by that time.

Refiner acquisition costs of crude petroleum for January, 1974, through September, 1975 were as follows:

		Domestic	Imported*	Composite
1974	January	\$6.72	\$ 9.59	\$ 7.46
	February	7.08	12.45	8.57
	March	7.05	12.73	8.68
	April	7.21	12.72	9.13
	May	7.26	13.02	9.44
	June	7.20	13.06	9.45
	July	7.19	12.75	9.30
	August	7.20	12.68	9.17
	September	7.18	12.53	9.13
	October	7.26	12.44	9.22
	November	7.46	12.53	9.41
	December	7.39	12.82	9.28

		Domestic	Imported*	Composite
1975	January	\$7.78	\$12.77	\$ 9.48
	February	8.29	13.05	10.09
	March	8.38	13.28	9.91
	April	8.23	13.26	9.83
	May	8.33	13.27	9.79
	June	8.33	14.15	10.33
	July	8.37	14.03	10.57
	August	8.48	14.25	10.81
	September	8.49**	14.04**	10.79**

*The refiner acquisition cost of imported crude petroleum is the average landed cost of imported crude petroleum to the refiner and represents the amount which may be passed on to the consumer. It includes transportation costs and fees, and any other costs incurred in purchasing and shipping crude oil to the U.S. Before March, 1975, the estimated landed cost of imported crude petroleum from selected countries did not represent the total cost of all imported crude. Imported crude costs to U.S. company-owned refineries in the Caribbean were not included in the landed cost, and costs of crude petroleum from countries which export only small amounts to the U.S. were also excluded. Beginning in March coverage was expanded to include U.S. company-owned refineries in the Caribbean.

**Preliminary Data

ESTIMATED LANDED COST OF IMPORTED CRUDE
PETROLEUM FROM SELECTED COUNTRIES

Beginning in March 1975, the estimated landed cost of imported crude from selected countries has been developed from data on import purchases reported to the FEA on Form FEA F-701 by all importers who import more than 500,000 barrels a month. Prior to March, 1975, the FEA Form 1001 was the source of this data. The estimated costs are a weighted average, by volume, of landed costs, and do not contain the supplemental import fees that were imposed during 1975. Verification of data for individual companies submitted on Form FEA F-701 is subject to audit by the FEA, which audit has begun and will continue. The data are also compared to those from traditionally recognized trade sources, i.e., Petroleum Intelligence Weekly, Middle East Economic Survey, the Petroleum Economist, and Platt's Oilgram, to generally verify their accuracy.

These data are published 45 days after the end of the reporting period.

The most recent estimated landed costs of imported crude petroleum from selected countries are as follows:

		Algeria	Canada	Indonesia	Iran	Nigeria	South Arabia	U. A. Emirates	Venezuela
					Dollars per barrel				
1973	December	NA	6.32	6.42	6.37	8.54	5.49	NA	6.70
1974	January	NA	6.70	NA	8.53	12.13	NA	NA	10.28
	February	NA	10.90	NA	12.11	12.74	NA	NA	11.31
	March	NA	11.14	12.13	13.02	13.26	NA	NA	11.78
	April	13.63	11.02	12.49	12.83	13.67	11.59	NA	11.38
	May	14.67	11.47	12.95	13.84	13.83	11.53	NA	11.28
	June	14.83	12.56	13.21	13.44	13.03	11.32	13.96	10.39
	July	13.65	12.65	13.77	13.02	12.75	11.97	12.34	10.64
	August	13.96	12.49	14.32	12.31	12.70	12.16	12.69	11.20
	September	13.83	12.51	13.42	11.27	12.28	11.45	NA	11.01
	October	13.20	12.52	14.24	12.07	12.12	11.51	12.84	10.95
	November	13.43	12.33	13.45	12.16	12.83	12.15	13.54	11.15
	December	13.08	12.15	14.15	11.63	12.88	11.75	14.59	11.37
1975	January	12.72	12.43	13.30	12.11	12.07	12.07	13.14	11.37
	**February	12.11	12.15	13.52	11.86	12.18	11.94	12.67	11.56
	**March	12.46	12.79	13.94	12.08	12.56	11.78	13.40	11.66
	**April	12.36	12.95	13.71	12.34	12.46	12.16	12.55	11.61
	**May	12.41	12.09	13.71	11.93	12.34	12.27	13.29	11.54
	**June	12.37	11.90	13.73	12.51	12.49	11.93	12.48	11.51

ORIGIN OF ESTIMATE PROVIDED CONFERENCE COMMITTEE STAFF

The following factors were used in preparing estimates furnished the Conference Committee staff and in all of FEA's calculations evaluating the effects of various proposals.

(1) Percentage of domestic crude production subject to price controls: 60 percent.

The derivation of this estimate is outlined in Enclosure 1.

(2) Average price of domestic crude production subject to price controls: \$5.25 per barrel.

The derivation of this estimate is outlined in Enclosure 2.

(3) Average price of domestic crude production not subject to price controls: \$14.00.

This latter estimate is based on FEA's best judgment of the trends in the market for domestic oil not subject to price controls.

These estimates were necessarily subject to a range of uncertainty. To minimize that uncertainty, FEA took as the baseline for developing the estimates the January 1975 price of domestic oil not subject to price controls of \$11.28 per barrel. This is the most recent reported figure that is free of the "market lag" influences of the supplemental fee additions of February 1, 1975 and June 1, 1975, and the OPEC price increase of October 1975.

Then, it was assumed, based on experience with the \$1.00 fee imposed February 1, 1975, that the full effect of the second \$1.00 fee imposed effective June 1, 1975, would be reflected in domestic uncontrolled oil prices by approximately January 1976. This produced an estimate of \$13.28 per barrel for uncontrolled domestic prices in that month, exclusive of any effect of the OPEC October price increase.

The amount of that increase agreed to at the October meeting of OPEC was 10 percent. Posted prices before the increase ranged from \$11.30 per barrel for Arabian light to \$15.80 per barrel for Libyan sweet. Thus, a 10 percent increase in postings ranges from \$1.13 to \$1.58, with a

conservatively estimated average of \$1.25 per barrel based on the possibility that the mix of various kinds of crude from different countries of origin will be weighted slightly toward the lower-priced crudes. Adding this increase to the \$13.28 per barrel estimate derived above generates an estimate that the price of domestic uncontrolled crude could rise to as much as \$14.53 per barrel.

However, in early November there was limited information available to indicate that not all OPEC countries were in fact posting the full 10 percent increases. Based on such data as were available at the time, FEA estimated that the increases to be expected during the remainder of 1975 would amount to approximately eight percent. Moreover, there was some evidence that even these postings were being shaded in some cases. Thus, to estimate the total dollar impact of the announced increase, the FEA staff used an estimate of 81 cents per barrel as the amount of the increase to be expected on the average for the remainder of 1975.

Adding this 81 cents to the \$13.28 price derived above generated an estimate of \$14.09 per barrel for domestic crude not subject to price controls. This figure was conservatively rounded down to the \$14.00 per barrel estimate used for all FEA's calculations.

(4) Price of imported crude oil: \$15.00 per barrel.

This estimate is based on the January 1975 value of \$12.77 per barrel as the last value before the imposition of the supplemental fees and the OPEC October price increase. To this amount were added \$2.00 for the supplemental fees and the 81 cents per barrel estimate for OPEC price increases in 1975, for a total of \$15.58 per barrel. Again, because of the uncertainty associated with these estimates, this estimate was reduced to \$15.00 for purposes of computations.

ESTIMATES OF PRICE LEVELS BY MONTH

September 1975

Assume:

- Old Oil 60 percent of domestic production
- Old Oil price \$5.25 per barrel
- Uncontrolled oil price \$12.56 per barrel. This price estimate is based on the new oil price as reported on Form FEA-90 for August, 1975, of \$12.38 per barrel, plus an estimated increase of \$.18 per barrel reflecting continuing upward adjustment in response to the \$2.00 supplementary import fee. (Uncontrolled domestic prices rose a total of \$1.10 per barrel in the seven-month period beginning in February, 1975, and are estimated to increase another \$.90 in the five-month period of September, 1975, through January, 1976, to reflect the import fee.)
- Total domestic production 8.5 MMB/D
- Total crude oil imports 3.9 MMB/D
- Imported crude oil price \$14.18 per barrel. This price is based on the average import cost for the seven months of February, 1975, through August, 1975, during which OPEC prices were relatively stable, and average monthly import costs as reported on FEA Form 96, exclusive of import fees, were between \$12.05 and \$12.28 per barrel.

Therefore, the composite price of crude oil would be determined as follows:

$$\frac{[5.25(8.5 \times .6) + 12.56 (8.5 \times .4) + 14.18 (3.9)]}{12.4} = \$10.06$$

The domestic crude price would be:

$$\frac{[5.25(8.5 \times .6) + 12.56 (8.5 \times .4)]}{8.5} = \$8.17$$

October 1975

Assume:

- All assumptions except the two noted below are identical to those set forth in the September calculations.

- Uncontrolled oil price \$12.94 per barrel. This represents an increase of \$.38 per barrel over the September estimate. It was included in recognition of a further \$.18 response to the supplementary import fee and a \$.20 increase as a partial response to the October OPEC price increase.
- Imported crude oil price \$14.99 per barrel. This reflects an increase of \$.81 per barrel over the September estimate and represents our best estimate of the short run magnitude of the October OPEC increase on imported crude prices.

Therefore, the composite price of crude oil would be calculated as follows:

$$\frac{[5.25(8.5 \times .6) + 12.94 (8.5 \times .4) + \$14.99(3.9)]}{12.4} = \$10.42$$

The average domestic crude price would be:

$$\frac{[5.25(8.5 \times .6) + 12.94 (8.5 \times .4)]}{8.5} = \$8.37$$

November, December and January

Assume:

- All assumptions applicable to October estimate remain except as provided below.
- Uncontrolled oil price \$13.32 for November, \$13.70 for December, and \$14.08 for January, reflecting monthly increments of \$0.38 per barrel as set out in the assumptions for October.

Therefore, the composite price of crude oil in these months, calculated as above, would be:

November	.....	\$10.52
December	.....	\$10.63
January	.....	\$10.73

The average price of domestic crude would be:

November	.....	\$ 8.47
December	.....	\$ 8.63
January	.....	\$ 8.78

PROPOSED NEW DATA SERIES FOR CRUDE OIL PRICING POLICY

FEA is in the process of determining the most appropriate data series to use in the administration of a crude oil pricing policy based upon a weighted average first sale price limitation on domestic crude oil. Among the alternatives currently being considered are:

1. Producer Reporting

This approach would involve the collection of data from a representative sample of producers under a new form in order to determine the prices and volumes of old and uncontrolled oil and thus provide the weights necessary for calculation of the domestic composite price.

2. Purchaser Reporting

All purchasers of crude oil directly from producers would be required to report under a new form and the producer-operator would be required to certify old and new oil.

3. Refinery gate price less transportation cost procedure

Determine the average first sale price of domestic crude oil by subtracting the average transportation cost per barrel (which would be determined under a new form) from the average cost of crude oil delivered to refineries (which is now compiled by FEA).

COMPARATIVE ANALYSIS OF 39-MONTH PROGRAM IMPACT vs.
ESTIMATES PROVIDED CONFERENCE COMMITTEE STAFF

The economic impact of the President's 39-month phased decontrol program was issued by the FEA on July 28, 1975. This analysis contained the results of sophisticated econometric modeling, and, although the pricing environment has substantially changed during the past four months, the data contained in that report is remarkably consistent with the abbreviated analytical methodology presented to the Conference Committee staff. For example, the July 28 analysis contained a price path for crude oil which reflected FEA's expectation of average costs (domestic and imported) for crude runs in domestic refiners. At that time it was projected that average crude costs would be \$10.56 in the fourth quarter of 1975 assuming a continuation of existing price controls. Uncontrolled domestic crude prices were projected to be \$13.50 with old oil at \$5.25 and foreign crude at \$14.50 per barrel. To the extent that these price estimates were made prior to the recent OPEC increase, it would be appropriate to adjust the uncontrolled oil price upward by the amount of the OPEC increase for purposes of current price projections. An increase in the price of imported crude will affect about 60% of the crude used by domestic refiners by the amount of the increase. Therefore, a one dollar OPEC increase translates into an increase of approximately 60 cents in the composite cost of crude.

To adjust the \$10.56 composite fourth quarter 1975 crude cost predicted in July for the OPEC increase requires adding \$0.49 ($0.6 \times \$0.81 = \$0.486 = \0.49) to that figure, for an adjusted estimate of \$11.05. This compares to the current estimate of \$10.73 for January 1976. These estimates are within a reasonable range of one another, considering the uncertainties involved, and show that FEA's November 1975 calculations were consistent with its July 1975 ones.

The estimates contained in the White House fact sheet of July 25, 1975, stated that domestic prices would decline by .5 cents to 1.0 cents per gallon by the end of 1975. This estimate was based on the fact that the 39-month program was to be implemented in September 1975 and would have rolled back the uncontrolled domestic price from \$13.50 to an initial price of \$11.50. By November 1975 this would represent a reduction of \$1.85 per barrel in what would otherwise have

been the price for uncontrolled domestic crude, since the price was to increase by \$.05 per month beginning in September 1975. To the extent that this increment of oil represents about 20% of total domestic demand, this would equal a reduction of approximately .6 cents per gallon after an appropriate reduction applicable to the phased decontrol of old oil. Additionally, since this program was scheduled to be implemented in September the cushioning effect of banked costs was anticipated to have been neutralized by the end of the year.



Carma
Final Report to Justice

FEDERAL ENERGY ADMINISTRATION
WASHINGTON, D.C. 20461

OFFICE OF THE ADMINISTRATOR

December 15, 1975

Honorable Henry M. Jackson
Chairman, Committee on Interior
and Insular Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This is in response to your letter of December 8, concerning my letter to you of December 6 on the oil price figures supplied by the Federal Energy Administration to the Conference Committee on S. 622, the "Energy Policy and Conservation Act."

You have asked for further clarification of several issues first raised in your November 24 letter and discussed in my December 6 response, listing seven specific questions to be answered. These questions are addressed below in the order set forth in your most recent letter:

1. Estimated recent and current prices of "old" oil.

As you know, first sale prices for "old" crude oil are fixed by regulation at the highest May 15, 1973, posted price for that grade of crude oil at that field, plus \$1.35 per barrel. The range of prices is from about \$3.50 to more than \$7.00 per barrel. The estimate of an average price of \$5.25 per barrel for price-controlled crude oil was made by the Cost of Living Council, as indicated in my December 6 letter to you. FEA has used the \$5.25 figure in all published data series and internal analyses.

As noted in my December 6 letter, there has never been any legal, regulatory, policy, or planning requirement to have an exact measurement of the average "wellhead price" of price-controlled crude oil, and the FEA has collected such

data only on Forms CLC-90 and FEA-90 incidental to data collected for properties that also produce new and released oil. The "old" oil data so collected represents about 60 percent of total old oil production, and thus does not include about two million barrels per day. As I indicated in my previous letter to you, the reliability of this information has never been verified and, for the reasons set forth below, is subject to question. Therefore, this information has never been used by FEA for any purpose.

In view of the questions you raised concerning old crude oil prices in your letter of November 24, FEA data analysts have been examining carefully the data that has been collected on those prices by Form FEA-90, in an effort to determine whether that data could be used to provide an estimate of actual recent and current prices for all old crude oil. Although this analysis is still incomplete, it does not appear that the current Form FEA-90 data provides accurate information on old crude oil prices. I would like to outline briefly the problems we have encountered with this data.

Data on crude production and prices was first collected on the Cost of Living Council Form-90 issued in August 1973. Due to subsequent changes in the crude oil price regulations and certain technical deficiencies in the form, the data obtained from this form on old oil prices was never considered reliable nor used for any purpose. In recognition of the technical problems associated with Form CLC-90, FEA revised and reissued this form as Form FEA-90. This revised form has been in use since January 1975, but it still does not have to be submitted by producers which produce only old oil.

Because there was never any need to compile the data on old oil prices collected on the CLC-90 and FEA-90 and because this data was known to be substantially incomplete in any event, this information was not a high priority item for computer processing. As of this date, therefore, the only old crude oil price data collected on Form FEA-90 which has been processed by computer is the data for January, 1975, and even that processing was completed after receipt of your November 24 letter. The data for February, 1975 is just now being entered into the computer for the first time. Since each monthly report involves some 30,000 separate leases, the data is too voluminous for manual processing.

Our analysis of the information that has been produced by the computer processing of the January, 1975, old crude oil price data has just been completed during this past week. This analysis has given us several bases for concluding that this data still is not reliable, notwithstanding the revisions in the Form 90. To begin with, there has been no effort to verify the reported information by comparison to reports filed with state agencies or with other existing sample data, as would be done if the information were to be relied upon for any regulatory purpose. Also, anomalies in the data appear to have arisen from the fact that one of the entries called for by Form FEA-90 can be a negative number (Column D of Part IV, "Adjusted Total Production," which is "Total Production" minus "Current Cumulative Deficiency"). It appears that many of the respondents to the form were confused by this fact, thereby making their responses somewhat unreliable.

Finally, there are certain anomalies in the cumulative figures we have been able thus far to derive from the January, 1975, Form FEA-90 data which suggest that the figures are unreliable. For example, the break-out of prices according to gravity shows, in some instances, significantly higher prices for lower valued low gravity crude oils than for higher valued high gravity crude oils in the same state, which, in general, cannot be an accurate reflection of actual price levels.

Enclosure 1 at Tab A is a tabulation of old crude oil prices for January, 1975, which has been prepared from the Form FEA-90 data for the seven largest domestic producing regions (Texas, Louisiana, Offshore-Gulf of Mexico, California, Oklahoma, Wyoming, and New Mexico). This tabulation omits information from the smaller producing regions, where some of the anomalies referred to above were most apparent. The weighted average price for that amount of old oil produced in these seven regions and reported on the Form FEA-90 is \$5.08 per barrel. I must again emphasize, however, that this number has been derived from an unvalidated, partial sample, using a computer system that does not yet take account of reporting inconsistencies.

It is important to note that this \$5.08 per barrel number has been derived solely in response to your letters of November 24 and December 8, and, therefore, was not available to me or members of the FEA staff at the time they were consulting with the Conference Committee staff on energy legislation. Furthermore, no other FEA data system collects

old oil price data at the "wellhead." In connection with the crude oil entitlements program, FEA does collect price data for controlled old crude oil at the refinery gate (which includes transportation costs in undetermined amounts). The reported refiner acquisition costs, however, have varied by \$.19 per barrel during the last year, ranging from \$5.31 to \$5.50 per barrel. This data is set forth in Enclosure 2 at Tab B. As noted in Enclosure 2 of my letter of December 6, fluctuations in actual average old crude oil prices are to be expected from month to month as a function of changes in the mix of types of crude oil selling at old oil prices.

It is clear that if the Energy Policy and Conservation Act becomes law, its implementation will require considerably different data collection and validation procedures. Until a new, reliable crude oil price data system is implemented (which will take at least until the middle of 1976) it is our intention to continue utilizing the figure of \$5.25 per barrel as the best estimate of the weighted average old crude oil price, for purposes of devising a new crude oil price regulatory scheme which complies with the \$7.66 per barrel maximum weighted average first sale price ceiling established in the Energy Policy and Conservation Act. We also intend to utilize the estimated 60/40 ratio of controlled to presently uncontrolled domestic crude oil for this purpose. Therefore, until our new data collection system is operative in mid-1976, no new FEA crude oil price regulatory scheme would allow a weighted average price for the presently uncontrolled domestic crude oil to exceed \$11.28 per barrel, except as allowed to be adjusted in accordance with the adjustment provisions of that Act.

As you have been careful to point out in your letters, and as I am well aware, the conferees arrived at the composite domestic crude oil price on precisely these assumptions, i.e., 60 percent of domestic crude oil to be sold at an average price of \$5.25 per barrel and 40 percent of domestic crude oil to be sold at an average price of \$11.28 per barrel. I want to emphasize again that I believe the estimate of 60 percent controlled domestic crude oil production at an average price of \$5.25 per barrel was arrived at in a reasonable manner and yields a conservative result for planning purposes.

As I am sure you understand, these estimates are closely related, and the extent to which either estimate may prove to be inaccurate would have equally significant effects on the composite price of all domestic crude oil. And, if I correctly understand the concern you have expressed with respect to our estimates concerning the price and ratio of old crude oil, it is that when these values are actually measured they should not turn out to be such that they result in allowing a higher price for the presently uncontrolled component of domestic crude oil production than the \$11.28 per barrel figure that was contemplated by the Conference Committee. For reasons set forth more fully below, I believe it is highly unlikely that such a result could occur.

I should first like to illustrate the relationship between old crude oil prices and the percentage of old crude oil under the composite domestic crude oil price policy. Assuming that an average price of \$11.28 per barrel is to be maintained for presently uncontrolled crude oil, a reduction of 1 percentage point in the ratio of old crude oil to other domestic oil actually produced would require a reduction in the ceiling price of old crude oil of more than \$.10 per barrel in order to meet the \$7.66 per barrel composite price limitation, as show in the following table:

<u>Old crude oil ratio</u>	<u>Old crude oil price</u>
60%	\$5.25/bbl
59%	\$5.15/bbl
58%	\$5.04/bbl
57%	\$4.93/bbl
56%	\$4.82/bbl
55%	\$4.70/bbl

Of course, if in fact the old crude oil ratio becomes less than 60 percent, ceiling prices for old crude oil cannot as a practical matter be reduced below their current levels. The only other alternative is to establish ceiling prices for what is presently uncontrolled domestic production at levels below \$11.28.

As you know, we used 60 percent as the estimate of the old crude oil ratio in our analysis. As set forth in my letter of December 6, at pages 4-6 and in Enclosure 1, we indicated that the 60 percent figure was "approximately the median within [the actual] month-to-month variability," and that

"this 60 percent figure would most likely prove to be a conservatively high estimate of what the percentage of price controlled crude oil will be in January or February of 1976 . . . because during the first quarter of 1972 there existed certain production constraints in major producing fields which were removed during the second quarter of that year and which resulted in significantly higher production for the balance of the year."

We therefore stated that

"the percentage of old oil during the first quarter of the next two years can be expected to average between four to six percentage points below the percentage of old oil produced during the last quarter of the preceding year."

Since my letter of December 6, we have received data in connection with the entitlements program which shows that the actual old crude oil ratio for October, 1975, is 61.0%. As discussed more fully below in response to paragraph 2 of your letter, this leads us to believe that the old crude oil ratio for November and December of this year will be in the range of 61 to 62 percent, and, if the present crude oil price regulations remain in effect, the ratio in the first quarter of 1976 may therefore be significantly less than 60 percent. Indeed, it could well be, in light of this later information, that the ratio of old crude oil may never again be as high as our 60 percent planning figure after December of this year, since the decline in that ratio in the past few months appears to have been more significant than we anticipated. The data on which these conclusions are based is summarized for your convenience in Enclosure 3 at Tab C.

The point is simply that, even if the actual weighted average price of old crude oil is somewhat less than \$5.25 in January 1976, it will be more than offset by the probability that the old oil ratio will be less than 60%. Thus, I am confident that, when the combined effect of the old oil price and

ratio is actually measured, it will be reasonably close to our estimate and, in any event, will not be such as to result in higher prices for presently uncontrolled domestic crude oil than were contemplated by the Conference Committee.

2. FEA published data series for the percentage of old oil and refiner acquisition costs for October through December, 1975.

Price projections for October through January were provided in Enclosure 6 of my previous letter and represent FEA's best estimate for planning purposes of the distribution of controlled and uncontrolled domestic oil, as well as domestic composite prices, at the first sale level. Two assumptions underlying these price projections were that the percentage of old oil of domestic production is 60 percent and the weighted average first sale price of old oil is \$5.25. As explained in my answer to your first question, these estimates were used because they were and still are the best available. We did not attempt to estimate actual percentages of old oil or refiner acquisition costs for the months of October through December as will be reported on Form FEA-P-102 and Form FEA-96, respectively.

Since my letter of December 6, we have prepared preliminary data for the month of October, which serve to update the information supplied on Enclosure 1 and 3 of that letter.

They are as follows:

Old oil receipts as a percentage of total domestic crude oil at the refinery (October, 1975): 61.0%.

Refiner acquisition cost of domestic crude oil (October, 1975): \$8.59/bbl.

Refiner acquisition cost of imported crude oil (October, 1975): \$14.66/bbl.

Refiner acquisition cost of all crude oil (October, 1975): \$10.95/bbl.

Our estimate of old crude oil as a percentage of all domestic crude oil for the months of November and December, 1975, is 61 to 62 percent.

This estimate is based on (1) the fact that the percentage of old oil has been approximately 61 percent for the four months of July through October, 1975; (2) the fact that the percentage determined through Form FEA-P-102 has generally paralleled that obtained through a combination of sources and published in the FEA's Monthly Energy Review, as set forth in Enclosure 1 of my December 6 letter; and (3) that although Form FEA-P-102 data is not available for the period of July through December, 1974, the data published in the Monthly Energy Review indicates that during that period, the level of old oil production remained relatively stable (an average of 66 percent). (See Enclosure 3 at Tab C.)

Accordingly, we would not expect the figures for November and December of 1975 to depart significantly from the figures for the preceding four months, except that the Form FEA-P-102 data indicates that the December figure may be somewhat higher than the November figure.

Our estimate of refiner acquisition costs for November and December are as follows:

Estimated refiner acquisition cost of domestic crude oil (November, 1975): \$8.69/bbl
(December, 1975): \$8.85/bbl

Estimated refiner acquisition cost of imported crude oil (November, 1975): \$14.99/bbl
(December, 1975): \$14.99/bbl

Estimated refiner acquisition cost of all crude oil (November, 1975): \$10.67/bbl
(December, 1975): \$10.78/bbl

These estimates are derived in part from the estimates set forth in Enclosure 6 of my December 6 letter with respect to estimated first sale or "wellhead" prices of domestic crude oil and the estimated landed cost of imported crude oil for September 1975 through January 1976, which were as follows:

	<u>Domestic Wellhead</u>	<u>Import</u>	<u>Composite</u>
September	8.17	14.18	10.06
October	8.37	14.99	10.42
November	8.47	14.99	10.52
December	8.63	14.99	10.63
January	8.78	14.99	10.73

Although the estimated first sale prices of domestic crude oil are exclusive of transportation, the estimated monthly increments in the first sale price would also be reflected in higher refiner acquisition costs. Accordingly, the monthly increments in these estimated domestic first sale prices (increments of \$.10 per barrel from October to November and \$.16 per barrel from November to December) have been applied to the October refiner acquisition cost of \$8.59 per barrel, to yield the estimated refiner acquisition cost of domestic crude oil for November of \$8.69 per barrel and December of \$8.85 per barrel. Landed costs of imported crude oil were previously estimated at \$14.99 for the months of October through January, and although our preliminary data indicate they reached a level of \$14.66 for October, we continue to anticipate that imports will reach \$14.99 for November and December.

3. Assumptions underlying price trajectories used to analyze alternative price policies.

The assumptions associated with the table entitled "Domestic Composite Price," and the untitled graph attached to a document entitled "Amendment Proposal" which was submitted to the Committee staff on November 10, 1975, were as follows:

For current controls:

- o Old oil price \$5.25 per barrel
- o Supplemental fee continued
- o Total domestic crude oil production, MMB/D:
 - End of 1976. 8.2
 - End of 1977. 8.3
 - End of 1978 and 40th month 9.5
- o Total old oil production MMB/D:
 - End of 1976. 4.7
 - End of 1977. 4.3
 - End of 1978 and 40th month 4.0

- o Uncontrolled domestic oil price
 - 1/1/76 \$14.00
 - End of 1976. \$15.42
 - End of 1977. \$16.15
 - End of 1978. \$17.70
 - End of 40 months \$18.08
- o Imported crude oil prices begin at \$15.00 per barrel, including the supplemental fee, and increase by approximately seven percentage points per year.

For Immediate Decontrol

- o All domestic crude oil production permitted to be sold at free market prices which were estimated to begin at \$12.00 per barrel and increase by approximately seven percentage points per year.
 - o Assumes immediate removal of supplemental fees.
4. Data series FEA intends to use to administer The Energy Policy and Conservation Act.

The implementation of the Energy Policy and Conservation Act, if it becomes law, will require a completely new data collection and reporting system. At this point, we are still evaluating alternative ways to collect the data, with the major alternatives being producer reporting, purchaser reporting, and refinery acquisition cost and transportation cost reporting, as indicated in my letter of December 6. However, I have not reviewed the detailed proposals and have made no decisions. Obviously, we will chose whichever method is both administratively feasible and complies fully with the requirement of the Act that we rely on "valid and reliable information."

5. Sampling of data for September-November.

FEA's experience under the Emergency Petroleum Allocation Act has been that samplings of product cost data which are not verified as representative have tended to be only rough reflections of what was ultimately contained in later reports. During the Conference Committee deliberations on S. 622, FEA used \$14.00 as the average uncontrolled oil price for purposes of estimating the domestic composite price and for evaluating

alternative proposals. The methodology used in these calculations was detailed in my previous letter. PEA staff has recently made random telephone inquiries concerning the uncontrolled price, but these inquiries were not structured in any sense and no conclusion could be drawn from them other than that prices were moving upward.

6. Estimates of price changes resulting from the Conference Committee pricing policy and the impact of various factors on such changes.

As set forth at page 12 of my December 6 letter, our estimate is that, when compared with prices that would have obtained under the current system of controls, domestic crude oil prices will be reduced from \$8.75 per barrel to \$7.66 per barrel -- a reduction of \$1.09 per barrel, and that overall crude oil prices will be reduced from \$10.72 per barrel to \$9.34 per barrel -- a reduction of \$1.38 per barrel.

We have further estimated, in the manner described in my December 6 letter, that this will translate into price reductions at the consumer level of from 1.0 to 2.5 cents per gallon.

(a) Effect of assumptions as to current domestic crude oil prices on these estimates.

As we have indicated, the predicted level of domestic crude oil prices is a function of three variables:

- o the price of old crude oil, which we have estimated to be \$5.25/bbl.
- o the price of presently uncontrolled domestic crude oil, which we have estimated to be \$14.00/bbl.
- o the percentage of domestic crude oil which is old crude oil, which we have estimated to be 60%.

As the composite price of domestic crude oil is set at \$7.66 under the oil pricing policy adopted by the Conference Committee, the impact of differing assumptions with respect to the three variables above is simply that a price somewhat different from the \$8.75 per barrel would obtain for domestic crude oil, were the present system of controls to be continued.

I believe it is reasonable to assume that the actual price of old crude oil could vary by as much as \$.25 per barrel less than the estimated price of \$5.25 per barrel; that the actual price of uncontrolled crude oil could vary by as much as \$.50 per barrel higher or lower than the estimated price of \$14.00 per barrel; and that the ratio of old crude oil could vary by as much as 5 percentage points lower than the estimate of 60 percent.

Using these margins of uncertainty, the price of domestic crude oil which would obtain if the present system of controls were to be continued, which we have estimated as \$8.75 per barrel, could vary from a high of \$9.41 per barrel to a low of \$8.40 per barrel, as calculated below.

A comparative analysis has also been prepared for the overall price of crude oil, which adds import prices as a variable, and assumes that they could vary by as much as \$.50 per barrel higher or lower than the estimated price of \$15.00 per barrel. This analysis indicates that the overall price of crude oil, which we have estimated as \$10.72 per barrel, could range from \$10.33 per barrel to \$11.33 per barrel. Obviously, it is most unlikely that all of the variables concerned would converge at the high or at the low side of our estimates, and we remain convinced that our estimates of \$8.75 per barrel for domestic crude oil and \$10.72 per barrel for all crude oil are reasonable. These analyses use the same methodology and should be compared with the analysis set forth in Enclosure 6 to my letter of December 6.

Domestic Crude Oil

o Low range

- January 1976 price estimate contained in December 6, 1975 letter		\$8.75
- If old oil price is \$5.00 instead of \$5.25		
	.25 ($\frac{8.5 \times .6}{8.5}$) = \$.15	- .15
- If \$13.50 is used as the price of uncontrolled domestic crude oil		
	.50 ($\frac{8.5 \times .4}{8.5}$) = \$.20	<u>-.20</u>

Lowest estimated price for domestic crude oil
in January 1976 \$8.40

The complete formula would be:

$$\frac{5.00 (8.5 \times .6) + 13.50 (8.5 \times .4)}{8.5} = \$8.40$$

o High range

- January 1976 price estimate contained in
December 6, 1975 letter \$8.75

- If 55% old oil ratio used instead of 60%
 $(8.5 \times .05) \left(\frac{14.50 - 5.25}{8.5} \right) = \$.463$ + .46

- If \$14.50 is used as the price for domestic
uncontrolled oil
 $.42 \left(\frac{8.5 \times .45}{8.5} \right) = \$.189$ + .19

Highest estimated price for domestic crude
oil in January 1976 \$9.40*

The complete formula would be:

$$\frac{5.25 (8.5 \times .55) + 14.50 (8.5 \times .45)}{8.5} = \$9.41^*$$

* The difference results from rounding of numbers.

All Crude Oil

o Low Range

- January 1976 price estimate contained in
December 6, 1975 letter \$10.73

- If old oil price is \$5.00 instead of \$5.25
 $.25 \left(\frac{8.5 \times .6}{12.4} \right) = \$.103$ - .10

- If \$13.50 is used as the uncontrolled price of
domestic crude oil
 $.50 \left(\frac{8.5 \times .4}{12.4} \right) = \$.137$ - .14

- If \$14.50 is used as the price for imported
crude oil
 $.50 \left(\frac{3.9}{12.4} \right) = \$.157$ - .16

Lowest estimated price for all crude oil
in January 1976 \$10.33

The complete formula would be:

$$\frac{5.00 (8.5 \times .6) + 13.50 (8.5 \times .4) + 14.50 (3.9)}{12.4} = \$10.33$$

o High range

- January 1976 price estimate contained in
December 6, 1975 letter \$10.73

- If 55% old oil ratio used instead of 60%
 $(8.5 \times .05) \left(\frac{14.50 - 5.25}{12.4} \right) = \$.317$ + .317

- If \$14.50 is used as the price for domestic
uncontrolled oil
 $.42 \left(\frac{8.5 \times .45}{12.4} \right) = \$.130$ + .130

- If \$15.50 is used as the price for imported
crude oil
 $.50 \left(\frac{3.9}{12.4} \right) = \$.157$ + .157

Highest estimated price for all crude oil
in January 1976 \$11.33

The complete formula would be:

$$\frac{5.25 (8.5 \times .55) + 14.50 (8.5 \times .45) + 15.50 (3.9)}{12.4} = \$11.33$$

(b) [paragraph (c) in your November 24 letter]
Effect of removal of the \$2.00 per barrel
supplemental import fee.

The effect of removing the \$2.00 per barrel supplemental fee
would be to reduce the price of imported crude and all
currently uncontrolled domestic crude by \$2.00. For the

composite price of all crude, the impact would be measured as follows:

$$2.00 \left(\frac{8.5 \times .4}{12.4} \right) + 2.00 \left(\frac{3.9}{12.4} \right) = \$1.18 \text{ per barrel less}$$

than if the supplemental
fee were to remain in
effect, assuming a 60/40
domestic old/uncontrolled
oil distribution

- (c) [paragraph (e) of your November 24 letter]
Influence of FEA regulations on reseller
margins.

FEA pricing regulations provide for the passthrough of increased product costs and, subject to certain limitations, increased non-product costs by all marketers and retailers of covered petroleum products. Briefly, this is accomplished by comparing the cost of product in inventory on a base date (May 15, 1973) with current product costs, and permitting the difference to be added to May 15, 1973, selling prices. Non-product costs are those costs incurred by the marketer or retailer other than the actual purchase price of the product and the additional cost, if any, of transporting it into inventory. Typical costs which would be included in this category would be labor, rent, utilities and other miscellaneous operating expenses. Such increased non-product costs may be passed through only to the extent they do not exceed specified increments which have been determined by FEA, generally on a product-by-product basis and according to the level of distribution concerned.

FEA regulations have therefore operated to freeze gross margins at May 15, 1973 levels, with the only exception being increases deemed necessary to offset the effect of increased non-product costs. An examination of the available data applicable to retail gasoline sales tends to indicate that a very competitive environment exists which has restrained retailers from receiving the maximum price permitted in accord with current regulations. Specifically, in May 1973, the gross margin applicable to retail gasoline sales was approximately 7.3 cents per gallon. Current regulations permit an increase of 3 cents per gallon for non-product costs. However, the most recent data available (August 1975) indicates that gross margins are 8.4 cents per gallon and therefore considerably below the maximum of about 10.3 cents per gallon.

To the extent that this data reflects considerable price pressure in the marketplace, it is reasonable to conclude that current margin controls at the retail gasoline level are having very little effect, because of the overriding effects of price competition. We believe this is a likely case for most of the major product categories with the possible exception of aviation fuel, of which only a small portion is not sold directly by refiners. The impact of this situation on the question of how fast the decreases in crude oil prices will flow through to the ultimate consumers is identical to the impact of "banked costs" on this question which is discussed in pages 13-14 of my December 6 letter.

(d) [paragraph (f) of your November 24 letter] Effects of supply and demand of refined products.

Except for anticipated possible spot shortages of propane, current estimates project adequate supplies of principal petroleum products in all regions of the country and levels of product distribution, so that competitive forces should continue to operate to reduce consumer prices to reflect reduced crude oil acquisition costs.

(e) [paragraph (h) of your November 24 letter] The role of relevant provisions of the Energy Policy and Conservation Act, including the amendment to the pricing provision offered by Senator Hartke.

As you know, the Hartke amendment is embodied in section 401 of the conference substitute, which among other things adds a new section 9 to the Emergency Petroleum Allocation Act which provides in relevant part that FEA pricing regulations

"shall provide for a dollar-for-dollar pass-through in prices at all levels of distribution from the producer through the retail levels of decreases in the costs of crude oil, residual fuel oil, and refined petroleum products (including decreases in costs which result from [the rollback of the weighted average first sale price of domestic crude oil to \$7.66 as required by the Conference Substitute])."

We understand this provision to be essentially the obverse of section 4(b)(2)(A) of the current Act, as amended by section 402(a) of the conference substitute, which provides in very similar language for a dollar-for-dollar passthrough of crude oil and product price increases. We have interpreted the latter provision in the past as requiring the FEA to permit sellers at least the opportunity to pass through all of their increases in the cost of crude oil or products incurred since the base date of May 15, 1973, even though market conditions may as a practical matter prevent the full passthrough of such increases. The courts have upheld this interpretation in several different cases. By the same token, we believe the new section 9 will require the FEA to force commensurate reductions in a seller's maximum lawful selling prices if he enjoys a reduction in his crude oil or product costs.

Thus, for example, section 4(b)(2)(A) requires the FEA to structure its pricing regulations so as to permit a seller who had a maximum lawful selling price of \$.50 per gallon and who incurred an increased product cost of \$.05 cents per gallon to increase his maximum lawful selling price to \$.55. As a practical matter, however, the seller may in fact be able to increase his actual selling price only from \$.50 to, say, \$.53 if he wants to remain competitive. Similarly, the new section 9 would require a seller who had a maximum lawful selling price of \$.50 and a price decrease of \$.05 cents to reduce his maximum unlawful selling price to \$.45. However, an actual price reduction of \$.05 may not result if, for example, the seller was previously selling at \$.48 cents per gallon, despite a maximum lawful selling price of \$.50, because of competitive conditions. The actual price reduction mandated by section 9 in such a situation would then be only \$.03.

In addition, we do not interpret the new section 9 as prohibiting the passthrough of existing "banked costs" during the period that the conference substitute would require crude oil costs to be rolled back below existing levels. This is so because the conferees, in addition to adopting the Hartke amendment, adopted amendments to existing section 4(b)(2) which expressly recognize the right of sellers to pass through existing banked costs, subject to the limitation in the case of refiners that not more than 10 percent of the amount of banked costs in existence as of January 31, 1976 can be passed through in any one month.

See section 402. Thus, a firm that incurs a decrease in crude oil or product costs may be able temporarily to delay passing that decrease on to its customers if it has banked costs currently available to offset any reduction in prices that would otherwise be required by the Hartke amendment and market conditions will permit it to pass through those banked costs.

Our view of the proper interpretation of the Hartke amendment is in every respect consistent with the interpretation contained in the Joint Explanatory Statement of the Committee of Conference. That Statement says in relevant part:

"The Conference Substitute required that decreases in a firm's cost of crude oil, residual fuel oil, or refined petroleum products be fully taken into account in computing that firm's maximum lawful selling prices."

" . . . This provision of the Conference Substitute will help to assure that as much of the crude oil price reduction as is possible will be passed through the various levels of refining and distribution to the consumer level. Of course, it cannot realistically result in a full and immediate dollar-for-dollar reduction if that seller is already below its maximum lawful prices and if the Federal Energy Administration does not alter the rules regarding so-called 'banked costs.'" S. Rep. No. 94-516, 94th Cong., 1st Sess., at 195 (Dec. 8, 1975) (emphasis in original).

Then, in order "to clarify the relationship between the passthrough in prices of cost decreases provisions of the Conference Substitute and the provisions on banked costs," the Joint Statement quotes at length and with apparent approval from the discussion contained in my letter to you of December 6, 1975 concerning our understanding of the likely passthrough of crude oil cost reductions in light of the interplay of the banked cost rules and existing market forces.

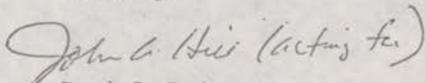
7. Effects of 39-Month Program.

As you requested, I am enclosing an evaluation of the economic impact of the President's 39-month decontrol proposal. It should be recognized that the analysis assumes continuation of the \$2 import fee, world oil prices held

constant, and a somewhat different short-term economic outlook (see Enclosure 4 at Tab D).

I hope this letter properly addresses your concerns. I look forward to responding to any further questions you may have.

Sincerely,



Frank G. Zarb
Administrator

Enclosures

Old Oil Price and Production Data
 Compiled From the January 1975 Form FEA-90

<u>Old Oil Production</u>	<u>Gravity Range</u>	<u>Weighted Average Ceiling Price</u>
<u>TEXAS</u>		
1,794,615	under 25	\$5.11
4,126,357	25 - 30	5.05
8,565,197	30 - 34	5.10
14,150,433	34 - 40	5.21
10,165,322	above 40	5.27
<u>LOUISIANA</u>		
3,086,688	under 25	\$5.10
2,521,614	25 - 30	5.13
3,197,018	30 - 34	5.19
6,058,445	34 - 40	5.28
3,242,625	above 40	5.32
<u>OFF SHORE GULF OF MEXICO</u>		
1,137,163	under 25	\$5.42
603,483	25 - 30	5.12
2,001,226	30 - 34	5.17
398,577	34 - 40	5.25
	above 40	5.35
<u>CALIFORNIA</u>		
5,182,558	under 25	\$4.02
1,086,027	25 - 30	4.77
346,615	30 - 34	5.04
90,832	34 - 40	5.16
58,466	above 40	5.06
<u>OKLAHOMA</u>		
143,160	under 25	\$5.02
632,526	25 - 30	4.80
264,086	30 - 34	4.94
1,698,864	34 - 40	5.10
645,734	above 40	5.20

WYOMING

2,551,260	under 25	\$4.48
549,560	25 - 30	4.86
209,738	30 - 34	4.91
1,792,196	34 - 40	5.20
232,578	above 40	5.21

NEW MEXICO

50,524	under 25	\$4.85
48,465	25 - 30	5.02
330,802	30 - 34	5.06
952,131	34 - 40	5.19
973,155	above 40	5.26

TOTAL FOR ABOVE SEVEN REGIONS

12,809,058	under 25	\$4.54
10,101,712	25 - 30	5.03
13,516,939	30 - 34	5.13
26,744,127	34 - 40	5.23
15,716,457	above 40	5.28

78,888,293*	--	\$5.08
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This figure represents 50.8% of all old oil production in January 1975.

Enclosure 2

WEIGHTED AVERAGE REFINER ACQUISITION
COST OF OLD CRUDE OIL (Form FEA-P-102-M-O)

	<u>1974</u>	<u>1975</u>
JANUARY		\$5.50/bbl
FEBRUARY		5.40/bbl
MARCH		5.38/bbl
APRIL		5.35/bbl
MAY		5.37/bbl
JUNE		5.35/bbl
JULY		5.31/bbl
AUGUST		5.33/bbl
SEPTEMBER		5.33/bbl
OCTOBER		5.31/bbl
NOVEMBER	\$5.36/bbl	
DECEMBER	5.44/bbl	

Enclosure 3

PERCENTAGE OF OLD OIL TO TOTAL DOMESTIC PRODUCTION

	<u>1974</u>		<u>1975</u>	
	<u>M.E.R.*</u>	<u>FEA-P-102</u>	<u>M.E.R.*</u>	<u>FEA-P-102</u>
January	60%		58%	58.4%
February	62%		61%	58.4%
March	60%		60%	58.5%
April	60%			59.9%
May	62%			60.5%
June	63%			60.1%
July	64%			60.2%
August	66%			60.7%
September	67%			61.8%
October	66%			61.0%
November	67%	65.3%		
December	66%	66.2%		

* Data published in FEA's Monthly Energy Review, which is derived from Form FEA-90 and from an annual survey conducted by the National Stripper Well Association and the Interstate Oil Compact Commission. (See Enclosure 1 of my December 6 letter).



FEDERAL ENERGY ADMINISTRATION
WASHINGTON, D.C. 20540

JUN 16 1976

OFFICE OF THE ADMINISTRATOR

Honorable John D. Dingell, Chairman
Subcommittee on Energy and Power
Committee on Interstate and
Foreign Commerce
House of Representatives
Washington, D.C. 20515

*see letter
to [unclear]*

Dear Mr. Chairman:

As I am aware of your continuing interest in domestic crude oil price levels, I want to apprise you of the preliminary results of a Federal Energy Administration (FEA) survey of February 1976 first-sale prices of domestic crude oil.

As you know, the crude oil pricing policy adopted by the Energy Policy and Conservation Act ("EPCA") includes the following provisions:

-- a requirement that regulations be adopted not later than February 1, 1976 to limit the weighted average first sale price ("composite price") for all crude oil produced in the United States during that month to not more than \$7.66 per barrel;

-- authority to provide limited monthly upward adjustments in the foregoing composite price of domestic crude oil to take into account the impact of inflation and as a production incentive; and

-- a requirement that adjustments be made in the crude oil price regulations each six months to compensate for any amount by which actual first sale prices of domestic crude oil exceed the composite price limitations, as adjusted, of the EPCA.

On February 1, 1976, FEA adopted regulations intended to result in a \$7.66 per barrel composite price for domestic crude oil during February, 1976. FEA subsequently adopted regulations to provide for monthly increases in crude oil

prices beginning in 1975, to take into account the impact of inflation and as a production incentive. A schedule of crude oil price adjustments (which is subject to such revisions in future months as may be necessary under the provisions of the EPCA) has been published for each month of the 40-month period of crude oil price controls required by the EPCA.

As discussed in detail in my letters to Senator Jackson of December 6 and 15, 1975 (copies of which were printed in the Congressional Record), FEA had neither any precise data concerning domestic old crude oil first sale prices nor very recent data concerning new, released or stripper well lease first sale prices at the time the EPCA was under consideration. Accordingly, certain estimates were relied on in evaluating the crude oil pricing policy set forth in the EPCA. And, as I indicated would be the case, these same estimates were subsequently used in formulating the regulations issued by FEA to implement the crude oil pricing policy of the EPCA.

I noted in my December letters that the implementation of a weighted average price concept for domestic crude oil would require more precise data series tailored to such a program. FEA has been developing such data series, and we have now acquired more comprehensive, although still not fully complete data.

In brief, these data indicate that the weighted average first-sale price for domestic crude oil for January 1976, prior to the EPCA regulations, was \$8.63 per barrel. For February 1976, the composite price for domestic crude oil was \$7.80 per barrel, or 14 cents higher than the target of \$7.66 intended by the new regulations adopted to implement the EPCA composite price requirement.

The February data are still preliminary and until such factors as actual old crude oil production decline rates have been better ascertained, we believe it would be premature to reduce the crude oil prices set forth in the schedule which has been issued. We are trying to provide a maximum degree of price certainty to crude oil producers so as not to impede producer investment decisions regarding enhanced recovery projects, new drilling, and field development, all of which we believe to be price sensitive.

We will, of course, make compensating adjustments in the future as required by the EPCA. However, before making any such adjustments, it is essential that we verify the data

The principal reasons for the apparent discrepancy between our earlier estimates and our preliminary actual first-sale price data are enumerated below. For purposes of our February 1, 1976, crude oil price regulations FEA estimated that the average first-sale price of old crude oil was \$5.25 per barrel and that the September 30, 1975 average of highest posted prices of new, released and stripper well crude oil was \$12.60 per barrel. Using the estimate that 60 percent of domestic crude oil production was old crude oil, and 40 percent was new, released and stripper well oil, the statutory composite price of \$7.66 was to be attained by reducing the price of upper tier (formerly new, released and stripper well) crude oil from \$12.60 to \$11.28 per barrel, a reduction of \$1.32 per barrel. Thus, the \$7.66 composite price would result according to the following formula:

$$(.6)(\$5.25) + (.4)(\$11.28) = \$7.66.$$

It now appears, based on the first results from a new FEA crude oil production and pricing report (FEA Form 124-M-O), that our estimates did not coincide with actual data for February with respect both to upper and lower tier crude oil first-sale prices and with respect to their proportions of total domestic production.

Rather than our estimate of \$5.25 per barrel, the actual average lower tier first-sale price in February appears to have been \$5.07 per barrel; the actual September 30, 1975 average of highest posted prices of upper tier crude oil appears to have been \$12.79 per barrel rather than the FEA estimate of \$12.60 per barrel (resulting in an actual upper tier price of \$11.47 in February instead of \$11.28 after the \$1.32 adjustment)..

The Form 124-M-O data also indicate that the share of total domestic production represented by lower tier crude oil was actually 57.09 percent in February 1976 rather than the estimated 60 percent. The share of upper tier crude oil was correspondingly higher than had been anticipated, actually 42.91 percent rather than the estimated 40 percent.

As I noted in my December 15 letter, FEA's estimates of 60 percent old crude oil production at an average price of \$5.25 per barrel were arrived at in a reasonable manner and yielded a conservative result for planning purposes. The close interrelationship of these estimates was also pointed out. In particular, it was noted that a reduction of one percentage point in the old crude oil ratio required a reduction of about ten cents per barrel in old crude oil

was illustrated that an old crude oil ratio of 60 percent at an average price of \$5.25 per barrel was equivalent to an old crude oil ratio of 57 percent at an average price of \$4.93 per barrel.

I stated in my December 15 letter that even if the actual average price of old crude oil were somewhat less than \$5.25 per barrel, that fact would be more than offset by the probability that the old crude oil ratio would be less than 60 percent. Even given the uncertainties existing at the time, I was confident that the combined effect of the old crude oil ratio and old crude oil prices, when actually measured, would be reasonably close to FEA's estimate and, in any event, would not be such as to result in higher prices for then uncontrolled crude oil than the \$11.28 per barrel figure that was contemplated by the Conference Committee. This has proven to be the case.

The major reason that the actual composite price for February appears to have been \$7.80 per barrel, rather than \$7.66 per barrel, was our inability accurately to estimate the average of the highest posted prices on September 30, 1975 for crude oil that was then not subject to ceiling prices. Posted prices rather than prices charged in actual transactions were used as a reference for establishing the new upper tier ceiling prices in order to avoid pricing disparities for crude oil of a particular grade being produced and sold from a particular field and to facilitate compliance and audit by establishing a single ceiling price rather than multiple prices for each grade of crude oil produced and sold from each field. Since no data on posted prices were available, we estimated that the average of September 30, 1975 postings would be approximately the average of the prices charged in actual transactions in September and October, 1975, as reflected in the data FEA then had available with respect to such transactions. This estimate was based on the theory that since prices of crude oil not subject to ceiling prices were moving upward, the average of the highest posted prices in effect on September 30 would be higher than the average prices charged in actual transactions during that month. This proved to be correct, only the September 30 postings appear to have exceeded September transaction prices by somewhat more than we anticipated.

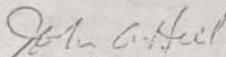
The schedule of crude oil price adjustments issued by FEA and effective March 1, 1976, was, as noted above, predicated on the \$5.25 and \$11.28 prices and the 60/40 percent ratio.

In addition, the schedule of upward price adjustments is based on a projected national decline rate in old crude oil production of eight percent annually. We do not yet know if this estimated decline rate or the assumed inflation rate will prove to be accurate. If the decline rate exceeds eight percent, this will further reduce the percentage of old crude oil and hence further limit the actual price increases which may be implemented under the EPCA limitations on the composite first-sale price of domestic crude oil. On the other hand, if the actual decline rate in old crude oil production is less than the projected eight percent annually, this will tend to compensate for the higher than expected \$7.80 per barrel initial composite price. We will need to accumulate several months of data before we can begin to assess what the actual decline rate will be, and we will then be able to compute more accurately the price adjustments necessary in subsequent periods to assure that the crude oil price provisions of the EPCA are fully met.

In summary, we want you to be aware of the apparent 14 cents per barrel excess over the EPCA required composite first-sale price of \$7.66 per barrel for domestically produced crude oil during February 1976 and to be assured that FEA will in the future make such adjustments in domestic crude oil price levels as may be required to comport with the EPCA requirements. However, we do want to make such adjustments on the basis of as complete data as practicable so as to avoid the creation of any undue disincentives to domestic crude oil production.

If you have any questions about these matters, I would be pleased to respond.

Sincerely,



John A. Hill
Acting Administrator

Mr. DINGELL. The subcommittee thanks you for your statement and your assistance this morning.

The Chair recognizes the gentleman from Texas, Mr. Eckhardt, for questions.

Mr. ECKHARDT. Mr. Hill, I would like first to get back to what you did in the very beginning in February after the act was passed. On page 6 you say that you had estimated the average price of new oil at that time was \$12.60 per barrel and in order to achieve the \$11.28 figure you needed a rollback of \$1.32 per barrel. Am I correct on that?

Mr. HILL. We had estimated from our data that the September-October 1975 price was \$12.60 per barrel.

Mr. ECKHARDT. That is September-October?

Mr. HILL. 1975.

Mr. ECKHARDT. 1975.

Mr. SMITH. Mr. Eckhardt, if I could add a clarification, that \$12.60 was an average of the actual transaction prices.

Mr. ECKHARDT. The average of actual transactions for September and October 1975 for new and released oil as reported to FEA on its form 90 was \$12.60 per barrel.

Mr. SMITH. Yes, sir.

Mr. HILL. Yes, sir.

Mr. ECKHARDT. So in order to achieve the \$11.28 figure which you at that time thought was your goal since you were assuming 40 percent new oil and 60 percent old, your \$11.28 figure in order to be achieved based on September and October 1975 information was \$1.32.

Mr. HILL. That is correct.

Mr. ECKHARDT. But when you applied that you came out with the \$11.47 figure instead of the \$11.28 figure. In other words, in view of enlightened hindsight you might assume that there had been an increase in the price of the average transaction from September and October of 1975 to the time you applied it of approximately 19 cents.

Mr. SMITH. No, sir.

Mr. ECKHARDT. Tell me why not.

Mr. SMITH. All right, sir. The regulation for the maximum price on what was then upper tier oil was established with respect to the highest posted price in any field for that quality of oil that existed on September 30, 1975, and it was not established with respect to actual prices paid during that period. Now the reason for that was that information on actual prices paid is available only to the parties to the transaction and sometime later to FEA so that everybody—

Mr. ECKHARDT. If you will pardon me for a moment, I am not trying to cast any blame on you for your calculations but let me ask you this simple question.

I am not saying you had the information to do so, but if you had applied a corrected figure of \$1.51—in other words, if you had rolled back the price of new oil by \$1.51—you would have come out with \$11.28.

Mr. SMITH. That is correct.

Mr. ECKHARDT. Now there were several reasons why you didn't do that.

Mr. SMITH. Yes.

Mr. ECKHARDT. One is that there was some change which you could not altogether estimate between September and October 1975 and the time you applied it. I guess that is the main reason, isn't it?

Mr. SMITH. No, sir. The principal difference, Mr. Eckhardt, is that during the period in question, September and October, prices were rising for the oil that was then uncontrolled in response to the imposition of the additional fees and it took a while for the actual domestic prices to rise up to those fee levels. Therefore, the postings in the fields were being changed from time to time and the average of the highest posted prices in the field on September 30 were in fact 19 cents more than the average of the transactions for 2 months.

We were using the average of the transactions, the \$12.60 figure, to try to make the best estimate we could of what the highest posted price in the field was on September 30. The difference between those actual transaction averages and what turned out to be the average of the highest postings was 19 cents a barrel.

Mr. ECKHARDT. I see.

Mr. HILL. We had to use the postings, Mr. Eckhardt, so that producers would have an easily accessible reference point in terms of how to produce their crude since they didn't have full knowledge of the transaction prices nor did the FEA for several months. It was really the difference between the posting price and the actual transaction prices which led to that differential.

Mr. ECKHARDT. How long did it take you then to find out?

Mr. DINGELL. Would the gentleman from Texas yield for a question?

Mr. ECKHARDT. Yes.

Mr. DINGELL. The Chair would like counsel to ask a question at this particular point. Would the gentleman yield, please?

Mr. ECKHARDT. Yes.

Mr. CURTIS. Just on this point, I understand the regulation as originally proposed to take effect in February used a formula based upon actual prices with the subtraction of the \$1.32 and when finally adopted it would bend that to go for the posted prices with the explanation that you wanted to rely on that formula for those fields for which there were not transactions occurring as I understand it.

Mr. SMITH. That was one reason, Mr. Curtis; there were three others. One was we wanted the regulation written with respect to prices that were generally available to everybody so that they would know what they were. In other words, the actual posted prices in the field were available publicly and producers had knowledge of those and had easy access to those figures so they would know how to figure their price.

Second, we wanted to assure that the same grade of oil, the same quality of oil from the same field sold for the same prices and the only way to do that was to write the regulation with respect to the highest posted price in the field because in fact during that period of time the transaction prices could have differed between different parties in the same field.

Finally, we wanted to peg the regulation to the posted price that was publicly available to facilitate our compliance actions because it is much easier to take a publicly available figure that everybody knows and a single figure for the field than it is to have to work a compliance case brand new by reference to the transactions of the parties involved during the period in question.

So all four of those reasons contributed to the change.

Mr. CURTIS. You also found it necessary to define what was to be the highest posted price in the field for regulatory purposes in August of this year, roughly 6 months after the program was in effect, on the basis that there was not general industry knowledge as to what would be the standard of measure of posted prices upon which they were to make their subtractions to judge the permissible price.

Mr. WILSON. We had clarifications with respect to what a posting actually was, that is correct. One of the problems with the original proposals, how to set the upper tier prices, was that we originally were under the impression that there were not postings in many of these fields for some of these prices. We were subsequently informed that there were and more or less were informed of the inequities that would occur with two producers producing from two reservoirs receiving different prices and we ought to go to a uniform rate as long as it is in the same field. That is what we attempted to do. Subsequent questions came up as to exactly how the rules were applied. We collected these from a number of parties, analyzed these and tried to clarify these in the August rulemaking.

Mr. CURTIS. Well, was it your impression that the clarification was necessary because producers did not have a reliable and readily recognizable base upon which to evaluate the permissible price for upper tier oil?

Mr. WILSON. It was necessary to evaluate exactly how our regulations applied to postings. Postings are set forth in different manners. Sometimes there will be a general posting that covers an entire field, sometimes there will be a separate posting within that field that covers a certain specific area and you have to determine which reference point you go to in looking to the highest posting and how this covers. There are a number of very detailed questions of that sort that arose that we obviously did not anticipate when we initially promulgated the regulations which we had to clarify to make certain that the system was working. I suspect more will be coming up in the future.

Mr. CURTIS. The only point I wanted to make is that your original formula is based on actual prices with the subtraction of \$1.32. As I understand it, when you actually promulgated the regulation you shifted the base to the highest posted price in the field and that formula states that if there is no posting then it is the highest posted price in the nearest field for the same quality and grade of oil.

Mr. WILSON. That is correct.

Mr. CURTIS. Because you were going to the highest posted price, was it not predictable that that would bias the prices all upward?

Mr. WILSON. That is why we took the average. The only data we had was with respect to actual transactions in the months. Since we were using September 30 for the transaction data and we were moving to the highest price in the field, we knew that the transaction data for September would be low and therefore the only estimate that we thought we could make of this was to try to do an average on the theory that prices were moving up between September and October and therefore we would take an average of the actual transaction prices for September and October. When we did that we always assumed that we would be off to a certain extent.

I should note that actually there is some anomaly in the February data that came in that showed a 19 cent discrepancy as the March data subsequently showed. The March data went down very significantly for upper tier prices which indicated that there may be certain data collection problems there which indicated we were much closer probably with the February data.

Mr. CURTIS: Thank you, Mr. Eckhardt.

Mr. ECKHARDT. Then whether there was fault involved or not, the calculation of how much to roll back, the price turned out to be 19 cents short of the amount necessary to come to the \$11.28 price assuming that the 60-40 ratio existed, is that correct?

Mr. HILL. That is right, sir.

Mr. ECKHARDT. Now there is another thing that you discovered somewhere down the line and that is that, at least according to the data that you had available to you from the producers and from their organizations, the mix was different which of course would tend to bring down the price of new oil assuming a fixed price of old oil in order to accomplish the final composite price of \$7.66. Is that correct?

Mr. HILL. Would you repeat the latter part of your question, Mr. Eckhardt?

Mr. ECKHARDT. Well, let me just put it simply that you found that lower tier domestic production was actually 57.1 percent in February rather than the estimated 60 percent while the share of upper tier production was 42.9 percent instead of the estimated 40 percent from the information that you then had from the industry.

Mr. HILL. That is correct, and the effect of that was to make the composite price higher than it would have been if the 60-40 had been achieved.

Mr. ECKHARDT. That is right. To put it another way, you would have had to reduce the price of upper tier oil in order to come within the maximum composite price of \$7.66.

Mr. HILL. That is correct.

Mr. ECKHARDT. And you also found another thing that apparently had been inaccurate in your estimates when you multiplied 40 percent times \$11.28 and 60 percent times \$5.25, and that is that your actual average price of old oil was \$5.05 instead of \$5.25, is that right?

Mr. HILL. \$5.07.

Mr. ECKHARDT. \$5.07, is that correct?

Mr. SMITH. No, sir. You are right in that the preliminary was \$5.05 and later corrected to \$5.07.

Mr. ECKHARDT. So \$5.07 is the actual correction.

Mr. DINGELL. Would the gentleman yield?

Would I be correct in assuming it would be the other way around?

Mr. HILL. That is right. The preliminary data indicated \$5.07; it turned out to be \$5.05.

Mr. ECKHARDT. I see. Well, we will get this right finally. I thought it was \$5.05. That is what it actually is.

So again not attempting to attribute blame, there were three sliding figures that ultimately resulted in a wrong composite under the standards of the act.

Mr. HILL. That is correct.

Mr. ECKHARDT. One had to do with the estimate of the actual price of new oil and the level to which it had to be reduced in order to come to the result of \$11.28 if that had been the correct result. Two,

the old oil mix was less than had been anticipated which of course would tend to bias the price upward due to the mistake. Three, the price of old oil was actually lower than you had thought which would tend to bias the figure downward. Those would be somewhat offsetting but the latter was not in as great a magnitude as the second factor.

Now I note in your testimony that in early June you found out that you probably were using data respecting the mix which may not have been true data; that is, that is the time when you were shaken on the 60-40 question. That was June of —

Mr. HILL. 1976.

Mr. ECKHARDT. 1976, this last June.

Mr. HILL. Yes.

Mr. ECKHARDT. At the time the act was being drafted around November of the previous year 1975 I seem to remember rumblings that the 60-40 ratio was not correct. Did you hear anything concerning that at that time?

Mr. HILL. There was some discussion as to whether or not the 60-40 was a precise number.

Mr. ECKHARDT. By the beginning of the year 1976 I seem to remember the oil industry saying that there was a considerably greater amount of new oil than the 40 percent. Do you remember any indications from the industry at that time?

Mr. HILL. We had some indications, Mr. Eckhardt, from the industry that they thought that the old oil mix was lower than what we were estimating. At that point no one had precise data. I think it was largely a few large producers who, on the basis of their experience, thought that our old oil mix should be lower but there was also, I think, complete agreement that that ratio was subject to wide degrees of fluctuation on a month-to-month basis.

Mr. ECKHARDT. And that was also subject to fluctuation with respect to how the oil company reporting treated its properties and that which was old or new oil from given properties, is that not correct?

Mr. HILL. I don't think there was much fluctuation in terms of how each company defined property during that period. I think they all adopted an interpretation of property in August of 1973 and pretty much stayed with it. That was not, in our mind, the reason for the fluctuation in the percentage volume of old as compared to new oil.

Mr. ECKHARDT. Now with respect to the major companies operating in the United States—companies like, for instance: Exxon, Gulf, Texaco, Mobil, et cetera—I would assume that those companies were competing with each other and were attempting to bring in new oil at about the same rate. They owned old oil properties and they were bringing in new oil properties, so some sort of estimate of that mix might be arrived at by those companies' own estimates of their old and new oil. Would that not be a reasonable assumption?

Mr. HILL. I think so.

Mr. ECKHARDT. Is there any reason why Gulf should be different in its ratio of old and new oil than the other companies?

Mr. HILL. I think so.

Mr. ECKHARDT. Has it been more lackadaisical in producing new fields or did it have a greater bonanza of old oil prior to the enactment of regulation or was there any real difference in its structure and ownership of oil production?

Mr. HILL. I think, Mr. Eckhardt, if you look at the oil companies, the majors or the medium sized companies, you will see quite a diverse pattern of old and new oil that reflects historical business judgments about where to produce. It reflects those, either domestically or abroad and it reflects the capability of the firm to lease on the OCS some of their drilling capabilities, plus their ability to put up the large bids. It reflects to some degree luck and chance.

Mr. ECKHARDT. I think we can pretty well assume that that is true because you have got several companies that developed differently with a different mix of production of OCS oil and overseas oil, et cetera. But it is true, is it not, that Gulf under its calculations as to what was old and new oil in its production calculated about 20 percent new oil, and presently does, as opposed to about 80 percent old oil?

Mr. HILL. I would have to check that exact number but I think that is approximately correct.

Mr. ECKHARDT. Have you checked with any of the companies with respect to their calculations respecting old and new oil? It would seem to me that you would want to make some of those checks as sort of a test against industry's general statements about the mix.

Mr. HILL. I think we have fairly good information on most of the companies although our data on the mix comes from the first purchasers of crude oil.

Mr. ECKHARDT. Essentially on the basis of fields, I assume.

Mr. HILL. That is correct.

Mr. ECKHARDT. Rather than on the basis of companies.

Mr. HILL. Yes.

Mr. ECKHARDT. Because you may have several companies in a given field.

Mr. HILL. Yes. You may have some companies selling some to the majors, some to the independents. You are going to have variations. Our data is based on the information from the first purchaser.

Mr. ECKHARDT. But if we should find that Gulf has a certain mix at say around 20-80 new to old and if we should make a check of other companies and we find that their mix is somewhat in accord with that, we would ultimately perhaps develop some skepticism about the oil companies' reports as respects old and new oil or we would develop some skepticism as to how they are applying the rule with respect to properties, would we not?

Mr. HILL. I think, Mr. Eckhardt, that our experience on the relative share of old and new oil would just simply indicate a lot of month-to-month variability. It would indicate the difficulty of trying to establish either a precise ratio or to project that ratio over time.

Mr. ECKHARDT. But you don't take their reports with respect to the mixture of old and new oil with respect to various properties on face value; you check those, do you not?

Mr. HILL. That is correct. Our audit program will certainly find if someone is reporting old oil as new and charging accordingly. It will also find the reverse if they have new oil and are reporting it as lower tier.

Mr. ECKHARDT. Is it true that your audit system has revealed that in approximately 50 percent of the audits there have been variances in favor of the oil companies that is in favor of the higher priced as opposed to the lower?

Mr. SMITH. In terms of the audits of the crude producers completed to date, that is about right, Mr. Eckhardt. Forty-nine percent has been the violation rate to date but that needs to be qualified in two respects: First because of the complexities outside and second with respect to the property definition. As to the complex production patterns that are found in most major oil companies, we have been unable until the issuance of the clarifications to complete the crude production audit at any major oil company. We have been hung up on the issues.

Mr. ECKHARDT. In any case?

Mr. SMITH. In any major oil company, that is right. The 49 percent therefore applies only to the smaller segment of independent crude producers where we have been able to complete our audits under the previous rule.

Mr. ECKHARDT. You have completed audits with respect to independents but not with respect to any major at the present time?

Mr. SMITH. And not with respect to large independents whose production patterns run into the same kinds of interpretation difficulties as those of the majors, that is right, sir.

The second qualification is that that 49 percent figure must be taken in the context that some of it was very minor. We have had cases where several million dollars of transactions had occurred and we had \$800 or \$1,000 violations. Others have been very substantial in terms of several hundred thousand dollars, but overall in the independent crude producers we have finished the rate of violations with respect to the transactions has run about 1½ percent.

Mr. DINGELL. Would the gentleman yield?

Mr. ECKHARDT. Surely.

Mr. DINGELL. You have used a word that has different meanings in different contexts. You said "in the independent crude producers." For the purposes of our discussion here, could you define those independent crude producers, please. For the second part, could you also tell us what you found with regard to those who are not independent crude producers?

Mr. SMITH. Yes, sir. An independent crude producer, Mr. Chairman, is a producer of crude oil, the operator of a lease who is not affiliated with any refiner and therefore the oil moves from that production in at least one arm's length transaction before it gets to a refiner.

Mr. DINGELL. With regard to those who do not fall within the universe just mentioned—in other words, those who are affiliated with the refiner—can you tell us what your findings are?

Mr. SMITH. We have no findings based on completed audits, but based on audits in process, the estimate is that from that group even after adjusting, now that we can adjust for the interpretations issued in August, we expect to collect in excess of \$500 million in terms of refunds on the classification of what will turn out to be old oil that has been classified and sold as new oil.

Mr. DINGELL. Thank you.

Mr. SMITH. Yes, sir.

Mr. DINGELL. I thank the gentleman for yielding.

Mr. ECKHARDT. Now what do you intend to do, Mr. Hill, with respect to retrieving the excessive cost figures that have resulted from the wrongful reporting, if anything?

Mr. HILL. What do you mean by wrongful reporting?

Mr. SMITH. You mean in violation of the regulation?

Mr. ECKHARDT. Yes.

Mr. DINGELL. If the gentleman will yield, the Chair does observe that there are some small problems. Mr. Hill is leaving tomorrow and I am not sure that he can fairly give us an answer.

Mr. ECKHARDT. I am sure that is true. I am not asking Mr. Hill, I am really asking what is the policy of the agency with respect to this question at the present time. It may change very drastically in a short period of time.

Mr. DINGELL. That is true. We will need to have further inquiry into this matter in order to get a more precise answer. Now within those bounds the gentleman is of course free to ask the question, but I think that that question might best be definitively answered at some time in the future.

Mr. ECKHARDT. Well, I think that is true, Mr. Chairman. I am simply trying to raise this point. It seems to me that if there have been violations, the violations have been to the injury of other producers and to the advantage of a producer who is both in competition and who affects the average.

So to permit this to stand without some recertification it seems to me would create enormous inequity in the industry and I would assume that the agency, whoever it is headed by, will attempt to retrieve totally the amount of money that was wrongfully paid. For instance, it could do it by simply treating certain of the new oil as old oil by a given producer who had wrongfully reported over an equal period to the time that an equal quantity with respect to the wrongful reporting in the past and I would assume that that would be within the authority of the agency without statutory change.

Mr. HILL. That is correct. I think we have to break your question down or the possible actions into a range of categories. We have no evidence to this date of wrongful reporting. We do have evidence of wrongful or erroneous classification of oil as lower tier or upper tier.

Mr. ECKHARDT. I understand.

Mr. HILL. The indications are that when the data is reported, it is accurate in terms of what happened. Now what happened may have been in error. Our compliance program, Mr. Eckhardt, is actively engaged in auditing all of the producers to make sure that they properly followed the regulations. As Mr. Smith has indicated, from the audits that are underway to date we probably are going to find something in the range of \$500 million.

Mr. ECKHARDT. How much?

Mr. HILL. \$500 million of overcharges which will be returned back to the marketplace with interest.

Mr. ECKHARDT. Is that only with respect to these independents in which the audit has been completed and would there be the possibility of an additional amount with respect to other audits in the majors?

Mr. HILL. This is just simply a projection we made based on the results of both the completed and preliminary audits to date. It won't be any lower than that, and it could turn out to be higher. I might also add that it does include the majors. Besides individual producers

being in compliance with the regulations, which problems will be resolved through a refund of any overcharges plus interest, there is also a secondary problem of the producer who appropriately or correctly reduced his sale price but he sold against an FEA reference point that turned out to be in error vis-a-vis the composite price. The latter part of my testimony weighs out the several options that the agency is considering to correct that particular problem. You have to treat separately the producer in violation and the producer who is not in violation but is using reference points which have turned out to be about a percentage point off.

Mr. DINGELL. Would the gentleman yield at this point?

Mr. ECKHARDT. Yes.

Mr. DINGELL. I have some curiosity. Is there any question with regard to the fundamental responsibility of the individual to comply with the law as opposed to the question of assessment of interest or penalties?

Mr. HILL. There is no question, Mr. Chairman, about the individual's responsibility to comply with the law nor is there any question about FEA's responsibility to comply with the law in terms of designing a program that achieves the composite price and corrects more over time, either overcharges or undercharges, against that composite price. There are two compliance parts to this program and there is no doubt in our mind that both parts have to be complied with.

Mr. DINGELL. I am sure we are in agreement.

One point that troubles me is that we might have to distinguish in the instance of the producer functioning against guidelines that have been incorrectly conceived or drafted by FEA. We might have to discuss the question of penalties but I don't think there is any question of the responsibility, philosophically speaking, of the producer to the public. Nor is there any question, I think, with regard to the fact that fairness to all producers requires the law to be uniformly applied.

Mr. HILL. I think that is correct and that it be so applied with some degree of speed and efficiency because the longer these violations go on the more people in compliance are affected.

Mr. SMITH. Mr. Chairman, I think that is the key. You have identified the key issue with respect to these proceedings. Based on the information available to us, had all producers complied with the interpretation of the regulations, we would not be now projecting any excess receipts as of January. In fact we would have been recovered some time significantly earlier, and we would be in a position to resume the escalation of the composite price under the provisions of the act probably before January. Based on the estimates available, we could have done it some time this month, given the magnitude, or certainly during December.

One of the principal considerations in fashioning the appropriate remedy at this point is one of equity. Should one roll back prices for those producers who have complied with the regulation or should one protect the consumers' interest by requiring refunds plus interest on the amount of the overcharge for the period in question. The latter approach would assure compliance not only with the regulations themselves, but at the same time achieve overall compliance with the composite price limitation. Our data show that the composite price rules, for all of their overshooting in the first of the year, given the freeze,

would have brought us into compliance with the overall EPCA provisions had every individual producer complied with the regulations. The immediate thing that has to be done, without regard to a price rollback or something else, is to complete the crude producer audits and require the appropriate restitution for any who have misclassified the crude oil they have sold.

Mr. DINGELL. Giving due consideration to whether the penalty should be applied to willfulness or negligence or innocent misreading of the regulations?

Mr. SMITH. That is right. The issue of penalties is separate from rollbacks and interest on the amount of refund.

Mr. DINGELL. Rollbacks and/or freezes?

Mr. SMITH. I am sorry.

Mr. DINGELL. Rollbacks and/or freezes depending on the policy?

Mr. SMITH. No, sir. I am speaking of the compliance policy with respect to an individual producer who if he has the financial resources is required to write a check to the appropriate party for the amount of overcharges. As Mr. Eckhardt indicated, in the case of some of the smaller producers who don't have the financial resources, the remedy is to require them to charge a lower price for the appropriate period in question so that on balance they make up the amount of the overcharge plus the interest on that amount during the period. There is not any room for negotiation or adjustment, if you will, with respect to that part of the remedy. If the consumer has been charged too much, he gets every dime of it back plus interest for the period the producer had it.

The question of penalties is a separate issue, judged on a case by case basis as to whether there is any appearance of undue laxity with respect to complying with the regulations. Any evidence of willful intent to fail to comply with the regulations is investigated in detail and pursued with the Justice Department as a potential criminal action.

Mr. DINGELL. I think that two questions will arise at some future time to which your agency should be prepared to address itself. The first concerns the level of personnel that you have to carry out these functions. The second concerns the laying down of clear guidance on the points that we have just been discussing so that all may know what the situation is. I am not prepared to deal with them on Mr. Eckhardt's time but I would like you to be prepared to address them in future responses to the Chair.

The Chair will transgress further on the time of the gentleman from Texas to yield to counsel for some questions here at this time.

Mr. CURTIS. Thank you, Mr. Chairman.

I would like to explore for a while questions related to the compliance program. First, are the audits that you referred to conducted for the full range of properties produced by a single producer or do you do it on a property by property basis?

Mr. SMITH. In most cases they are conducted on the range of properties managed by that individual producer, but if a producer operates a substantial number of properties, the audit may be conducted on some of those individual properties. In other words, we may close out the results for some subset of that producer's properties in one action and then come back and get the other properties in a separate action, but

the majority of the cases involve all of the properties of a particular producer.

Mr. CURTIS. The price control mechanism as applied to old oil derives from Cost of Living Council regulations which were incorporated by FEO, later to become FEA, and have been in effect roughly since August of 1973. Those have remained substantially unchanged except as they may have varied by the new property definition adopted by FEA in August as I understand it.

Mr. SMITH. One other change was adopted in conjunction with the first stage rulemaking effective February 1, 1976, having to do with a modification of the specific mechanism for computing the base production control level and a provision for the adjustment of the base production control level on a 6 month period, but with that exception—

Mr. CURTIS. That change also eliminated the release barrel concept.

Mr. SMITH. Yes; but that has to do simply with the definition of how much is old oil. Once it is old oil your statement is correct that it is still CLC regulation.

Mr. CURTIS. For record purposes would you describe what compliance activities were engaged in for the 1973 period by CLC or FEO in determining compliance with the old oil price requirements?

Mr. SMITH. I would have to do some research and find that out for you, Mr. Curtis. I would be glad to do that and submit it for the record. I am not personally familiar with it. I can tell you about FEO.

Mr. CURTIS. Let's take calendar year 1974. Can you tell us the number of—first of all, what is the universe of producers?

Mr. SMITH. There are approximately 15,000 independent crude producers. Then of course there are 110 or so refiners many of whom have some crude production. So the universe is of the refiners who have some crude production of something like 85 and I will get you an exact number for the record and some 15,000 independent crude producers.

Mr. CURTIS. But you have over 15,000 crude producers. Can you tell us for calendar year 1974 what number of audits were initiated by FEA?

Mr. SMITH. I would like the opportunity to clarify this for the record, but to my knowledge none was completed during calendar year 1974.

Mr. CURTIS. How many were initiated in calendar year 1974?

Mr. SMITH. I believe we got a few started in December, but not more than a half a dozen or so in October 1974 or September 1974. When I assumed my present position on an acting basis, one of the first actions I took was a redirection of what was then FEA's compliance program inherited from the IRS and part of it from FEO.

Mr. CURTIS. What was the effect of that redirection in calendar year 1975? Just half a dozen or so audits initiated in calendar year 1974 of the in excess of 15,000 producers. In 1975 how many audits were initiated?

Mr. SMITH. Again I will get you the specific figure in 1975. To date as of the first of November we have closed 1,397.

Mr. CURTIS. That is the first of November of 1976?

Mr. SMITH. 1976, that is correct. We have completed and closed cases involving 1,397 producers and we now have 594 crude producer cases open and working. A number of those, as I indicated, have been

held up pending the clarifications of the regulations with respect to the issues involved in their application to circumstances that were not foreseen.

Mr. CURTIS. Just so we avoid mixing the calendar years, is it your response that you do not have the figures for the number of audits which were initiated in calendar year 1975?

Mr. SMITH. I don't have them available to me right now. I have them available in our system and will certainly provide them for the record.

Mr. CURTIS. Mr. Chairman, I wonder if the record can be reserved for a breakdown for each of the calendar years 1973, 1974, 1975, and 1976—the number of audits which were initiated, the number of audits completed and the findings for the completed audits.

Mr. DINGELL. I think that would be very helpful. Without objection, so ordered.

[The following information was received for the record:]

AUDITS OPENED AND CLOSED DURING 1974-1976

Responses to items a, b and d include only information pertaining to independent crude oil producers.

(a) Number of audits opened—1,894: January through December 1974, 119; January through December 1975, 761; and January through September 1976, 1,014.

(b) Number of audits closed—1,283: January through December 1974, 24; January through December 1975, 444; and January through September 1976, 815.

(c) Approximate size of producers in cases closed to date: The information provided below is based upon a project conducted August 10, 1976, in which 1974 Oil and Gas Reserves Survey volume data was made available for crude producer cases initiated after July 1, 1974. The following information pertains to only closed producer audits during this period with reported volumes (501).

Selected producer audits closed during July 1, 1974 through August 10, 1976, classified by annual crude oil production

Annual production—volume, in barrels:

1-10,000	144
10-50,000	142
50,000-100,000	74
100,000-500,000	99
500,000-over	42

(d) Amount of settlements—\$13,986,598: January through December 1974, \$48,815; January through December 1975, \$4,246,688; and January through September 1976, \$9,691,095.

Mr. DINGELL. After further scrutiny of the record and particularly of the response of FEA to the question of counsel, the Chair may wish to ask some additional questions for some further information. I think it would be helpful to know the amounts recovered, the penalties and so forth. I would like to have some appreciation as to the size of the companies involved, the number of majors, and how many were just independent producers with out refining capabilities.

The Chair recognizes the gentleman.

Mr. HILL. Mr. Chairman, if I may, I also would like to provide for the record a narrative regarding the history of the compliance program. Early in 1974 when FEO was using the Internal Revenue Service primarily during the embargo period, the principal focus of the compliance people in the field was essentially gasoline retailers and heating oil dealers, because of the tremendous difficulties that

were being experienced by our consumers both on the price side and on the allocation side. In late 1974 and 1975, the program began to shift to the large resellers, particularly of fuels to utilities and large resellers of propane and heating oil, moving somewhat away from the retail sector.

By late 1975, I think a very robust compliance program had evolved covering all the sectors of the petroleum industry in varying proportions. We discussed that somewhat with you last year, but we would like to put that as a part of the record, too, to show this shift and to give some indication as to how we are moving into the areas now that we had not done before just from a resource management point of view.

Mr. DINGELL. Mr. Hill, I think that would be helpful in terms of giving us perspective and giving the agency an opportunity to have a fair input into the hearing.

[The following statement was received for the record:]

HISTORY OF COMPLIANCE PROGRAM

Crude oil pricing controls were introduced in 1973 with the passage of the Emergency Petroleum Allocation Act (EPAA). The Federal Energy Administration (FEA) is responsible for both administering and enforcing the provisions of this Act, as well as the Energy Policy and Conservation Act (EPCA) of 1975 and the Energy Conservation and Production Act (ECPA) of 1976. The underlying intent of these acts is to monitor and control crude oil pricing while still encouraging increased domestic crude oil production. The FEA has developed a set of regulations which implement the basic petroleum pricing and allocation requirements of these Acts.

Beginning with regulations established as a result of the Economic Stabilization Act (ESA) of 1970, as amended, and carried forward pursuant to the EPAA of 1973, crude oil price rules have employed the concept of a "two-tier" price system. This system provided for a ceiling price on "old" oil (1972 production levels), but allowed "new" oil (that portion of total production exceeding old oil levels) to be sold at free market prices. In addition, "released" oil could also be sold at free market prices. "Released" oil is defined as a barrel of old oil from a certain property that is released from the ceiling price rule due to a new barrel of oil being produced from the same property.

On December 22, 1975, the President signed the EPCA which both extended and significantly amended the pricing regulations of the EPAA. The EPCA provides for a 40-month pricing program beginning February 1, 1976, with controls on all domestic crude oil production.

The previously price-controlled "old" crude oil, estimated to comprise 60 percent of all domestic production, was termed "lower-tier" oil. "New" oil was referred to as "upper tier" oil. FEA's implementation of the EPCA pricing provisions was approached in three stages.

The first stage, which became effective February 1, 1976, was intended to result in a maximum weighted average first-sale price ("composite price") of \$7.66 per barrel for domestic crude oil.

The second stage, which became effective March 1, 1976, implemented regulations for upward adjustment of the composite price. The regulatory provisions adopted in both these stages were applicable to all domestic crude oil production.

In the third stage, which is presently being planned, FEA will submit to Congress justification for increases in the composite price escalators. The third stage will also consider the need for additional incentives for usually high-cost domestic production methods such as tertiary recovery, deep horizons, and offshore leases.

Prior to the completion of action on the third stage implementation of the EPCA, Congress enacted the Energy Conservation and Production Act (ECPA) on August 14, 1976. The ECPA gives high priority to the implementation of incentives for the application of "tertiary enhanced recovery techniques" by removing the former three percent limitation upon the production incentive adjustment. An additional feature of the ECPA is that "stripper well" oil is again

released from price controls. "Stripper well" oil had not been regulated under the EPAA of 1973, but had been controlled at the upper tier under the EPCA of 1975.

In the early days of the Program under IRS, compliance efforts focused on violations which were readily apparent, easily remedied, and most often the subject of consumer complaint. In other words, most of the effort was concentrated at the retail and wholesale levels.

In late 1974, the FEA instituted a substantial reordering of priorities in its compliance program. Efforts were redirected away from the retail level and towards refiners and crude producers.

This redirection is demonstrated by the following statistics. RARP staffing has increased from 64 on-site auditors at the inception of FEA, June 26, 1974, to a presently authorized ceiling of 293 resident auditors. Staffing in the Crude Producer program has also increased from close to zero to almost 200 positions. In addition, the number of audits opened in the Crude Producer Program has increased from 119 in 1974 to 1,014 in 1976.

Mr. CURTIS. Let me return now to the current calendar year. Mr. Smith, you indicated you have completed 1,397 audits as I understood the figure. Now these audits that have been completed were, as indicated in the previous response to Mr. Eckhardt, generally speaking small and independent producers as distinguished from large independent producers and it is in these cases that you found roughly a 49 percent noncompliance. I understand that the range is significant. What is the cumulative dollar amount of overcharges involved in this noncompliance?

Mr. SMITH. The amount of the overcharges discovered in those cases is \$12.5 million and that represents 1½ percent of the total dollar volume of the transactions involved in those same audits.

Mr. CURTIS. You have remaining open and not completed 594 audits. I take it that within this grouping are the audits of all the major oil companies.

Mr. SMITH. Yes.

Mr. CURTIS. Which I understand no one of which has been completed.

Mr. SMITH. Yes; and neither have the large independent producers. Mr. Curtis, if I could elaborate just a minute, our overall strategy for crude oil compliance is to get the biggest producers first because they account for most of the oil. In moving into the program, we ran into a number of the issues that had to await regulatory resolution and so were able to apply the existing regulations only in the case of the smaller producers. We continued the program by getting the largest of the smalls, if you will, by trying to find as many as we could to whom we could apply the existing regulations. That is why the disparity between the results to date and what we expect to find when we get into the big volume producers.

Mr. CURTIS. Well, I take it the numbers are that you have got audits either completed or outstanding on roughly 10 percent of the numbers of producers but a much more significant proportion of the oil in production.

Mr. SMITH. Exactly.

Mr. DINGELL. I recognize the gentleman from Texas.

Mr. ECKHARDT. I just wanted to clear this up. I assume that these results you have got from the limited number of the audits projected out would give the \$500 million in overcharges for the period in question that Mr. Hill has referred to on page 22 of his testimony and I believe also Mr. Smith used that figure a moment ago in discussion with me.

Mr. SMITH. Yes, sir.

Mr. ECKHARDT. I guess it was Mr. Hill and I think Mr. Smith made it clear that that applied to both large and small companies, it is a projection of the whole field.

Mr. SMITH. Yes, sir, and the projection on the large ones is based on the results of preliminary audits to date. It is more than just a mathematical projection of the \$12.5 million so far across the total industry.

Mr. CURTIS. Let me ask a few questions on that. You mentioned in response to an earlier question that with respect to producers who produce from a number of properties and especially in cases where those properties are widely scattered throughout the country that you made complete audits in part. Do you have partial completions of the number of the remaining 594 and is that the basis for your estimate of \$500 million in overcharges?

Mr. SMITH. That is right, Mr. Curtis.

Mr. CURTIS. These are partial completions?

Mr. SMITH. I am sorry. When I say partial completions I don't mean we have completed part of their properties. What I mean is that we have done a substantial amount of audit work, identified substantial divergencies in classification, and have adjusted for the resolution of the outstanding issues in making this estimate. Based on the work done on those cases to date, our estimate is that we are going to get something in excess of \$500 million. Frankly, the estimate by the auditors is substantially larger than that. I have been burned often enough by that. Auditors tend to get optimistic about the extent of the refund and I have reduced that.

Mr. CURTIS. What is the estimate?

Mr. SMITH. They come a lot closer to \$700 million, but I am only saying over \$500 million.

Mr. CURTIS. Are you reasonably confident that there is at least \$500 million?

Mr. SMITH. Yes; I am. I am confident there is more than that out there but I am not willing to go on the line as to exactly how much more at this point. I am confident that there is at least that much and some more.

Mr. CURTIS. Can you give us some estimate of whether the percentage of violations—that is, 49 percent violations which you found with the small independent producers—is characteristic of the ongoing audits? Are you finding violations in 50 percent of the cases?

Mr. SMITH. In the 594 open cases?

Mr. CURTIS. Yes.

Mr. SMITH. Well, all 594—no, that is an overstatement. The vast majority of the 594 are potential violations which is why they are still open and have been held up. If they had found out that there were not any violations, they would have been closed.

Mr. CURTIS. So you have completed audits of 1,397.

Mr. SMITH. That is right.

Mr. CURTIS. Half of those have closed out with no violations shown.

Mr. SMITH. That is right.

Mr. CURTIS. Half have shown violations.

Mr. SMITH. That is right.

Mr. CURTIS. In the aggregate amount of \$12 million, but as you point out between 1 and 2 percent of the receipts collected by the producers.

Mr. SMITH. Yes.

Mr. CURTIS. In this universe.

Mr. SMITH. Yes.

Mr. CURTIS. And the second universe outstanding which is 594, the reason for their noncompletion at this date is that the vast majority then have shown compliance problems.

Mr. SMITH. That is right.

Mr. CURTIS. And that their noncompletion relates to a noncompliance so that you might expect upwards of 70 or 80 percent of those will test out as noncompliance.

Mr. SMITH. Exactly. That is exactly right.

Mr. DINGELL. I am curious.

Mr. CURTIS. Which means of the 10 percent of producers that you are auditing you found much more than 50 percent in violation?

Mr. SMITH. Yes.

Mr. CURTIS. Mr. Hill in response to the reflective concern of the chairman of the committee on the need to pursue with alacrity the compliance program mentioned that it must be applied with speed and efficiency because these are long-standing violations and the longer they exist it becomes much more difficult to recoup the amount of the overcharge because of cash flow problems, reinvestment, et cetera. Now that the so-called property definitional problems have been dealt with in the administrative finality, can you give the committee a date when these outstanding audits may be completed? Is it within the next couple months?

Mr. SMITH. No; it is not within the next couple months. We are talking about 6 to 9 months.

Mr. CURTIS. When is the first audit likely to be completed of a major oil company?

Mr. SMITH. I would prefer, Mr. Curtis, to provide the answer for the record after consulting in more detail with my people on the individual status of the audits.

Mr. CURTIS. Mr. Chairman, I wonder if the record might be reserved at this point for the status report that Mr. Smith just described on each of the audits with a projected completion date.

Mr. DINGELL. I think that would be very helpful.

[The following information was received for the record:]

STATUS REPORT ON AUDITS

Compliance has given top priority to completing the open crude producer audits of the 20 major oil companies. These companies account for approximately 70 percent of total domestic production. These audits were based on a sample of the companies leases and cover the period from September 1973 to September 1975. Much of the audit work at the major refiners is complete but the audit results must be reevaluated in light of the property definition clarification issued August 26, 1976. One must understand that crude production audits at the majors are extremely difficult because of their size. For example, the largest number of leases operated by a major is over 8,000 whereas most independent crude producers have less than two hundred lease holdings. Until this first phase of audits is completed and future audit requirements can be determined, it will not be possible to project a completion date of the audits of crude holdings of the major oil companies.

Mr. DINGELL. I am rather concerned about audits prepared with respect to the majors because, as I gather it, the audits are not all going forward.

Mr. SMITH. They are now, Mr. Chairman. They are now in progress because we have been able to resume them since the issuance of the property definition in August.

Mr. DINGELL. I think that would be very helpful for us to receive.

Mr. SMITH. Mr. Chairman, I think to give a balanced picture I should elaborate on my earlier response to Mr. Curtis' question about finding more than half of those we opened audits on in violation. The reason for that is that we have tried to carefully target the selection of people for audit based on the reports available to us; for example, an analysis of the FEA form 90's for people who show higher proportions of new oil and any other indications we can find. We have tried to target our audits on those people who appear to be most likely in violation. It would be misleading in the extreme to generalize from the experience of these carefully targeted audits to arrive at a conclusion that well over half of the 15,000 crude oil producers have in fact been in violation of the regulations. There is simply no basis for that kind of a conclusion.

Mr. CURTIS. Your targeted group shows much more than half in violation.

Mr. SMITH. Yes. The point is though the people we select are those who appear to be most likely the violators so we have taken a very unrepresentative sample of the universe of 15,000 crude producers. We have looked at many more who showed no evidence at a very early pass that there would be any reason to suspect a violation at this time and never even considered them. The only point I want to make is that there is no basis whatsoever for coming to a conclusion that half or more than half of all the crude producers in the country have violated FEA's regulations. We have selected here a sample of a little less than 10 percent of them, and that has been a sample that has been carefully selected based on what we can know about the likelihood of a possible violation. We found more than half of that sample in violation which simply says we have had a reasonably good system for targeting crude producer audits.

Mr. DINGELL. I applaud that. You have indicated then that your unrepresentative sample indicates that you have violation of 1 in 2 or 50 percent. I am advised here by Mr. Curtis that it is better than 50 percent.

Mr. SMITH. Yes.

Mr. HILL. To elaborate a little bit more we have an internal system in FEA where we take our past experience and look at situations which seem to lead to violations of the regulations. We take our data from the form 90 and determine that certain kinds of data images or reflections in the data also can lead to instances of higher violation in certain situations. We have done that examination and picked those from this computer profile which indicate the most likelihood of violations. It is like the IRS system.

Mr. SMITH. Mr. Chairman, if our targeting system were good enough, we would show 100 percent violation or nearly 100 percent in those people selected for audit.

Mr. DINGELL. I appreciate that. What we are really talking about then is the level of something on the order of 65 percent of your 10 percent sample.

Mr. SMITH. That is right. That should be taken as a confirmation that our targeting system is working and helping us improve the efficiency of the program. It should not be taken as a conclusion by any means that anything like that percentage of crude oil producers has in fact been violating FEA regulations.

Mr. DINGELL. I am not drawing that inference. As a matter of fact, the next question I propose to ask is what can you tell us about the 90-plus percent that you have not begun audit on? Where do they fall as far as violation? Can you give us any appreciation on that?

Mr. SMITH. No, sir, I can't. All I can tell you is—

Mr. DINGELL. You have made some projections of approximately \$500 million in violations. Now is that just with regard to the 10 percent you have audited?

Mr. SMITH. Yes, sir.

Mr. DINGELL. Or with regard to the industry as a whole?

Mr. SMITH. That is the 10 percent, by the evidence available to us, which appear to be most likely in violation. I cannot tell you anything based on statistical results about the rest of the industry. I can tell you that a substantial number of the remainder have gone through that target screening system and have not yet been selected because there was no evidence to lead us to think they would be high probability violators. That does not mean we can—

Mr. DINGELL. What was the number of those that have gone through your screening system?

Mr. SMITH. I will have to get that for the record.

Mr. DINGELL. Would you, please.

Mr. SMITH. Yes.

Mr. DINGELL. Now, you have \$500 million in violations with less than 10 percent of the industry involved. Admittedly, we are agreed that this is a high 10 percent or a 10 percent by reason of your preliminary screening. What can you tell us about the other 90-plus percent? Where do they fall and how much money is involved in the balance of the industry?

Mr. SMITH. The answer is, Mr. Chairman, we cannot tell you anything with certainty about the remainder of the industry except that we can say that the probability that the remainder of the industry would be in violation to this same extent is virtually zero.

Mr. DINGELL. Virtually zero.

Mr. SMITH. To the same extent. I grabbed the best targets, picked the cream off the top, went to work on them, and found that about 65 percent of them are in violation. Now I simply can't tell you anything with certainty about the remainder except that they present a less likely opportunity for violations than the ones we did pick.

Mr. DINGELL. As a matter of fairness to those in the 10-percent sample you are looking at, why don't you go after the rest of the industry?

Mr. HILL. Let me take that.

Mr. DINGELL. You ought to figure out what their level of violation is.

Mr. HILL. Mr. Chairman, when we submitted our budget last year we laid out to the appropriations committees the overall audit program

indicating 10 categories, among them crude producers, refiners, and resellers, and the level of frequency on which audits would be performed. I would be glad to provide that to you and your staff for your information. It is confidential information, but I think you will see that throughout the course of the program every crude producer will be audited. Some will be audited more frequently than others, but that was all laid out in our budget justification.

Mr. CURTIS. I do not understand that every producer will in fact be audited, is that correct?

Mr. HILL. What is the frequency variations?

Mr. SMITH. I will have to provide for the record the percentage of the total coverage involved. The concept, Mr. Chairman, was to first audit all refiner producers, both major and small refiners. All of them would be audited. That accounts for about 65 percent of the total production. Then for the remaining 35 percent of the total crude produced in the country, select 20 percent of the independent producers who accounted for the majority of the volume. This 20 percent accounts for about 85 percent of that volume produced in the independent sector. Thousands of little guys account for the rest of it. The plan is to audit all of the 20 percent during the life of the regulatory program and then screen the remaining 12,000 or 13,000 little ones through the targeting system and audit as many of those who looked like potential violators as we could with the resources available.

Mr. DINGELL. Can you tell us how many you requested in terms of numbers of auditors and how many you got?

Mr. SMITH. Yes, sir.

Mr. DINGELL. Can you tell us how many? Can you also tell us the frequency of audit? Furthermore, I would like to know the difference between the numbers of audits you could have carried out with the personnel you requested and the number of audits you are carrying out with the number of auditors you actually got.

Mr. DINGELL. Can you give us some appreciation of that now and a more definitive statement for the record?

Mr. SMITH. The President's budget, Mr. Chairman, contained a request for 1,326 personnel in the compliance program, an increase of 263 over its authorized base staffing of the previous fiscal year. That was for fiscal year 1977.

Mr. DINGELL. That is what you requested?

Mr. SMITH. Yes, sir.

Mr. DINGELL. 263 more.

Mr. SMITH. Yes.

Mr. DINGELL. What was the number you had last year?

Mr. SMITH. The appropriations committees and the appropriations bill approved that staffing level for the program, sir.

Mr. DINGELL. They approved 263?

Mr. SMITH. They approved 263 more for a total staff of 1,326.

Mr. DINGELL. Of auditors?

Mr. SMITH. That is total staff in the compliance program; auditors, managers.

Mr. DINGELL. Secretaries, custodial employees, and that sort of thing?

Mr. SMITH. Yes.

Mr. DINGELL. In terms of enforcement they may be useful but —
Mr. SMITH. They are necessary to support the auditors, Mr. Chair-
man.

Mr. HILL. That is fiscal year 1977.

Mr. DINGELL. Sir?

Mr. HILL. That is fiscal year 1977.

Mr. DINGELL. Can you give us some appreciation of your request for 1978?

Mr. HILL. I cannot at this point, Mr. Chairman.

Mr. DINGELL. I think that would be helpful. Is it too early to give it?

Mr. HILL. Yes, sir.

Mr. SMITH. The President has not yet made a decision on the budget levels to request for 1978, Mr. Chairman.

Mr. DINGELL. Can you give us some appreciation of how many of the personnel you have outlined to us are in fact involved in crude oil pricing and the crude oil pricing audit?

Mr. SMITH. Yes, sir. In the material that we will submit in response to the earlier question by Mr. Curtis we will outline and give you a summary of the distribution of those personnel across all 10 of the compliance programs that we are operating and outline explicitly the total number of personnel devoted to the crude producing area.

Mr. DINGELL. Could you give us also a horseback estimate right now?

Mr. SMITH. Mr. Chairman, it is on the order of some 350. That is to the best of my recollection, sir. That is in the independent crude producer area. The majors that account for most of the production, the audit of crude production in the majors is incorporated as part of the ongoing refinery audit program and there are no specific numbers of people devoted to this. That is simply a question of directing the efforts of the resident teams in the major refiners to that particular area.

Mr. DINGELL. As opposed to major oil refiners?

Mr. SMITH. Yes.

Mr. DINGELL. We want to keep that straight because we sometimes use the words differently at different times.

The Chair is going to yield back to counsel.

Mr. SMITH. That material will be provided in detail for the record, Mr. Chairman.

[The following information was received for the record:]

Compliance staffing—fiscal year 1977 authorization

Program :

Importers	19
Crude oil resellers.....	18
Independent crude producers.....	336
Major refiners.....	337
Small refiners.....	52
NGL	99
Propane resellers.....	36
Propane retailers.....	63
Resellers—Other.....	172
Retailers—Other	32

Mr. CURTIS. Just to summarize, Mr. Smith, of the 10 percent targeted audits, as I understand it the producer subject to those audits accounts for some 80 percent of domestic production.

Mr. SMITH. That is right.

Mr. CURTIS. You believe that you have violations of that targeted group in excess of 50 percent, you don't know how much, and that the dollar amounts involved are ranging between your certain or confident estimate of \$500 million—that is, in addition to the \$12 million of those already completed—and could range as high, based upon your auditors' estimates, as \$700 million, the bulk of the money is involved in the 594 cases which are yet to be completed and that you are looking forward to a completion date of roughly between the next 6 to 9 months for this universe of uncompleted audits. If your audits are not completed for the remaining 6 to 9 months, how can you take action prospectively with respect to these producers which would recover the amount of the overage in the program which was suggested in Mr. Hill's statement anywhere in the near term? Does that mean that the recovery to the extent that it exists will be deferred until the end of 1977 through 1978?

Mr. SMITH. The recovery from any individual producer, Mr. Curtis, has to be deferred of course until the audit is complete and the remedial order is issued.

Mr. CURTIS. Then I take it that there could be an appeal from the remedial order both in internal review within FEA and then court appeal?

Mr. SMITH. Yes; those are possible.

Mr. CURTIS. Is it conceivable that that machinery could get us beyond the 40-month control period which would terminate in May of 1979?

Mr. SMITH. I don't think so. I don't see that it could be that way. It is conceivable if we went into litigation on some of the points. Mr. Wilson advises me that the litigation could well extend beyond that period.

Mr. CURTIS. Isn't there an incentive on the part of producers to in fact litigate necessary matters beyond the control period?

Mr. SMITH. I am not sure because FEA has the authority to fashion the appropriate remedy even beyond the controlled period. This is incorporated in the law itself in the EPAA.

Mr. CURTIS. The EPAA would do that with respect to these producers for a period beyond the control period?

Mr. SMITH. If it needed to, yes.

Mr. CURTIS. Both necessitating a blanket extension of that control program beyond the period, is that correct?

Mr. SMITH. Yes.

Mr. WILSON. Yes; our savings clause expressly allows that.

Mr. CURTIS. That recovery would be in some period in 1979 or 1980.

Mr. WILSON. Of course you would have enormous mechanical problems such as everybody is selling crude oil at the market price and some people selling below that. You would almost have to continue an entitlements program or something of that sort.

Mr. CURTIS. The redeeming grace of the current program is if you compel some producer to classify his old oil in proportion to the amount of the past violations that the entitlements program equalizes the refinery level so that you don't get a preferred customer problem, is that correct?

Mr. WILSON. That is right.

Mr. DINGELL. Am I fair in inferring that the standard period for audit, correction, and penalties, et cetera, for those in violation of the regulations will be 6 to 9 months?

Mr. SMITH. No, sir.

Mr. DINGELL. You have indicated that that would be the case in connection with these approximately 10 percent.

Mr. SMITH. That is right. That is the case with these open cases because these are the largest and most complex of the entire set of cases, Mr. Chairman. That is the reason it is going to take a substantial amount of time to complete them even though we have done all the work we could do up to this point on them.

Mr. DINGELL. You say the largest and most complex. Then, you are talking about the largest of your producers or—

Mr. SMITH. Both. Both the largest producers and the largest dollar amounts involved, yes.

Mr. HILL. They will vary, Mr. Chairman, from case to case. Some of these 590 cases may be closed in the next several weeks, some of them may not be closed for 6 months, some 9 months. Some will be litigated, some will not be litigated. They will vary internally.

Mr. SMITH. The 6 to 9 months referred to my estimate to wrap all of those up that turn out to have violations, Mr. Chairman.

Mr. DINGELL. Mr. Curtis has asked you for your comments with respect to these violations overlapping the end of the period for control set out in EPCA. I am troubled about this. Are you prepared at this time to make any recommendations about what we are to do if such an overlap does occur? It would seem to be pretty obvious what the legislative intent was with regard to such violations. Maybe you would want to think about that and give us some suggestions or comments.

Mr. SMITH. I would prefer to have a chance to study that a little bit before we give you an answer.

Mr. DINGELL. I think that would be fair to all of us.

[The following information was received for the record:]

STATUTES UNDER WHICH FEA'S OFFICE OF COMPLIANCE ENFORCES PRICING,
ALLOCATION, RECORD KEEPING AND REPORTING RULES

The FEA's Office of Compliance presently enforces pricing, allocation, record keeping and reporting rules which have their authorization in a number of statutes:

- (1) Energy Conservation and Production Act (P.L. 94-385, 8-14-76).
- (2) Federal Energy Administration Act of 1974 (P.L. 93-275, 5-7-74 as amended by P.L. 94-332, 6-30-76 and P.L. 94-385, 8-14-76).
- (3) Emergency Petroleum Allocation Act of 1973 (P.L. 93-159, 11-27-73, as amended by P.L. 93-511, P.L. 94-99, P.L. 94-133, P.L. 94-163 and P.L. 94-385).
- (4) Emergency Petroleum Allocation Act of 1975 (P.L. 94-99, 9-29-75 as amended by P.L. 94-163).
- (5) Economic Stabilization Act of 1970 (P.L. 91-379 as amended by P.L. 93-28 and P.L. 92-210)—incorporated, in part, by reference in numbers 1, 3 and 4 above and by incorporation of rules issued pursuant to the ESA.
- (6) Energy Policy and Conservation Act (P.L. 94-163, 12-22-75 as amended by P.L. 94-385).

Mr. DINGELL. Now I have a further question. We have been addressing ourselves to the 10 percent being audited. What will transpire with regard to the other 90-plus percent of the producers? How are you going to assure that there are no violations in these instances if you are not auditing?

Mr. SMITH. We use the same approach the Internal Revenue Service uses, Mr. Chairman, and without going into too much detail that is how we developed the approach. A number of our people have come from the Internal Revenue Service plus we have worked with them in developing the approach to this program and the approach to the remainder of the universe. As to the large number of small producers who account for a small part of the production, the procedure will be to continue to screen the reporting forms.

For example, on the P-124 that was instituted in conjunction with the first stage rulemaking to get the pricing data, we have devised a second stage of that form requiring more detailed reporting by the first purchaser on a property by property basis from the people from whom he buys crude oil explicitly as an input to the compliance target selection program for crude oil producers. In effect it will be used the same way as the 1040 is used by the IRS. We will collect this data monthly and screen it, and when we see the right kinds of variations or the right kinds of indicators we will select that particular small producer for an audit.

Mr. DINGELL. Am I fair in saying that you propose to go through a pattern of screening through smaller and smaller mesh to try and catch the violations in terms of descending order of probabilities, of magnitude of money involved and of size of producers involved?

Mr. SMITH. Well, the magnitude of the transactions involved, Mr. Chairman. In other words, there are two components to the program. The first is to assure compliance on a universe basis by that fraction of the universe including the major refiners and the large crude producers who account for the majority of the production, and then to screen the remainder of the producers and devote the available resources to those who appear most likely to be in violation.

Mr. DINGELL. Can you give us some appreciation of how long the screening will take?

Mr. SMITH. Well, it will be a continuous process, Mr. Chairman, in the sense that the screening will go on continuously. We don't ever expect to audit every crude producer if that is the sense of the chairman's question. We don't expect to audit each of these 15,000 people nor do we deem it necessary to do so, sir.

Mr. DINGELL. I am only trying to figure out how fast you are going to get down toward the bottom and where you think the bottom is in terms of cost-effective auditing. Also, what will the unaudited residue be and why? I am not sure that I have gotten answers on this matter.

Mr. SMITH. Yes, sir. I think the only thing I can tell you, sir, is that we will go as far as we can with the resources available and apply those resources to the producers who account for the largest amount of the volume. Given the ability to conduct so many man-years of audits, we will see that those man-years go to those areas where it appears that the consumer may have been overcharged the largest amount. That is the first criterion.

The second criterion which is the judgment of how far one should go in a compliance program, is one that is resolved in the budget preparation and appropriations process. I can only assure the chairman that I have always gone into that process on the high end of

the scale and will continue to do so as long as I have the responsibility for submitting budgets.

In principle it would seem to me that the easy criterion would be that as long as the program is at least paying for itself in terms of refunds to consumers, it is a program that is worth its effort. Right now we have about a 5 to 1 ratio. We are getting back not just in this program but in all 10 of our compliance programs, something close to \$5 in terms of refunds, rollbacks and avoidance of potential overcharges to consumers. We are getting about \$5 for every dollar that we are spending on the program. Now unfortunately those don't show up in an actual budget offset so it is easier to convince some people that that is a good ratio than it is others.

Mr. DINGELL. Thank you.

Mr. Curtis.

Mr. CURTIS. Thank you, Mr. Chairman.

I would like to shift to another aspect of the administration of EPCA pricing requirements. Just to summarize the scenario of experience in administering that program, the initial price regulations as Mr. Eckhardt pointed out missed the estimate of mix and missed the estimate of price on both the lower tier of oil and the upper tier of oil creating a composite which was in excess of the statutory limit, that when that data firmed up for you in June and FEA made the determination of the freeze which took effect July 1 and was as initially proposed to remain in effect for 3 months and that had subsequently been extended for 3 additional months or 2 months.

Mr. SMITH. July and August and then that was extended an additional 3 months.

Mr. CURTIS. At the time that FEA promulgated its regulations addressing the property definition problem as well as the posted price clarification, et cetera, you had approximately \$160 million in cumulative overcharges resulting from the mix in the initial regulation, is that correct?

Mr. SMITH. This is as of August?

Mr. CURTIS. In August when the regulation was promulgated, an overcharge that you were attempting to address by freezing the adjustment on both lower and upper tier prices and letting the composite catch up which was moving by 10 percent.

Mr. CHRISTIE. The end of August the figure is about \$160 million. In August, let me check and see what our projection was at that point in time.

Mr. CURTIS. Well, in your September 28 letter to the committee you were showing preliminary data estimating \$160 million in August.

Mr. CHRISTIE. That was a projection, right.

Mr. SMITH. It turned out to be \$164 million on the basis of later data.

Mr. CURTIS. As I understand it the prospective change in the property definition which allows a calculation of the base period control level volumes to treat separate reservoirs within the same property for the first time in your regulatory history, your preliminary data show that that accounts for approximately a 1 to 1.5 percent shift from lower tier to upper tier, is that correct?

Mr. SMITH. That is correct.

Mr. CURTIS. A summary of your statement, Mr. Hill.

Can you give us a dollar value on that? Can you express that in dollar terms?

Mr. CHRISTIE. You mean the difference?

Mr. CURTIS. How much is it valued at? If you get a 1 to 1.5 percent shift from lower tier to upper tier, how much further out of compliance with the composite does that make you if that holds?

Mr. CHRISTIE. Let me give you the answer. The difference between a 1 percent shift and a 2 percent shift in terms of excess receipts at the end of January 1977 might be of the order of \$80 million—between \$70 million and \$80 million difference at the end of January. Now it will vary from month to month.

Mr. CURTIS. That is \$80 million a month?

Mr. CHRISTIE. No; that is total cumulative by January of 1977.

Mr. CURTIS. By January?

Mr. CHRISTIE. That is right?

Mr. CURTIS. Can you tell us what figures you had to estimate the impact of the shift of lower tier to upper tier oil which would result from the change in property definition at the time you promulgated it in August?

Mr. SMITH. I certainly can, Mr. Curtis. We had estimates from as many people as thought they knew how to address the issue but we didn't have any specific information.

Mr. CURTIS. You basically had no information, yet you knew it would bias the composite?

Mr. SMITH. The direction was clear, that is right.

Mr. CURTIS. Now in February of 1976 in implementing the first stage FEA also considered at that time a redefinition of property and made the following statement:

After consideration of all the written and oral comments submitted in connection with the first stage proceeding FEA determined that it was not possible at that time to evaluate with any degree of certainty the effect on the proportions of old, new and stripper well release crude oil that would result from a change in the basic property concept; accordingly, the reservoir concept was not added to the definition of property.

Apparently in August of this year you still had no means of evaluating the shift that would occur and yet you proceeded to promulgate it and this was done at a time when you were known to be cumulately \$160 million out of compliance. Can you supply for the committee the rationale for taking that step in the absence of information dissuaded you from taking that step?

Mr. HILL. Mr. Curtis, let me break that into several parts. I think you have to recognize first that the whole property definition issue was a question that took a little over a year to evaluate. We started that evaluation early or about mi-1975 and completed that effort in August of this year.

The principal focus of that evaluation was to try to determine problems with past interpretations of the property definition or applications in terms of their impact on production and incentives for production and the ease of administering the regulatory compliance program. We tried to develop a property definition which would be not only easily applied by those in the field and by FEA auditors, but also one that would provide within the context of the composite price a maximum incentive for production.

The focus was on the theoretical side. We were unable throughout that period to determine or to collect data on exactly how much the shift from lower tier to upper tier might be. It has been our experience that it is very hard to predict those kinds of things in advance so you have to set up the regulatory program in terms of certain objectives, in this case being to maximize production consistent with the composite price, then to collect the data once those interpretations are put into the effect and to make any adjustments that are necessary once you have enough data. It is very hard to do that in advance. The objective here again was to maximize production, not to change the ratio. We did have information that the shift would be from lower to upper tier. That was theoretical information and not hard data.

Mr. CURTIS. Is it correct, Mr. Hill, that had the property redefinition not been promulgated that you would have recovered the overage by maintaining the freeze through the second 6 months had the overage occurred in the first 6 months?

Mr. HILL. That was our projection, Mr. Curtis. At the same time I think —

Mr. CURTIS. Which is the statutory requirement, is it not?

Mr. HILL. Correct, but it was also our feeling that given some of the perverse incentives of the property definition as it had been promulgated in August of 1973, it was more important, since the property definition is really the building block of the whole two tier regulatory program to establish an adequate property definition and then to make whatever corrections were necessary to account for any excess receipts which resulted from that. In our minds, it would have been very detrimental to the long-term program in crude production to have avoided changing or improving the property definition solely because of excess receipts.

Mr. SMITH. Let me also add —

Mr. CURTIS. Just one moment, Mr. Smith. Let me ask this.

If you are evaluating the effects after the occurrence of the change in regulation, looking forward to making in the future whatever adjustment proves to be necessary, don't you introduce an element of uncertainty in the regulations? Indeed, aren't we speculating now that we will either need a legislative change adding 90 cents to the composite or effect a rollback in order to recover the overages in the beginning of next year? How does that fit with the objective of the act to set out a stabilized price structure over the 40-month period upon which producers may plan their investment positions and consumers may evaluate their consumption patterns?

Mr. HILL. I think there is a great deal of uncertainty associated with the whole composite price concept and its implementation unfortunately, but I think at the same time we have to recognize the tremendous importance, at least in terms of the overall regulatory program of having a robust and vigorous and good property definition. If we would have tried in August or September to estimate what the impact might be, it is likely we would have been wrong so we would have made some prior adjustment at the time we were making the change but then we would have had to come back again several months later and make a further adjustment. It was our feeling that it was better to have a one time adjustment, collect the data, feel

confident about the impact and make the adjustment once instead of trying to predict it and then having to adjust again several months later to correct the error. So it was a matter of minimizing uncertainty in a situation we knew was going to be uncertain.

Mr. CURTIS. In ruling 1975-15 the Federal Energy Administration attempted to lay to rest, as I understand it, the various interpretative problems that may have arisen in connection with the property definition. In August of this year the regulation did two things: One, it made a perspective change in property definition to incorporate a reservoir concept and, two, it reinterpreted the property definition giving administrative finality to these interpretations through the control period. Was the reinterpretation labeled "administrative finality" an overruling of the ruling of 1975-15 at least in part?

Mr. WILSON. Possibly in part. Let me try to explain the process that we go through in one of these regulations. Essentially you start with a general regulation which is developed in the broadest sort of conceptual terms which is usually done on economic theory and unfortunately at the time the Cost of Living Council was doing many of these without a great deal of expertise in the industry. You then go ahead and try to apply that regulation and you soon find that people come in and ask for guidance which means that you have to start issuing various rulings and the like which in the producer area I would say the first rulings that we came out with were rulings concerning stripper well leases.

We also would run into other problems as the compliance effort would start taking effect. The other area in which we had a great degree of difficulty was with the natural gas liquids where the same producers were producing condensate and natural gas liquids and were inquiring exactly how that was treated. Since we had not specifically set forth detailed regulations in that regard, we had to address that.

We had a series of other rulings dealing with various aspects of stripper well production and other aspects of crude production. As the compliance effort proceeded and more people came in, more questions were raised. We began to see broader issues that were common to a great number of people and this finally culminated in August 1975 by issuing ruling 1975-15 which dealt with a large number of basic issues with respect to the property definition.

Once you do something like this it in turn raises new issues, it brings new people in to see you, it communicates to you more information about the industry, it tells you how people have been operating, how they have been interpreting it. With respect to many of our rulings, we get subsequent comment on those rulings. We go back and we readdress them. Sometimes after reconsidering we determine that the first ruling was not legally sufficient and we either rescind portions of that ruling or make changes. Generally we have not done this. Usually rulings really are addressing new fields.

With respect to the occurrences after we issued ruling 1975-15, we had a number of people who came in and told us that really they had been interpreting the definition of property to mean that they could use a reservoir basis and they urged us to adopt that definition of property. We considered this in the first stage rulemaking and decided to reject it at that time because we were not certain what the implications would be.

However, we continued to address the issues that had come up after that and this again culminated in a second interpretative ruling which was in the preamble of the property definition rulemaking on August 20, 1976. This interpretative ruling basically addressed new issues, new areas which had not been addressed in ruling 1975-15. It also prospectively amended the definition of property to now state that you could use a reservoir basis for this definition but that retroactively you could not do that although in certain instances you could use things other than a strict interpretation which would limit it solely to a lease. Since that time we have received additional comment.

We are now in the process of coming out with a further proposed rulemaking to address additional areas in this field and I anticipate as the compliance effort proceeds and we cover sets of new problem areas we will have a series of rulings which will have to continue to interpret these. What you do is sort of move from one level to the next. You take the broadest issues first and then after you cover those you move down to the next level. You may try to give some clarifications with respect to how you dealt with the issues on the first level over the second level, the second level over the third level. We are on about the third level now and I am sure we will go on until such time as we have addressed many more either in terms of rulings which are generally applicable or in compliance cases where we just make a determination with respect to an individual who may have a unique problem.

Mr. CURTIS. I would like to ask a series of questions on action taken in August of this year which I do for the purpose of eliciting record statements, not to imply criticism or quibbling with the action taken.

The 594 ongoing audits yet to be completed you indicated in an earlier response, Mr. Smith, that in essence these were held in abeyance pending the further definition of the property concept to assist the auditors in proceeding with the audit and in that sense this has now been accomplished, that those audits will now proceed to completion, is that correct?

Mr. SMITH. That applied to the substantial number of 594, not necessarily to all of them.

Mr. CURTIS. Now Mr. Wilson has just notified us that you intend yet a further redefinition of property as a proposed rulemaking. Will that—

Mr. WILSON. Excuse me. It is not a redefinition, Mr. Curtis. It is a ruling as to the correct application of the definition as it was issued in August 1973.

Mr. CURTIS. Well, when it is supplied retroactively I take it it has the same effect as a redefinition.

Mr. WILSON. We basically have to describe what that definition means, whether it is a very broad one sentence definition. There are a very great many factual definitions.

Mr. CURTIS. Would the 1974 audits be suspended yet anew on this?

Mr. WILSON. No.

Mr. SMITH. No. The work that is underway now is work that can proceed on some of the issues that were resolved by the August 19 rulemaking proceeding and some of those will be able to be completed without any further reference to regulatory issues. Others involve the kinds of regulatory issues Mr. Wilson described, and for ones affected by those, the work will proceed as far as it can. That is why we are try-

ing to get the kind of additional information that Mr. Wilson referred to.

Some of those have been generated by comments from the industry, others have been generated by our compliance program. When we and they participated in the review of the August 19 rulemaking, there were still unanswered questions, which we must have a ruling on or at least a determination on a case-by-case basis.

Mr. CURTIS. Now your estimate of between \$500 million to \$700 million in noncompliance in the remaining 594 audits, how was that affected by the clarification ruling of the applicability of the property concept? Does that wipe any portion of that out or is that a measure of violation over and above what may have been involved in those applications of the property definition?

Mr. SMITH. It is the latter.

Mr. CURTIS. Do you have any estimate as to the value in dollars of noncompliance which would have been occasioned by a strict or literal interpretation application of the property definition had you not made the clarification adjustments contained in your August release and applied those with administrative finality?

Mr. SMITH. No; I don't have one, Mr. Curtis.

Mr. CURTIS. Do you have an appreciation that they may be substantial?

Mr. SMITH. I would have to get the auditors to review the individual cases to find out. I really would not want to give an answer since we did not permit the interpretation to apply to reservations that accounted for the biggest part of the elements involved. In other words, had the interpretation permitted an application of the reservoir concepts under the original regulation, that would have accounted for a big chunk of the estimate that is still there and I just don't have an estimate as to what the other provisions did.

Mr. CURTIS. Your release seems to indicate that substantial dollars are involved by your statement that your failure to do so could occasion enormous cash flow problems and disruptive effects in recovering the amounts.

Mr. SMITH. The most rigid possible interpretation of the regulation that existed prior to September 1 would have occasioned the reclassification of substantial volumes of new oil and therefore would have involved a lot of money. That is true by definition but how much that was I have no estimate of. As Mr. Wilson indicated, the requirement to adhere to that kind of a definition that would have required a substantial change in the accounting practices used by the industry would have been hard to justify on any grounds—equity, administrative feasibility and particularly in terms of its effect on production and those kinds of things.

Mr. CURTIS. You say in the preamble of that release that FEA recognizes the substantial reliance that has been placed on these determinations by numerous parties, that there is no basis for conclusion in general that such determinations were other than good faith attempts to comply with the regulation and that there is substantial need for a measure of administrative finality to attach to as many of these determinations as possible so as to avoid subsequently disruptive retroactive adjustments.

Now in previous discussions with the committee and specifically in a letter of September 23, 1976, to Chairman Dingell, Mr. Zarb stated that:

FEA has never—and never shall as long as I am Administrator—permitted any firms to be excused from compliance with our regulations merely on the basis that a misinterpretation of the regulations was made in good faith.

Indeed there have been several cases in which FEA has rejected as a means of granting exceptions relief the mere showing that there was substantial reliance or indeed good faith interpretation requiring adherence to the correct literal meaning of the resolution. Does your action giving administrative finality here conflict with that previous notion that the mere showing of good faith or indeed as you say here the absence of showing that it was otherwise than taken in good faith validate the failure to comply?

Mr. WILSON. Let me see if I could address that one, Mr. Curtis. Basically, with respect to rulings, what we are doing is trying to go back and interpret existing regulations. When we do this we, of course, have to do this with full disclosure of our litigation posture as to what sort of interpretation we defend in court realizing that many parties may be interested in litigating this sort of matter. The producers may be interested in litigating to the extent to which we try to enforce an interpretation which they think is not lawful. Consumers that are purchasers purchasing crude oil may wish to litigate to the extent they think we are adopting an interpretation which is not supported by law.

So we have to walk a tightrope there and make sure we come up with something that we can subsequently defend. When we do this we basically go back and try to say how would a reasonable man—given the circumstances and what we had issued and said about this regulation and the purposes and intent for which it was adopted—have interpreted the regulation. That is the test we apply with regard to the proper definition.

We look back at the period of time in August 1973 when the definition was first promulgated, the fact that it was a very short definition and it was not articulated or explained in greater detail except to have explained that it was the basic building block for the incentive system, second, that it was part of a temporary economic stabilization program in which the industry that was regulated was not expected to drastically have to change its method of recordkeeping, and third, that it was premised upon a compliance effort by the Cost of Living Council to be able to look to records that the producers would keep themselves such that we could go in and audit the entire system.

When we did all this and when we looked at the numerous factual situations that had arisen and listened to the justifications that the various members of the industry and the various producers had put forward as to why they had interpreted the definition in various manners, we came up with the final clarifications in August of this year.

With respect to our statement about administrative finality, what we were talking about in that regard is the fact that we have producers out there that are doing everything across the spectrum. When we came up with our clarifications, we discovered some were still not in compliance. Even under those clarifications, basically producers had been using a reservoir definition all along.

There were some other companies which had interpreted the definition more strictly and had stricter compliance. With respect to those

companies we said we were not going to allow these companies to go back and readjust their billings. We are saying we are not going to do that because it would confuse the system too much and to that extent we thought there was a need for administrative finality. Some people operate in a manner that complies even more strictly with the regulations than subsequently is determined that it was necessary.

Mr. HILL. Let me add to that, Mr. Curtis, in Mr. Zarb's comment there I think you have to distinguish between situations where FEA determines that the regulation was clear and that certain misinterpretations of the regulation were just improper because of the guidance that FEA had given. That happens to be the case in the question of the nonproduct cost pass through sequence. It was our own determination from public comments that in spite of the fact that people had used different methods, our regulations had been clear and precise during that period.

They may have been bad regulations, but nevertheless they were clear and precise and hence no one, even if it were a bad regulation, could be allowed to be relieved of any compliance obligations; whereas in this case, the public hearing and the comments, we think, clearly indicate that the initial interpretation was very broad and there was a substantial difficulty in applying that to thousands and thousands of very unique situations. It was not clear throughout that period exactly what the regulation meant; it was not even clear to the regulatory agency itself. So we frankly see those as two very separate categories. It has an awful lot to do with the quality of our instructions and guideline consistency as carried out in our compliance program.

Mr. CURTIS. Mr. Hill, this sounds like a quarrelsome question and perhaps it is but the definition of property, as you pointed out, clearly is the most fundamental aspect of the two tier pricing mechanism which has been in effect since August 1973. Isn't it a little disturbing that that definition was not clear and precise to even FEA as you indicate in August 1976, 3 years after the program has been in effect?

Mr. HILL. Absolutely, Mr. Curtis. When we started the full scale examination of the property question we never thought it would take a year to explore it, to understand it and to promulgate some final interpretations. The issues just turned out to be exceedingly complex, staff resources limited, and it just took that long. That was a matter of great concern to us. We didn't feel like it was fair to regulated entities, nor to consumers or anyone else when you had this degree of uncertainty.

Some of these issues are just so complex that you can't resolve them overnight. We tend to think we can when we start, but they frequently turn out not to be that way. We have had other cases. Under our reseller rules we have been working on those for several years and you just can't establish these things with any degree of precision very quickly, at least in the complex cases. This is very troublesome to FEA.

Mr. CURTIS. It appeared to me in reading ruling 1975-15 that FEA at least in 1975 was under the impression that the use of the term "property" to describe the lease or fee interest from which the right to produce arises was a readily understandable term upon which

records are kept and that it was for that very reason that it was used in order to be an auditable and enforceable standard.

Mr. HILL. I think to some extent that is true but again we started with a very broad and simple definition, but then you find that when you try to apply these things in these complex cases, tremendous inequities arise.

Mr. CURTIS. Let me try to define it.

Mr. HILL. Then you start to try to have rulings and interpretations to insure that people are treated fairly and equally under the regulations.

Mr. CURTIS. Let me try and define it. Was the problem that the standard in general was working considerable inequities because of the vagaries of the various complicated producing interests or was it in fact understandable?

Mr. HILL. I think it was fairly understandable, the problem being that when it was applied to the vast matrix of crude oil property it was highly inequitable. Then I think the fact of that inequity began to work back and make the original definition not very clear—that is, exactly what do you mean? Surely, the questions began to come. Is this the result you want when you have a 55,000 or 60,000 acre lease in Louisiana? That is the most absurd thing in the world. It is then those questions of inequity which begin to make your original definition very vague and less acceptable and you need more language and clarification.

Mr. CURTIS. The action taken in August to give administrative finality to your clarification rulings was to deal with the inequities as occurred from the application of the standard.

Mr. HILL. No, sir.

Mr. CURTIS. Or was it to deal with a misunderstanding as to what the standard was in the first place?

Mr. HILL. I think it was a combination of both, but there were some inequities which led to the lack of understanding and the need for clarification which became apparent as we tried to apply a very broad and general definition of property to a situation that just did not fit.

Mr. CURTIS. To the extent that it is based on inequities, doesn't that have a classic exceptions type of approach?

Mr. WILSON. Mr. Curtis, I think it is much better to view what was done in August of this year, in contrast with ruling 1975-15, as just building upon that earlier ruling and addressing areas that were not addressed by the earlier ruling in light of information and further data that we obtained about how the industry operated. It did not reverse the ruling of 1975-15; it basically addressed different areas that subsequently came to our attention as demanding clarification before our compliance effort could proceed.

The same thing has happened again since we issued that clarification in August. We have now had new questions come in as to what does this mean; statements such as we don't think you were aware of this additional situation at the time you adopted the change in August. Therefore, we are going to have to come out with further rulings to address those issues and this will continue for some time until we have cleared up most of the major areas. I think we are getting very close to that but it is a very, very complicated area to deal with.

Mr. DINGELL. I understand what you are saying but I don't get the impression, Mr. Wilson, that you are responding to the question.

Mr. Curtis' question is, does this constitute essentially an exception?

Mr. WILSON. No, sir.

What we are doing—

Mr. DINGELL. I don't see how you can say it is not.

Mr. WILSON. What we are trying to do technically is state what the regulation has meant from the inception. We are not trying to say the regulation meant a different thing and we are going back to retroactively change it in a manner of class exception, nor are we saying that although it meant that, we are not going to enforce compliance with it which is what a class exception is.

Mr. HILL. An exception is when the FEA determines that the regulation is valid, but that the application of that particular regulation in an individual circumstance creates an undue hardship or catastrophic situation and the circumstances are such that there is some relief from that particular regulation demanded because of the fairness provisions of the EPCA and the FEAA.

Mr. DINGELL. Are you then considering hardships in the ruling of August as opposed to your prior statute?

Mr. HILL. No, sir, Mr. Chairman. What we are trying to do is to provide further interpretation and clarification to what the property definition meant.

Mr. DINGELL. Maybe we can find out how that worked by inquiring. The first regulation treated properties, is that right? All oil produced on the property, is that correct?

Mr. HILL. Yes.

Mr. DINGELL. And the second one broke it down and treated different reservoirs on the property, is that right?

Mr. WILSON. That is a prospective change.

Mr. DINGELL. Pardon?

Mr. WILSON. We redefine the definition prospectively starting September 1, 1976, which accounts for the shift in proportionate mix of old and new oil. Before that time we had not adopted a reservoir definition of property, all we had done was maintain the same definition that was on the books since August 1973 and had gone into greater and greater detail as to exactly what that means as applied to the specific factual situations.

Mr. DINGELL. I want to pursue this further but I will yield back to Mr. Curtis.

Mr. CURTIS. I think it was Mr. Hill's response which suggested that what you are attempting to do is to correct certain inequities in the application of the property definition upon which people evidence some good faith or at least there is no evidence that they had not exercised good faith rather than as Mr. Wilson is indicating giving flesh to the original terms of the property definition and to state its specific application as a matter of intent of the original regulation rather than attempting to balance equities or inequities involved.

Mr. WILSON. If I can respond to that, I think what Mr. Hill is trying to indicate about the equities of the situation is that 3 years down the road when you are trying to interpret a definition, you must apply basically a reasonable test. You must look back and say how would a reasonable individual who is subject to those regulations have

acted. This is the same test a court would apply in determining whether you are practically enforcing compliance for a certain interpretation.

If you had interpreted that regulation within a week after the regulation was issued, you might have come up with an entirely different interpretation because you would not have had certain problems until the passage of time. You basically have to look to all the factors that a court would look to such as, is this a reasonable interpretation of the agency now enforced upon this individual.

Mr. HILL. I was not meaning to imply inequities as we use it in our exceptions process but was merely trying to elaborate on the fact that as you go down the road of granting further and further interpretation and clarification you are trying to treat like situations alike which is the basic definition of equity. In the exceptions process you are trying to accommodate the different situations and not the like situations and that is a hardship kind of problem whereas this was not.

Mr. DINGELL. Am I coming to the wrong conclusion here? I gather from Mr. Wilson's comments that the interpretation of August was rather different from the interpretation that FEA put out in January. Now, am I correct or incorrect on that?

Mr. HILL. The basic property definition has not changed, Mr. Chairman. We have just expanded and clarified the meaning. We have expanded the interpretation to take account of situations that we had to take account of. If we had had perfect knowledge in August of 1975 and could have written the complete rule, we would have done it but we had to start and then get more specific.

Mr. DINGELL. Aren't you in fact agreeing with me though? You seem to be going the long way around but I gather that you are agreeing with me.

Mr. HILL. I am not sure what I am agreeing to, Mr. Chairman.

I think this is generally the case in lots of regulatory situations including the IRS where they are continually putting out interpretations regarding some rule established 3 and 4 years ago on how it is to be treated.

Mr. DINGELL. The IRS does most curious things from time to time, but we are not dealing with the IRS.

Mr. Curtis.

Mr. CURTIS. Although the body of FEA regulations is rapidly approaching the Treasury regulations.

Mr. HILL. I think I started to use another example of the Federal Election Commission which started out with the separate regulations and they seem to expand and be more clear over time.

Mr. CURTIS. Let me ask about your prospective change in the property definition. Again in our ruling 1975-15 FEA makes this statement:

While the FEA recognizes that various state and other Federal regulatory authorities may, for other purposes, have monitored production levels on other bases (e.g., by physical boundaries or by producing formations or reservoirs), it is necessary that the price regulations embody a uniform concept, the parameter of which can be readily applied to all domestic production, regardless of varying state classifications. For this reason, FEA regulations utilize as a reference a property concept based upon the right to produce crude oil that can be readily identified for all producers.

It was thought at that time that it would be fundamental to your compliance program. In August of this year you changed the definition to resort to a reservoir definition which indeed incorporates the

State regulatory standards or records kept for tax purposes or whatever. Can you tell us why the shift in position and what implications does it hold for your ability in the future to determine compliance with the regulation which in 1975 you thought would make impossible your compliance?

Mr. SMITH. The principal reason for the shift, Mr. Curtis, was to create the maximum possible incentive under the limitations of the EPCA pricing provisions for the production of domestic crude oil.

Mr. CURTIS. Excuse me, Mr. Smith. Just allow me a preference. I don't quarrel in any way with moving to the reservoir concept, indeed when this committee was involved in an attempt to fashion a statutory price regulation there was a lot of interest and moving to a reservoir concept as one which provides more finely targeted incentives to production and makes more sense considering the realities of how oil is produced. This committee, like FEA in 1975, was dissuaded from doing that because of the administrative complexity.

What I would like you to address is have you introduced administrative complexity which in 1975 you felt would undercut your compliance effort and make unenforceable the regulation?

Mr. SMITH. We have introduced additional administrative complexity after a judgment that based on the historical accounting practices because of the State regulatory provisions we could minimize the additional administrative complexity; that is, we could still have a program that was enforceable and we were willing to trade off the increased burden of determining compliance in order to get the production incentive impact of that. In 1975 we simply did not know as much as we had learned by August of 1976 about the ability to distinguish among reservoirs under the same piece of surface land.

In the process of working this property definition issue through this period, we learned more about how to make those distinctions and were persuaded that although there will be difficulties with them, there will be more sets of individual circumstances where the tradeoff in terms of the ability to assure compliance with the program was worth the added production incentive that would be generated by it. We learned this additional information through the process of two rule makings in which public hearings were held and comments and testimony were received and through additional research on the part of our own people. We just knew more in August 1976 than we did this earlier discussion was held in 1975.

Mr. CURTIS. If I understood you when you were talking about the tradeoff, your new standard introduces vagaries that weaken the compliance program but you felt that whatever loss of compliance value was justified by the production incentive that you would obtain by making the change in definition, is that correct?

Mr. SMITH. I would not like to accept the word "weaken," but I would substitute "complicate."

Mr. DINGELL. I would like to interject. You made a point of the complicated program that you already have resources to administer and in which you are now, according to the testimony earlier received, significantly behind. Now in the light of those comments, how am I to interpret the judicial complexities being any different than weakening?

Mr. SMITH. I think the additional complexity is an argument for additional resources to the program, not an argument for postponing the maximization of production, Mr. Chairman.

Mr. DINGELL. I have a few comments on the point you just made, Mr. Smith. I have always been in sympathy with your getting the moneys that you need for this undertaking. Have you asked for additional personnel to carry out this additional administrative burden and, if so, how many for your forthcoming budget year?

Mr. SMITH. I am not at liberty to disclose at this time, Mr. Chairman, the specific additional request but the answer to your question is "Yes," we have asked for additional people in the compliance program in the 1978 budget and we have proposed a supplemental in the compliance program.

Mr. DINGELL. Have you requested a supplemental?

Mr. SMITH. We have proposed one to the Office of Management and Budget for our 1977 compliance efforts, Mr. Chairman.

Mr. DINGELL. It would be most helpful to have these figures for the record because I think this very directly impinges upon the questions that Mr. Curtis has been asking. Is there any way they could be made available?

Mr. HILL. Mr. Chairman, under the Budget Reform Act of 1974 there was an agreement between the Congress and the President that this information would not be made available until the President's budget had been submitted to the Congress.

Mr. DINGELL. That is statutory?

Mr. HILL. This was part of the Budget Reform Act to my knowledge.

Mr. DINGELL. I am going to direct counsel to find out if there is any way we could review that material.

Mr. HILL. We will be glad to explore that ourselves.

Mr. SMITH. Mr. Chairman, I don't want to leave an impression that we have seriously changed the work to be done in adopting the new definition because it is keyed to the historical practices in the industry; in fact, that is where we got into a lot of trouble in the first part of the program, by saying that the records were kept on the accounting practices of the industry and in conformance to state regulations which did not coincide with our initial shot at the program. In many respects the records will be segregated. The clarification will preclude our auditors from having to amalgamate a record from a number of different places to conform to our overall.

Mr. DINGELL. Mr. Smith, that appears to be the controversy to which Mr. Curtis was alluding.

Mr. Curtis.

Mr. CURTIS. Thank you, Mr. Chairman.

I would like to switch to a different subject now and I will be brief. You have indicated, as I understand it, that you might seek a 90 cent addition to the composite to correct the overage and allow the program to get back on plan. This would be a one time adjustment. Is that a correct figure?

Mr. HILL. That is correct approximately.

Mr. CURTIS. Now a 90 cent addition to the composite that would occur as would be calculated for January, as I understand, is roughly 11 percent addition. Ninety cents is 11 percent of that composite figure.

Mr. HILL. That is right.

Mr. CURTIS. Then if the composite were to continue to increase by the new composite, were to increase by 10 percent for 1977, can you give us an idea of how much the overall increase is valued through the year?

Mr. CHRISTIE. That request would be for only 1 month as I understand it, for January, if it was a proposed request for an increase in the composite for 1 month. It is the legal limit composite only and there would be no—

Mr. HILL. The return to the original schedule in February with 90 cents over whatever the number turned out to be. If that were the approach we were taking, it would be simply for 1 month.

Mr. CURTIS. Then it becomes kind of a fictional value, does it not? It is a fictional value?

Mr. HILL. Yes.

Mr. CURTIS. As I understand the terms of the Emergency Petroleum Allocation Act, as amended by EPCA, there is authority to seek an adjustment to the composite by increasing it in an amount greater than 10 percent but there is no authority by submission of an energy action to obtain an addition to the composite, be it for 1 month or some longer period of time. That would require a legislative change. I wonder if your testimony seemed to apply that you could submit an energy action for that purpose.

Mr. WILSON. Mr. Curtis, technically what I think is under consideration if an energy action is to be submitted would be to calculate the extent to which the combined adjustment limitation would have to be raised for, say, a 1-month period and then come in and say that we propose and we have increased the 10 percent combined adjustment limitation to 95 percent or something like that for the month of January only, whatever the amount is. That ends up giving you enough even when you continue to freeze during that month such as you then offset the overage that you had in the previous time. Mechanically that would be the way you would accomplish that if you were to do it. We agree there is no way we can come up and raise the composite price itself.

Mr. CURTIS. Right. Then what you would be requesting is a percentage increase to be in effect for 1 month and you estimate—or what other period. If you did it in 1 month, you would estimate that you would need a 95 percent—

Mr. CHRISTIE. It would be larger than that.

Mr. CURTIS. Larger than 95. It is 104 percent. Don't you think that is going to be difficult to explain?

Thank you, Mr. Chairman. I have no further questions.

Mr. DINGELL. The Chair recognizes the gentleman from Texas, Mr. Eckhardt.

Mr. ECKHARDT. I would like to ask a few questions about this change of property definition in 1976 and its effect and about the only way I can do it is by sort of illustrating it.

Mr. DINGELL. If the Chair may interrupt the gentleman from Texas, the Chair has got to ask this. Are we going to get this for the record?

Mr. ECKHARDT. I understand before the change a property was generally a geographical area in which production existed and in which production existed in the year 1972.

Mr. WILSON. This was the issue at hand, Mr. Eckhardt. This is what we resolved in the ruling that came out in August.

Mr. ECKHARDT. For instance, if you had a well in this property [see fig. 1, well No. 1] that was tapping this formation [see fig. 1, formation A] at, say, 9,000 feet and if the base period control volume was 350 barrels per day and if this well were producing at this time at 175 barrels per day, of course all that would be old oil, would it not?

Now suppose there is also determined to be another geologic strata in this area [see fig. 1, formation B] and under your old rule you would have a well that was built after 1972 but in the same property [see fig. 1, well No. 2] and that well is producing another 175 barrels. Now that would also be at the old oil price, would it not?

Mr. SMITH. That is right, sir.

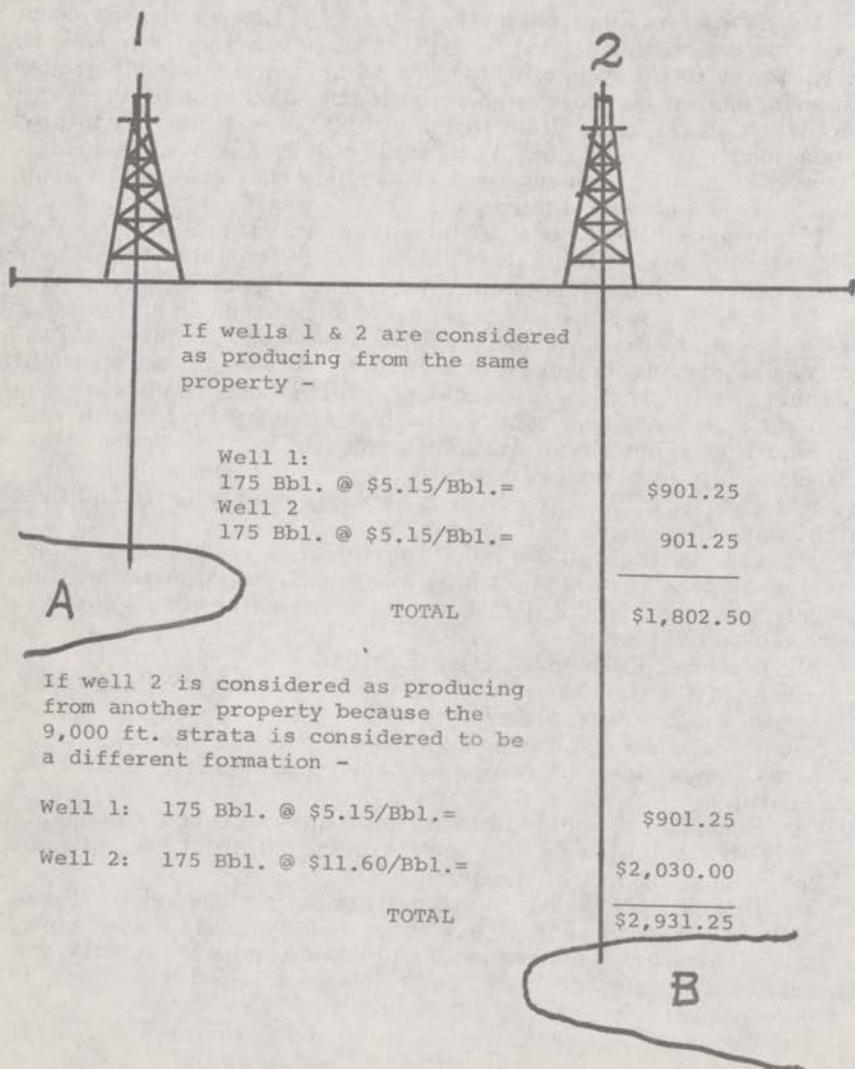


FIGURE 1

Mr. ECKHARDT. Now say this is at around 5,000 feet. Now under the new rule this could be treated as new oil, could it not?

Mr. DINGELL. Would the gentleman yield?

Depending on the date the new well went in.

Mr. ECKHARDT. No. I am asking suppose it goes in at some time after 1972.

Mr. WILSON. It depends on more complex factual circumstances, Mr. Eckhardt. If that situation is one such as they had in Louisiana where they had very large tracts and they had separate formations that were developed at separate times although within each of those formations there were then any number of separate reservoirs such as you have—I am not sure whether you are drawing a formation or a reservoir up there, but in that situation we said we would treat the formation as being the right to produce which arises from the lease.

Mr. ECKHARDT. But prior to the change it would have been limited to the old rate, would it not?

Mr. WILSON. We had not addressed these specific issues prior to the clarifications issued in August. It was not a change, it was a different interpretation.

Mr. ECKHARDT. Before that.

Mr. WILSON. People reported it in all different manners which was the problem because they were interpreting it many different ways. Many people were interpreting it the way you are stating, others were interpreting them totally differently.

Mr. ECKHARDT. You had no definite rule, they could report it either way and you would accept that as valid either way they reported it?

Mr. DINGELL. Would the gentleman yield? I think the gentleman is making an assumption. How would you have accepted it prior to the August 15 change? I think that is the proper question.

Mr. ECKHARDT. Which would you have considered correct reporting?

Mr. WILSON. If there is a surface property lease there, the August change would have made no difference at all. Prospectively you could separate those two.

Mr. ECKHARDT. I am not asking that. I am asking if they are separate formations, how would you the proper formation—

Mr. WILSON. If they are separate formations—and the formations have historically been—the August clarification said you could treat those formations as separate properties, that is correct.

Mr. ECKHARDT. Prior to the August determination what was your rule? What would you accept as proper reporting?

Mr. WILSON. We had bumped into those cases in the compliance effort and that had stopped the compliance people from proceeding.

Mr. ECKHARDT. You had accepted either kind of reporting?

Mr. WILSON. We had not accepted or denied it. Basically they had come up and said, "We cannot continue and complete this compliance case until such time as you give us an interpretation."

Mr. ECKHARDT. But assuming that the producer in this property treated this as a separate formation [fig. 1] and therefore claimed the price of new oil, he would be making for the 175 barrels here [fig. 1, well No. 1] \$5.15 per barrel at about August and \$11.60 here [fig. 1, well No. 2]. Now I figure that would be a total of \$2,931.25. On the other hand, if he treated this as a single property and felt that the law

so compelled him to do, he would be selling his oil for \$1,802. So you let him do it either way and either way was in compliance before the change?

Mr. WILSON. No.

Mr. HILL. No. We had not determined what compliance was. They were actually interpreting it themselves different ways but we had not determined what the proper interpretation was and there were some people who—

Mr. ECKHARDT. Suppose Company A had interpreted the rule in such a way that he charged for the oil a total of \$2,931.25 and Company B charged \$1,802.50. Subsequent to the definition, the \$2,931.25 would be proper. Are you not going to go back and recover from that particular producer the difference between the two figures because you at that time also established, did you not, a provision called administrative finality which would prevent you from going behind that date in order to collect the difference between \$2,931.25 and \$1,802.50?

Mr. WILSON. Mr. Eckhardt, what we said was compliance cases come to us and they said, "We have this legal problem as to how we should be interpreting this." The companies are arguing and making the case they have correctly applied the definition, and we are not certain whether they did. We made the determination which was issued in August and that if those were separate formations—such as large lease in Louisiana that you could treat those as separate properties. If there were a company that had not been treating those as separate properties prior to that, the administrative finality provision said that that company cannot go back and bill the purchasers that take crude oil at a different price because he was not charging the full price that he would have been allowed to under the interpretation of the rules that were adopted in August.

Mr. ECKHARDT. And as a corollary to that you would not go back against the company that did treat those as separate properties and require them to treat that as an overpayment and out of compliance?

Mr. WILSON. No, because we said that was the correct interpretation of the definition.

Mr. ECKHARDT. But at the earlier time, as I understand, you had determined that such complexity of determining that these are separate formations was not practical from an administrative enforcement standard so you had generally treated this exception—at least you had not agreed that it was admissible.

Mr. WILSON. Sir, that is the distinction between a formation and a reservoir within a formation. A formation may be an entire field which may have different reservoirs.

Mr. ECKHARDT. You say you just had none prior to the time August of 1976?

Mr. WILSON. We had not spoken as an agency and explained exactly what was supposed to be done because we were in the process of acquiring knowledge as to exactly the types of factual situations that operated out there, how the people treated these properties.

Mr. ECKHARDT. You were telling companies that they could operate either way and you would later make a determination of whether they acted rightfully.

Mr. WILSON. Sir, that is true of many of our regulations unfortunately because it is a very complicated area. You put forth general regulations, you subsequently learn that there are involved factual situations which you then must interpret as to how those fall within the regulations.

Mr. ECKHARDT. But the company that operated under what they considered to be the literal regulation at the time and therefore only collected the smaller amount, as you say, could not come back and make any kind of adjustment to collect the additional amount; the company that had collected the larger amount could keep its gains. Now it strikes me that that is enormously inequitable because the companies that were the most scrupulous with respect to determining that a property is what a property apparently was at the time is simply out that difference.

Mr. DINGELL. Would the gentleman yield?

Mr. ECKHARDT. Surely.

Mr. DINGELL. Can you give us any appreciation of how many companies interpreted the ruling one way and how many interpreted it the other prior to the time of the rules change or prior to the time of the reinterpretation of the rules?

Mr. WILSON. Generally, we think our clarifications in August basically accepted what the industry had been doing in general. There were some companies that were not doing it in that manner. Those companies we said were not going to be allowed to make an adjustment except to the extent they come in through the exceptions process and show that it would be an inequity.

Mr. DINGELL. How was Gulf dealing with it? As I understand it, Gulf was taking the interpretation that a property constituted a geographical tract on the ground as opposed to different reservoirs.

Mr. WILSON. I am not certain exactly how Gulf was treating its definition of property. I know that in the comments in the rulemakings they were concerned about the fact that we had under consideration possibly going so far as to say that you could use a reservoir as the property which we did not—

Mr. DINGELL. Gulf was?

Mr. WILSON. Yes; and that was primarily what their comments were addressed to. They said, "You cannot do that because the rules do not say that; we have not been doing that." I do not know how they came out in relation to the clarifications that were adopted.

Mr. DINGELL. Can you submit to us the comments from the proceedings which were adverse to the interpretation that is now in force at FEA with regard to this particular point, please?

Mr. WILSON. Certainly.

Mr. DINGELL. Could you also give us your best judgment with regard to what companies are adversely affected by the change? That may be rather difficult but we would appreciate if you would do your best on that.

[Testimony resumes on p. 124].

[The following material was received for the record:]

Using as the criterion of "adversely" affected those firms filing with the Office of Exceptions and Appeals, eight applications under Section 212.72, regarding the property clarification, have been received since August 26, 1976.

ANALYSIS OF ORAL PRESENTATIONS AND WRITTEN SUBMISSIONS ON
 CLARIFICATIONS TO MANDATORY PETROLEUM PRICE REGULATIONS
 APPLICABLE TO DOMESTIC CRUDE OIL

FOREWORD

By notice in the Federal Register, Volume 41, No. 75, of April 16, 1976 the subject Proposed Rulemaking and Public Hearing was announced. Regional public hearings were thereafter held in Denver on April 27, 1976, and in Dallas on April 28. National public hearings were held in Washington on April 29 and 30.

At the public hearings held in Denver, Dallas, and Washington, a total of 54 oral presentations were made. In addition, 48 written submissions were made. Because of duplication at the various hearing sites and because of combined presentations (where two or more speakers presented the views of an association) the actual number of communications has been established at 84. By source, presentations and submissions were as follows:

Integrated Oil Companies	22
Independent Oil Companies	40
Royalty Owners	3
State Agencies	7
Independent Refiners	6
Crude Oil Gatherers and Buyers	2
Consumers Groups	1
Consultants	2
Shale Oil Company	1
	<hr/>
Total	84

A table has been prepared and is attached which lists, alphabetically, the companies, associations, and individuals within each of the above categories. The table shows whether a written or oral submission was made and the place of delivery. Duplicate submissions are shown. The subjects discussed are indicated by the following coding system:

A. Definition of Property

- A 1 General reservoir approach to DOP.
- A 2 Use of state agency approved lease subdivisions and aggregations for separate property designation
- A 3 Transfer of Base Production Control Level calculations on enhanced recovery units from separate property to unit total basis

- B. Definition of Posted Price
 - B 1 FEA definition of field and area price posting procedures
 - B 2 Premium payments above posted price
- C. Stripper Well Lease Rules: Clarification of Exclusion of Non-Associated Gas Well Condensate
- D. Certification of Crude Oil Sales and FEA Proposed Data Collection Forms
- X. Miscellaneous comments not within scope of hearings

Definition of Property

Of 22 integrated oil company submission to the hearings, all discussed some part of the definition of property issue. Twelve of the 22 discussed the transfer method and time of adjusting from separate property to unit total Base Production Control Level (BPCL). The independent operators were also deeply concerned with definition of property. Out of 40 respondents, 35 commented on the issue. A smaller number of the independent oil producers were concerned with the enhanced oil recovery unit definition of property; only eight of the 35 also discussed that part of the issue.

Seven state agencies responded. All were concerned only with the basic definition of property issue. None of the seven commented on BPCL adjustment on enhanced recovery units.

Three independent refiners, one consumer group, and three consultants also commented on the definition of property issue.

In all, 73 submissions (out of a total of 84) were concerned with the definition of property issue. Only 22 of the 73, however, commented on the enhanced oil recovery unit part of the issue.

Of the 22 integrated oil companies commenting on the definition of property issue all except one, directly or by inference, supported the principle that reservoir accounting should be allowed in defining property and in Base Production Control Level (BPCL) determinations. Only seven of the 22 companies commented directly on the retroactive feature of the proposal. Three companies made laudatory comments and strongly implied that they--and possibly other oil producers--had never conformed to the present FEA regulations. Four companies strongly opposed the retroactive feature of the proposal and pointed out that it would cause tremendous bookkeeping adjustments and oil price adjustments. Further, retroactive oil payment corrections would back up into past calculations of the buy/sell program and would cause recalculation of oil entitlements for prior years.

Nine of the 22 integrated oil companies favored allowing state agency rules and regulations to determine the separate reservoir definition. (Even though the rules might not be consistent among the various states). One company said that the FEA should write its own consistent definition. Five of the companies favored allowing the companies to use "historical accounting entities" even when they went beyond any state-recognized division of a base lease. The other integrated oil companies did not discuss this feature of the FEA proposal.

The sub-issue of when and how to transfer from a lease-by-lease to a unit total procedure for BPCL calculation drew comments from 12 integrated oil companies--and almost as many variations. It was suggested that the point of shifting should be:

- o When 15% of proposed injection wells had been drilled or converted
- o When a "major portion" of the investment had been made
- o When the unit first showed production response
- o Two years after date of unitization
- o Date of unitization
- o At the option of the operation (i.e. whenever the upper tier oil fraction became greater under a unit basis of calculation)

Several of the integrated oil companies wanted the rule to include projects as well as units. This would apparently include adjacent leases under the control of one operator. Three independent oil producers also favored this addition to the proposed rule modification.

Of the 40 responding independent oil producers or associations of independent oil producers, 35 commented on the definition of property issue; 27 supported the principle that reservoir accounting should be allowed in defining property and none were opposed. Twenty of the 27 proceeded then to propose that a farmed out portion of a reservoir within a base lease (or property) should have separate property status.

Fourteen independent oil producers or association of independent oil producers supported the idea that state regulatory body definition of separate reservoirs should be allowed. Three of them supported the principle that "economic interests" including aggregates of leases or parts of leases as used historically by an operator should be allowed separate property status.

Only eight of the independents commented on the procedure from changing from lease-by-lease to unit total method of determining DPCL. Two recommended changing immediately upon unitization, two recommended changing when the majority of injection wells were converted; one recommended changing when the production trend had been recovered; three recommended at the option of the unit operator. Two royalty owners also supported the "option of the operator" method.

State agencies unanimously supported the principle of separate reservoir property definition. They all either supported the idea that state regulatory definitions should be accepted or, tactfully, refrained from comment on this point.

Independent refiners and independent consultants generally opposed changing from the present definition of property. The one consumer group vigorously opposed change.

The reasons advanced for the various positions were disappointingly vague. Proponents of changing the definition of property generally said it would "increase production" or "accelerate drilling." Opponents said it would legitimize past pricing abuses or increase volume of upper tier oil without necessarily increasing total crude oil production. Opponents said it would also cause havoc in pricing adjustments if it were made retroactive.

Definition of Posted Price

Ten out of the 22 integrated oil companies making submissions commented on posted prices. Seven of the ten extended their remarks to cover premiums and payments above posted price.

Out of 40 responding independent oil producers, 21 commented on posted prices. Of these, 13 were concerned only with the posted price definition, two were concerned with premiums or extra payments, and six were concerned with both parts of the issue.

Independent refiners were deeply concerned with the issue. All of the six refiners making submissions commented on posted prices and three of them also discussed premium payments.

In general, the integrated oil companies and independent refiners strongly supported the FEA proposals although many wanted a clearer definition of such items as "field" and "area." The responding independent producers almost unanimously opposed the proposed FEA definition of posted price, holding that "actual sales price" on September 30, 1975 should prevail. The two crude oil gatherers split on the issue.

It is apparent that widespread buying of crude oil by private negotiations, at secretly-arrived-at terms, and often including what could be termed "premiums" was taking place in September, 1975. The independent producers, on balance, were the gainers in the situation.

Stripper Well Lease Rule: Non-Associated Condensate Exclusion

Eleven integrated companies, 13 independent oil producers, two independent refiners, one consumer group, and one consultant group commented on the issue of stripper production exclusion of the non-associated leasehold condensate.

Five of the integrated oil companies, one independent refiner, the one consultant, and the consumer group generally supported the FEA position. Comments on how to make the rule more definitive were almost completely lacking. Several commented that the rules was clear enough now.

Six integrated oil companies, all 13 of the independent producers, and one of the refiners who responded on the issue did not address themselves to discussing how to make the rule clearer and more workable. Instead they said the rule was wrong, that gas wells producing less than 10 barrels of lease condensate per day should be regarded as stripper wells and that the condensate should be qualified to be sold at upper tier prices. They recommend that the FEA change pricing rules to allow this.

Certification of Production and FEA Proposed Forms

Eight integrated oil companies, eight independent oil producers, three independent refiners, and one consultant group commented on the issue.

On certification of production, the independent oil producers, with one exception, wanted purchaser (refiner) certification. The others all wanted producer certifications. It was pointed out by several proponents of producer certification that producers were the only ones with access to some of the required information and that some, other information the producers claimed not to have available could be made available given a time lag. In other words, an accounting system with producer certification would be needed but that either a time lag in reporting or a method of correcting initial reports would also be required.

Seven integrated oil companies and four independent oil producers commented on the FEA form P-124-M-0. All comments were adverse. Generally the respondents insisted that the data was not fully available or that it would place an intolerable burden on the reporting oil companies.

INTEGRATED OIL COMPANIES

Code Number	Company Name	Type Presentation	Where Presented	Subjects
182030	Amoco Producing Company	Written	washington	A1,A2,B1,C
00002	Amoco Producing Company	Written	washington	-----
182032	Ashland Petroleum Company	Written	washington	A1,A2
182024	Atlantic Richfield Company	Written	washington	A1,A2,A3,C
182028	Burnah Oil and Gas Company	Written	washington	A1,A2,A3,D
182054	Cities Service Company	Oral	washington	A1,A2,B,C,D
182012	Cities Service Company	Written	washington	-----
182039	Continental Oil Company	Oral	washington	A1,A3,C
182025	Continental Oil Company	Written	washington	-----
182042	Exxon Company, U.S.A.	Oral	washington	A2,A3
182007	Exxon Company, U.S.A.	Written	washington	-----
182033	Getty Oil Company	Written	washington	-----
182033	Getty Oil Company	Written	washington	A1,A2,A3,D
182043	Gulf Oil Company, U.S.	Oral	washington	A1,A2,A3,C,D
182026	Gulf Oil Company, U.S.	Written	washington	-----
9	Husky Oil Company	Oral	Denver	A1,A2,B,C,D
182021	kerr-McGee Oil Company	Written	washington	A2
182016	Marathon Oil Company	Written	washington	A1,A2,A3
182019	Nobil Oil Company	Written	washington	A1,A2,A3,B1,B2,C
J 15	Phillips Petroleum Co.	Written	washington	A1,A3,B,C
182052	Shell Oil Company	Oral	washington	A1,A2,B1,B2,C,D
00009	Skelly Oil Company	Written	washington	A1,A2,B1
182008	Standard Oil Co. - Sohio	Written	washington	A1,D1
182029	Standard Oil Co. - Calif.	Written	washington	A2,A3,D1,B2,C
13	Sun Oil Company	Oral	Dallas	A1,A2,A3,C,D
182023	Tenneco	Written	washington	A1,A2,A3,D
182044	Texaco, Incorporated	Oral	washington	A2,A3,B1,B2
00011	Texaco, Incorporated	Written	washington	-----
11	Texaco, Incorporated	Oral	Dallas	-----
02	Texaco, Incorporated	Oral	Denver	-----
182013	Union Oil Co. of Calif.	Written	washington	A1,A2,B

INDEPENDENT OIL PRODUCERS OR ASSOCIATIONS OF INDEPENDENT OIL PRODUCERS

Code Number	Company Name	Type Presentation	Where Presented	Subject
182057	Association of Independent Wilcox Operators	Oral	Washington	Al,A2
182053	Belridge Oil Company & M.H. Whittier Corp.	Oral	Washington	A2
3	Boucaw Oil Company	Oral	Dallas	Al,A2
182038	Caldwell Oil and Gas Company	Written	Washington	B1
00004	California Independent Producers Association	Written	Washington	Al,A2,B1
00007	Coastal States Natural Gas Company	Written	Washington	Al,A2,C
D3	Cotton Petroleum Company	Oral	Denver	A2,B1
D10	Davis Oil Company	Oral	Denver	Al,A3,B
182006	William H. Fuller	Written	Washington	Al,A2,B
182018	General American Oil Co. of Texas	Written	Washington	Al,B2,C
D11	Gary Operating Company	Oral	Denver	X
10	Hewitt and Dougherty	Oral	Dallas	A2,A3
182003	Houston Oil and Minerals	Written	Washington	E1
4	Hunt Oil Company	Oral	Washington	A2,A3,C,D
48	Illinois Oil and Gas Assoc.	Oral	Washington	Al,A3,B1,E2,D
D5	Independent Petroleum Assoc. of Mountain States	Oral	Denver	A,B1
182040	Independent Oil Producers Tri-State	Oral	Washington	Al,E1,C
182041	Independent Oil Producers Association of America	Oral	Washington	Al,A2,C
182001	Inexco Oil Company	Written	Washington	Al,A2,B1
D6	Inter-American Petroleum Corporation	Oral	Denver	Al
16	Jones-O'Brien, Inc.	Oral	Dallas	X
00003	Kansas Independent Producers Association	Written	Washington	Al,A2,E1,C,D
1	Liaison Committee of Industry Associations and T.I.P.K.O.			
2,3,4		Oral	Dallas	Al,A2,A3,E1,C
182051	Long Beach Department of Oil Properties	Oral	Washington	Al,D
182014	Louisiana Land and Exploration Company	Written	Washington	Al,A2,B
182005	McAlester Fuel Company	Written	Washington	A
14	McGoren Exploration	Oral	Dallas	Al,A2
8 & 6a	Mid-Continent Oil and Gas Association	Oral	Dallas	Al,A2
182059	Ohio Oil and Gas Assoc.	Written	Washington	Al
37	Oil Investment Institute	Written	Washington	Al,A2,B1,C,D
05005	Peoples Gas Company	Written	Washington	Al,C,E
18031	Florida Oil Company	Written	Washington	X
182009	Quintana Petroleum Company	Written	Washington	Al,A2

Code Number	Company Name	Type Presentation	Where Presented	Subject
17	Regal Petroleum Company	Oral	Dallas	X
D1	Rocky Mountain Oil and Gas Association	Oral	Denver	A1, A2, A3, B1, C
12	Sante Fe Natural Resources	Oral	Dallas	-----
00008	Sante Fe Natural Resources	Written	Washington	A2, A3, B1
182058	Small Producers for Energy Independence	Oral	Washington	A1, A2, B1, C, D
182035	Small Producers for Energy Independence	Written	Washington	-----
D7	Smith-Faucher	Oral	Denver	B
00001	T-C Oil Company	Written	Washington	A
182050	Texas Independent Producers and Royalty Owners	Oral	Washington	A2, A3, B2, C, D
	(Note: See Liaison Committee of Industry Associations)			
182010	Texas Pacific Oil Co. Inc.	Written	Washington	A1, A2, B, C
19	Tipperary Oil and Gas Co.	Oral	Dallas	A1, A2

ROYALTY OWNERS OR ASSOCIATIONS

Code Number	Company Name	Type Presentation	where Presented	Subject
7	Glenn Butler	Oral	Dallas	A3
8	Ross Hemphill	Oral	Dallas	X
9	Joe Wadberry (Same as Glenn Butler.)	Oral	Dallas	A3

GOVERNMENT AGENCIES

Code Number	Company Name	Type Presentation	Where Presented	Subject
182002	Arkansas Oil and Gas Commission	Written	Washington	A2
182004	California State Lands Commission	written	Washington	A
5	Interstate Oil Compact Commission	Oral	Dallas	A1,A2
182047	Louisiana State Mineral Board	Oral	Washington	A
182054	Louisiana Department of Conservation	Oral	Washington	A2
00010	Mississippi State Oil and Gas Board	Written	Washington	A1
16	Texas, Governors Energy Advisory Council	Oral	Dallas	A1,A2

INDEPENDENT REFINERS

182017	Paraland Industries, Inc.	Written	Washington	B1,B2,D
182020	Independent Refiners Association of America	Written	Washington	B1,B2
182022	Pennzoil Company	Written	Washington	A1,A2,A3,B1,C,D
00006	Pride Refining Company	Written	Washington	A1,B1
182017	Tesoro Petroleum Company	Written	Washington	A1,A2,B1,B2
182056	United Refining Company	Oral	Washington	B1,C,D

CRUDE OIL GATHERERS, BUYERS

D4	Black Hills Oil Marketers, Incorporated	Oral	Denver	B1,B2
182034	Siller Oil Company	Written	Washington	B1

CONSUMER OR CONSUMER GROUPS

182035	Air Transport Association	written	Washington	A1,A2,C,C
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OTHER

182045	Henry Coutret, Jr.	Oral	Washington	A2,A3
D8	Robert Park	Oral	Denver	A1
182011	Rio Blanco Oil Shale, Inc	written	Washington	X
15	Society of Independent Professional Earth Scientists	Oral	Dallas	A1,A2,C,D

A table has been prepared and is attached which lists, alphabetically the companies, associations, and individuals within each of the above categories. The table shows whether a written or oral submission was made and the place of delivery. Duplicate submissions are shown. The subjects discussed are indicated by the following coding system:

A Definition of Property

- A1 - General. Reservoir approach to DOP.
- A2 - Use of state agency approved lease subdivisions for separate property designation.
- A3 - Transfer of Base Production Control Level calculations on enhanced recovery units from separate property to unit total basis.

B Definition of Posted Price

- B1 - FEA definition: field and area posting procedures.
- B2 - Premium payments above posted price.

C Stripper Well Lease Rules: Clarification of Exclusion of Non-associated Gas Well Condensate.

D Certification of Crude Oil Sales and FEA Proposed Data Collection Forms.

X Miscellaneous Comments, Not within Scope of Hearings.

Mr. DINGELL. Would the gentleman from Texas permit just a further intrusion in his time?

Mr. ECKHARDT. Yes.

Mr. DINGELL. Let me read this. This is dated Thursday, September 4, 1975, Federal Register Volume 40, No. 172, Ruling 1975-15.

While the FEA recognizes that various state and other Federal regulatory authorities may, for other purposes, have monitored production levels on other bases (e.g., by physical boundaries or by producing formations or reservoirs), it is necessary that the price regulations embody a uniform concept, the parameter of which can be readily applied to all domestic production, regardless of varying state classifications. For this reason, FEA regulations utilize, as a reference, a property concept, based upon the right to produce crude oil, that can be readily identified for all producers.

That seems to be rather at variance with the conclusion that you arrived at later in August of 1976. Can you give us a comment?

Mr. WILSON. I think basically the situations that we are addressing in Ruling 1975-15 varied from the situations that we came across later; that we were again trying to say that we were not going all the way down to the reservoir basis; that we had the most producers that can come in urging that interpretation on us. We had not addressed some of these other situations such as exactly how the formations of Louisiana had been treated, and once we learned more about those, basically we felt that they should be treated as separate properties.

Mr. DINGELL. Well, you even went into the question of unitization and examples.

Now on the next page you have:

Production from more than one reservoir on a single property. Because the property concept is based upon the right to produce crude oil, whether arising from a lease or from a fee interest, the existence of two or more separate and distinct reservoirs will not in itself create two or more separate properties. Therefore, for purposes of determining BPCL, where a producer holds a single right to produce crude oil from two or more reservoirs, together the two or more reservoirs constitute a single property; where there are separate and distinct rights to produce crude oil from each reservoir, each reservoir accordingly represents a different property.

So you did make a significant change in your regulation, did you not?

Mr. WILSON. No, sir. Basically we said that the main right to produce is usually the operating interest that arises out of the lease that is granted in a legal context.

Mr. DINGELL. What you came out with is strikingly different than the language I just read. Earlier you said that if you got a right to produce out of one reservoir—

Mr. WILSON. That is prospectively.

Mr. DINGELL. There are two properties.

Mr. HILL. That is a change, Mr. Chairman, but that is only a prospective change looking forward from the August ruling and not backwards.

Mr. DINGELL. Well, I hear what you say, but I find myself hard put to be convinced.

I thank the gentleman for the transgression on his time.

Mr. ECKHARDT. I will ask a question about a slightly different situation. Let's suppose you have a property with a well on it which was operating in 1972. The base control period volume was 350 barrels. The well runs through a formation to a deeper formation,

again let's say 5,000 feet and 9,000 feet [see fig. 2, well No. 1]. Now under your regulations which existed prior to August if this well is producing, say, 175 barrels from this formation, this would be at the old oil price, would it not?

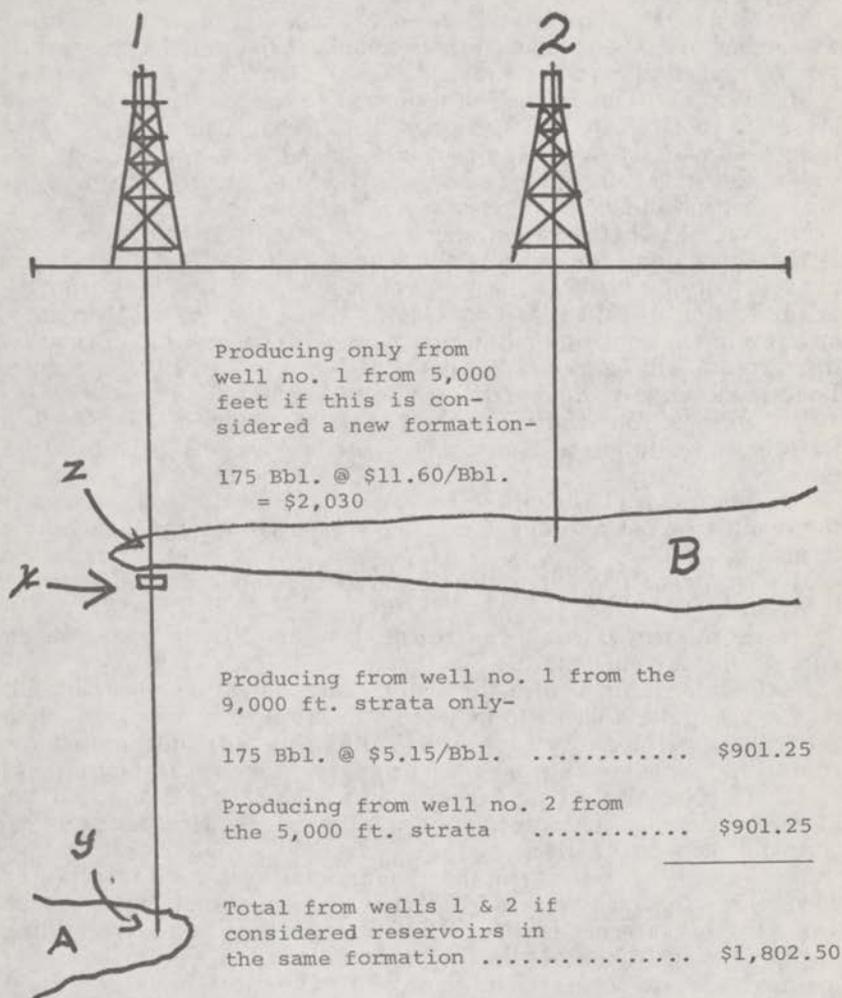


FIGURE 2

Mr. WILSON. Yes.

Mr. ECKHARDT. Now under the regulation prior to August, suppose this is cut off [see fig. 2, point x] so as to draw from this formation [fig. 2, formation A] at 175 barrels per day. Would that be new or old oil under the prior ruling?

Mr. WILSON. Both of these are under a single surface lease but you tell me they are separate reservoirs.

Mr. ECKHARDT. Separate formations.

Mr. WILSON. I don't believe so. I am not a geologist but I think formations are large enough that they are entire fields. You don't really have one field on top of another field. You have reservoirs on top of each other.

Mr. ECKHARDT. You never have one formation on top of another as, for instance, the formation that extends in like this [fig. 2, formation A] and another one that extends in like that [fig. 2, formation B]?

Mr. WILSON. The factual situations involved in these things are extremely complicated, I agree, in the legal relationships of these things. This is why we have had so much difficulty.

Mr. ECKHARDT. There may be some difficulty in determining what is a formation and what is a reservoir, is that correct?

Mr. WILSON. That is correct, sir.

Mr. ECKHARDT. And that is the reason originally you didn't pay much attention to this distinction, you simply said if it is a property in production in 1972 and if it covers a certain geographic territory, any production out of that property, regardless of what formation it goes into, will be considered under the basic control period figure. Isn't that essentially what you did prior to August?

Mr. WILSON. We said the right to produce which derives from a lease or a fee interest. The right to produce may be an operating interest.

Mr. ECKHARDT. I thought I noticed Mr. Smith nodding in assent to my question but I would like to know what the answer is in simple terms.

Mr. DINGELL. The Chair has observed that nods do not show on the record.

Mr. ECKHARDT. That is the reason I would like to give him an opportunity to comment.

As I understand, before the August determination you had felt that it was quite difficult to make this determination with respect to formations within a given property and generally interpreted the rule to mean that within a given property whatever formation was struck the base control period amount would be governing and the mere assertion that a new formation was drilled into from that property would make no difference.

Mr. WILSON. I believe in the August clarifications the types of formations that we were addressing were ones that were clearly separate, they are not smaller formations such as you were talking about. Obviously one of the things we have to do in further rule-making is try to separate out some of these as to how large a tract you have to have, for instance, to gain the benefits.

Mr. ECKHARDT. There is a difference between the formation and a reservoir which has to do with its size. If it is a big reservoir, it is a formation, is that right?

Mr. WILSON. The difference between reservoirs and formations is one of the items we will be addressing in this next rulemaking.

Mr. ECKHARDT. Have you decided what the difference is yet?

Mr. WILSON. It is one of the things we will have to collect comments on and get additional information as to how to make these distinctions.

Mr. ECKHARDT. So each producer determines whether he is producing out of a new formation or producing out of a new reservoir and if

he decides that he is producing out of a new formation he charges the new oil price and if he decides that he is producing out of a new reservoir he continues to charge the old oil price?

Mr. WILSON. Prospectively, this problem has been eliminated since we have gone to a reservoir basis.

Mr. ECKHARDT. But you have not determined what is a reservoir and what is a formation?

Mr. WILSON. The lowest common denominator will be the reservoir. The formation will be larger than the reservoir and will encompass a number of reservoirs.

Mr. ECKHARDT. How much larger?

Mr. WILSON. That is the issue.

Mr. ECKHARDT. So he still determine whether it is a reservoir or formation and charges in accordance with his determination?

Mr. SMITH. Mr. Eckhardt, I think the key is prospectively. He does not care any more as long as it is at least a different reservoir. He can count production from those two separately.

Mr. ECKHARDT. I would certainly care in this situation because if he is producing—I have calculated 175 barrels at \$5.15 here (fig. 2, point y) for a total of \$901.25 and he can simply plug here (fig. 2, point x) and produce 175 barrels here (fig. 2, point z) at \$11.60, he gets \$2,030, under the present rule if A and B are considered separate formations. But if these are considered as separate reservoirs, if he drills another well (fig. 2, well No. 2) and continues to produce the 175 barrels at 9,000 feet and the 175 barrels at 5,000 feet, he only gets \$1,802.20. So he gets more money by plugging this well at this point if he can call this a formation instead of a reservoir than by continuing to produce from both if both are considered reservoirs in the same formation. Now it seems to me it becomes extremely important to him whether it is a formation or a reservoir.

Mr. DINGELL. Well, if the gentleman will yield, it also becomes important as to the amount of oil recovered.

Mr. ECKHARDT. Sure. If by producing 175 barrels from 5,000 feet and calling it a new reservoir you make more money than if you produced 175 barrels from both places making a total of 350 barrels, you have a strong incentive to plug the lower formation, it would seem to me.

Mr. WILSON. The incentives that we are trying to give, Mr. Eckhardt, are, of course, that you may have a separate reservoir there that formerly was in the same unit that is defined as the property. If you had old oil on that property on a cumulative basis and you had a cumulative deficiency to overcome, there may be no incentive for drilling a separate well down into that new reservoir. We are trying to eliminate that and treat the incentives for building that new well and developing that new reservoir to get extra oil.

Mr. ECKHARDT. Mr. Chairman, I think this is a rather complicated issue and I don't want to further belabor the record but I would like to ask unanimous consent to be permitted to place some calculations and illustrations similar to those here presented in the record at the appropriate point.

Mr. DINGELL. I think that would be entirely appropriate. The Chair would request that the gentleman do that in the appropriate fashion. Without objection, so ordered (see pp. 110, 125).

Mr. WILSON. We would be very happy to sit down with Mr. Eckhardt at any time and go over this in much greater detail as to the mechanics.

Mr. ECKHARDT. Thank you, Mr. Chairman.

Mr. DINGELL. Any question?

I am just curious about one phenomenon about which I know only very little and that is this "behind the pipe" matter. That is something that comes into play with regard to natural gas, so that if you drill through two different formations or reservoirs—and you have not decided whether it is a formation or a reservoir yet—you have to recover from the bottom one first. Is that correct? I think the purpose was to get all that you can out of the lower one and then come up and get the next higher one. Or do you draw from the higher reservoir and get the lower one later?

Mr. WILSON. I think the States regulatory agencies may require that. There is nothing in our regulations that requires that.

Mr. DINGELL. Am I fair in saying that you should withdraw first from the one that has the greater pressure? It is all a matter of assuring the greater possible ultimate recovery of petroleum from the site.

Mr. SMITH. Mr. Chairman, my understanding is that those processes are regulated by the State regulatory agencies with a view to maximum conservation and assuring the maximum production of those. I am not familiar with the detailed engineering requirements which of course are based on the geological characteristics of the particular producing zones in question, but the representations to us in this rulemaking are that the State regulatory agencies establish the requirements more of the nature that the chairman has referred to with a view to maximizing the total recovery of the reserves that are in place.

Mr. Chairman, may I also add one supplement? You asked me how many people we had assigned to the independent crude producer audit program now. I estimated about 350 and the exact number is 336 for fiscal year 1977.

Mr. DINGELL. That is pretty close.

Any further questions or comments?

Gentlemen, we thank you. We have had a long and difficult day. We appreciate your courtesy to the subcommittee.

The subcommittee will stand adjourned.

[Whereupon, at 1:35 p.m., the subcommittee adjourned.]