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Department of Defense

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REPORT TO THE CONGRESS

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Procedures For Evaluating Reasonableness Of Petroleum Pipeline Rates Need Improving

B-153389

Department of Defense

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

~~701271~~ 096292

SEPT. 20, 1972



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-153389

To the President of the Senate and the
Speaker of the House of Representatives

This is our report on the need for the Department of Defense to improve its procedures for evaluating the reasonableness of petroleum pipeline rates.

Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

Copies of this report are being sent to the Director, Office of Management and Budget; the Secretary of Defense; the Secretaries of the Army, Navy, and Air Force; and the Secretary of Transportation.

A handwritten signature in black ink, appearing to read "A. M. Koller".

Acting Comptroller General
of the United States

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ABBREVIATIONS

CONUS	Continental United States
DOD	Department of Defense
GAO	General Accounting Office
ICC	Interstate Commerce Commission
MTMTS	Military Traffic Management and Terminal Service

CHAPTER 1

INTRODUCTION

The Department of Defense (DOD) spends an estimated \$17 million annually for transporting fuel within the continental United States (CONUS) via commercial pipelines. A major portion of this cost is associated with fuel shipments to Air Force bases.

Pipeline companies, as common carriers, are subject to the regulations of the Interstate Commerce Commission (ICC) and various State regulatory bodies, such as public utility commissions. They are required to furnish transportation for all shippers, without discrimination, at rates and charges that are just and reasonable for the services rendered. Pipeline companies file tariffs for the transportation of fuel with ICC or appropriate State regulatory bodies. Usually the regulatory bodies review rates only when such rates are challenged.

Section 22 of the Interstate Commerce Act allows common carriers to offer reduced rates to Government or charitable organizations. Rates filed under this section are quite common and are known as section 22 rates. Similar provisions are contained in the regulations established by State regulatory bodies for intrastate movements of commodities by common carriers.

ICC and State regulations require pipeline common carriers to maintain a uniform system of accounts and to file annual reports concerning the volume of fuel shipped, cost of operations, income from operations, changes in investment in facilities dedicated to the transportation of fuel, and other financial data. This information is available to the general public.

Within DOD, the Secretary of Defense designated the Secretary of the Army as single manager for military traffic activity within CONUS. The Secretary of the Army assigned this responsibility to the Military Traffic Management and Terminal Service (MTMTS). D1000

The Commander, MTMTS, is responsible for continuing reviews of section 22 rates to insure that they are fair and reasonable and that appropriate action is taken to obtain relief from any rates which are found to be unfair or unreasonable. However, the Commander cannot prevent cancellation or modification of a section 22 rate by a common carrier.

In 1954 the Department of the Air Force initiated a program to connect Air Force bases to commercial pipelines. These connections were installed by pipeline companies at no cost to the Government. Substantial savings have been realized through the use of such pipelines because the cost of transporting fuel into air bases by other modes of transportation--such as tank truck and rail tank car--is generally substantially higher than the rates charged by the pipeline companies.

CHAPTER 2

NEED TO IMPROVE PROCEDURES FOR

EVALUATING REASONABLENESS OF PIPELINE RATES

Our review of the pipeline activities of three Air Force bases which account for about \$3.3 million of DOD's annual bill of \$17 million for transporting fuel by pipeline showed that DOD had paid excessive rates to transport fuel by pipeline to the three bases. DOD, in evaluating the reasonableness of section 22 rates, compared the pipeline rates with rates for higher cost modes of transportation (rail and motor), rather than with commercial pipeline rates.

Also the commercial pipeline rates of one company had been reduced, but no adjustment had been made in its section 22 rates covering the same traffic.

If DOD had made its cost comparison on the basis of commercial tariff pipeline rates, had obtained cost data in support of the additional services rendered to the military, and had made periodic reviews of commercial rates, we believe the Government could have obtained substantially lower rates.

As a result of our review, DOD has negotiated retroactive rate reductions with the carriers discussed in this report. Company A has refunded \$91,883 for shipments to two bases--one covered by our review--and company B has refunded \$162,847. On the basis of the average volume of fuel moved each year between 1969 and 1971, we estimate that savings of about \$748,000 will be realized annually on future fuel shipments to the three bases covered by our review and to two additional bases to which the carriers reduced their rates as a result of our review.

ADDITIONAL SERVICES PROVIDED TO DOD DID NOT JUSTIFY SUBSTANTIALLY HIGHER RATES

Section 22 rates for transportation of fuels by pipeline to the Air Force bases selected for review were substantially higher than commercial rates for transportation of fuel to commercial terminal locations near the Air Force bases. Our analysis of the facilities and services provided to the military beyond the commercial terminal showed that the additional services provided to the military did not justify the substantially greater rate charged by the pipeline carriers. These additional services included temporary

storage of fuel, quality control testing, filtering fuel, and transportation of fuel from the companies' commercial terminals to onbase, Air Force-owned storage tanks.

The following analysis shows the difference between the commercial rates from refineries to the commercial terminals nearest the three Air Force bases selected for review and the section 22 rates covering Government fuel shipments from the same refineries to these bases.

	Commercial rate to nearest commercial <u>terminal</u>	Section 22 <u>rate</u>	<u>Difference</u>
—(Rates in cents per barrel)—			
Company A:			
Refinery to commercial terminal			
Distance in miles (330)	\$0.415		
Refinery to Air Force Base No. 1			
Distance in miles (331)		\$0.825	\$0.41
Company B:			
Refinery to commercial terminal			
Distance in miles (425)	\$0.46		
Refinery to Air Force Base No. 2			
Distance in miles (443)		\$0.76	\$0.30
Refinery to commercial terminal			
Distance in miles (303)	\$0.35		
Refinery to Air Force Base No. 3			
Distance in miles (310)		\$0.67	\$0.32

In each of the above cases, the carrier charged DOD almost as much for moving the military fuel a few miles from its terminal to the air base as it charged for moving commercial shipments 300 or 400 miles. For example, the carrier's

commercial rate for the 330-mile move to its terminal near Air Base No. 1 was \$0.415 per barrel. For the additional 1-mile move from this same terminal to Air Base No. 1, the carrier charged DOD \$0.41 per barrel.

Although additional services were provided in moving the fuel from the terminals to the air bases, these services did not warrant the rates charged.

Companies A and B did not maintain detailed cost accounting systems; however, with the assistance of company officials, we were able to ascertain the investment in facilities and the estimated operating costs incurred by the two companies to ship military fuel from the commercial terminal locations to the respective Air Force bases. We also compared the additional charges assessed on military fuel shipments with the investment in facilities required and the operating expenses to establish the rate of return to the pipeline companies. The results of our analysis showed that profit margins for the Air Force bases selected had ranged from 210 to 792 percent on cost and from 23 to 276 percent on gross investment.

ONE COMPANY REDUCED COMMERCIAL RATES BUT NOT MILITARY RATES

Our review showed that one company had reduced its commercial rates but had not offered comparable reductions to DOD. Since MTMTS did not analyze commercial pipeline tariff rates, it was unable to detect the reductions and therefore made no analysis to determine if similar reductions in section 22 rates would be in order.

For example, transportation service to the commercial terminal near Air Force Base No. 1 was initiated in 1961. A section 22 rate was filed with ICC to cover transportation from the refineries to the base. The initial commercial tariff provided for the transportation of commercial fuel at \$0.50 per barrel from the refineries to the commercial terminal. The section 22 rate filed was \$0.825 per barrel from the same refineries to Air Force Base No. 1, which is only about one-half mile from the commercial terminal.

During the period 1966 through January 1970, the commercial rate was reduced in increments from \$0.50 per barrel to \$0.415, or \$0.085 per barrel. However, the section 22 rate was not reduced.

A reduction of \$0.085 per barrel would have reduced DOD's transportation costs by about \$253,000 during the period 1966 through 1970. In addition, on the basis of present

volume of fuel transported to Air Force Base No. 1, future savings of about \$150,000 annually would be realized if the section 22 rates were reduced by an amount equal to the reduction allowed the commercial shippers under the commercial tariff.

CONTRACTUAL AGREEMENTS WILL NOT INSURE
REASONABLE TRANSPORTATION RATES

In 1965 the Air Force initiated a program which provided for the execution of agreements with pipeline companies for new pipeline connections to Air Force bases. Our review showed that, of the 47 Air Force bases served by pipeline, about seven are now covered by such agreements.

The change from the section 22 rate basis to an agreement basis was initiated by the Air Force because of unilateral action by some pipeline companies to substantially increase section 22 rates after the pipeline connections to the Air Force base had been completed. The Air Force was not granted access to financial data necessary to assess the reasonableness of the increase.

In considering the establishment of pipeline service, the Air Force makes an agreement with the successful company granting an exclusive right to provide pipeline service to the base at a specified rate per barrel. The agreement also provides that any modification, such as a change in rate, needs the consent of both parties to the agreement. Furthermore, the agreement contains a provision for examination of company records to assess the reasonableness of rate increases.

These agreements improved procedures for the procurement of pipeline services by DOD in that they protected the Government from unilateral increases by pipeline carriers. However, we believe the agreements do not assure the Government of a reasonable rate based on the carriers' operating costs because the agreements do not provide for, nor has the Air Force established, procedures for a periodic appraisal of the rates for the purpose of possible downward adjustments warranted by increased volume, operating efficiency, or reductions in rates in the common carrier portion of the pipeline.

CHAPTER 3

AGENCY AND CONTRACTOR COMMENTS

AND OUR EVALUATION

We brought our findings to the attention of the Secretary of Defense in a draft report dated November 2, 1971. We proposed that DOD continue its efforts to negotiate pipeline rates no higher than those charged to commercial customers for similar service. We proposed also that, for any additional services provided to the military which are not provided to commercial customers, charges be negotiated subject to the requirement of the Truth in Negotiations Act of 1962 for submission of certified cost or pricing data. In addition, we suggested that, if DOD could not reach agreement with pipeline companies on rates to be charged on military shipments, it submit the rates to ICC for review and determination of reasonable rates.

At the same time we brought our findings to DOD's attention, we furnished copies of our draft report to the two pipeline companies involved in transporting fuel to the three bases covered by our review. We informed these companies that, if they desired to comment on our findings, we would be glad to consider their views.

AGENCY COMMENTS

At the request of the Secretary of Defense, the Deputy for Supply, Maintenance and Transportation, Department of the Army, commented on our findings and proposals in a letter dated January 5, 1972. (See app. I.) He stated that DOD agreed with our findings and concurred in our proposals. The Deputy added that, although attempts by MTMTS to evaluate the reasonableness of the rates had been unsuccessful because the carriers had consistently refused to separate the transportation rates from rates for other services, DOD had been able to negotiate and obtain greater cost adjustments.

The Deputy indicated that significant innovations in negotiation actions currently underway encompassed such considerations as requiring (1) pipeline operators to precisely identify costs for transportation services and for each accessorial service, (2) retroactive adjustments, (3) transportation charges based on comparisons with commercial tariff rates, where available, and (4) monetary considerations for the value of the service rendered where there is evidence that pipelines are providing direct delivery into military bases.

CHAPTER 4

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS

We believe DOD should be commended for aggressively seeking reduced rates for pipeline services furnished by the companies included in our review. However, DOD efforts were hampered due to lack of cost and pricing information on charges for accessorial services. In our opinion DOD should change its method of procuring pipeline transportation services under section 22 quotations.

We believe rate quotations should be limited to only that portion of pipeline services used in common carriage and thereby subject to ICC regulation. Accessorial services and other services provided exclusively to the military services should be procured under an annual requirements contract. Since the potential volume of fuel delivered to most installations would result in accessorial charges in excess of \$100,000 annually, the provisions of the Truth in Negotiations Act would apply, requiring carrier submission of cost and pricing data and certification as to the accuracy and completeness of such data.

We further believe that the method of contracting adopted by the Air Force after 1965 should be changed to conform to these same procurement concepts.

RECOMMENDATIONS

We recommend that the Secretary of Defense direct responsible DOD officials to negotiate rates for new pipeline services and to review the reasonableness of present pipeline rates by requiring companies to limit rate quotations to that portion of pipeline service used in common carriage. DOD should accept rates no higher than those charged commercial customers for transporting fuel to commercial terminals.

We recommend also that the Secretary of Defense require DOD officials to negotiate annual requirements contracts for accessorial services provided exclusively to the military. These contracts should recognize the composition of costs incurred by carriers in providing these services. Since a substantial portion of accessorial charges relates to fixed costs for depreciation of assets, taxes, and similar fixed charges and since the remainder of the costs

comprise variable elements which relate to the volume of fuel shipped, we believe that the requirements contract should be based on a range of costs that would reflect differing volumes of fuel shipments. The provisions of the Truth in Negotiations Act should be applied to contracts when the annual estimated volume will result in cost in excess of \$100,000.

We recommend that, if the carriers refuse to enter into negotiations for annual requirements contracts, the Secretary of Defense direct DOD officials to solicit the cooperation and assistance of ICC in establishing reasonable rates under ICC's general regulatory authority.

CHAPTER 5

SCOPE OF REVIEW

At the headquarters of companies A and B, we reviewed, as necessary, financial and operating data in support of pipeline activities for calendar year 1969. We also obtained from the two companies information pertaining to their operations from inception of pipeline service to various Air Force bases and certain other information pertaining to their commercial operations.

We obtained information and comments from the Transportation Division Director of Air Force Aerospace Fuels, Headquarters, San Antonio Air Materiel Area, Kelly Air Force Base, Texas; Headquarters, Air Force Logistics Command, Wright-Patterson Air Force Base, Ohio; MTMTS, Washington, D.C.; and ICC, Washington, D.C.



DEPARTMENT OF THE ARMY
OFFICE OF THE ASSISTANT SECRETARY
WASHINGTON, D.C. 20310

5 JAN 1972

Mr. T. E. Sullivan
Director, Transportation Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Sullivan:

The Secretary of Defense has asked me to reply to your letter T-OD-G-87 of 2 November 1971 in which you forwarded your draft report entitled "Procedures for Evaluating Reasonableness of Petroleum Pipeline Rates Need Improving" (OSD Case #3369).

We agree with the draft report of the GAO findings and concur in the recommendations made. The GAO recognizes, in the draft report, that the use of pipeline carriers has resulted in substantial savings to DOD over other transportation modes. The initial filings of Section 22 pipeline rates, however, contained a unit charge which included transportation as well as accessorial charges. All attempts by the MTMTS to evaluate the reasonableness of the rates were unsuccessful because the carriers consistently refused to separate the transportation rates from rates for other services. The 3 cents per barrel for additional services, mentioned in the report as being used by MTMTS in its negotiations with Companies A and B, was based on estimated costs. As a result of further discussions with GAO representatives, MTMTS recognized that specific charges for required services and respective cost values would have to be obtained from the shipper services and adjusted accordingly. During the subsequent negotiations, these procedures were followed and greater cost adjustments were made.

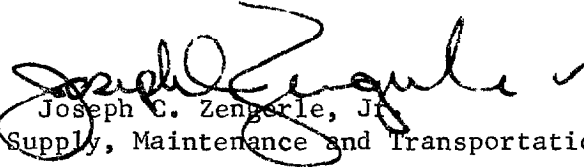
Significant innovations in negotiation actions currently underway encompass such considerations as requiring (i) pipeline operators to precisely identify costs for transportation services, and costs for

APPENDIX I

Mr. T. E. Sullivan

each accessorial service; (ii) retroactive adjustments; (iii) transportation charges based upon comparisons with commercial tariff rates, where available; and (iv) monetary considerations for the value of the service rendered, where there is evidence that pipelines are providing direct delivery into military bases.

Sincerely,



Joseph C. Zengerle, Jr.
Deputy for Supply, Maintenance and Transportation

PRINCIPAL OFFICIALS OF
THE DEPARTMENT OF DEFENSE AND
THE DEPARTMENTS OF THE ARMY, NAVY, AND AIR FORCE
RESPONSIBLE FOR THE ADMINISTRATION OF ACTIVITIES
DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
<u>DEPARTMENT OF DEFENSE</u>		
SECRETARY OF DEFENSE:		
Melvin R. Laird	Jan. 1969	Present
Clark M. Clifford	Mar. 1968	Jan. 1969
Robert S. McNamara	Jan. 1961	Feb. 1968
DEPUTY SECRETARY OF DEFENSE:		
Kenneth Rush	Feb. 1972	Present
David Packard	Jan. 1969	Jan. 1972
Paul H. Nitze	July 1967	Jan. 1969
Cyrus R. Vance	Jan. 1964	June 1967
ASSISTANT SECRETARY OF DEFENSE (INSTALLATIONS AND LOGISTICS):		
Barry J. Shillito	Jan. 1969	Present
Thomas D. Morris	Sept. 1967	Jan. 1969
Paul R. Ignatius	Dec. 1964	Aug. 1967
<u>DEPARTMENT OF THE ARMY</u>		
SECRETARY OF THE ARMY:		
Robert F. Froelke	July 1971	Present
Stanley R. Resor	July 1965	June 1971
Stephen Ailes	Jan. 1964	July 1965
ASSISTANT SECRETARY OF THE ARMY (INSTALLATIONS AND LOGISTICS):		
Dudley C. Mecum	Oct. 1971	Present
Vincent P. Huggard (acting)	June 1971	Oct. 1971
J. Ronald Fox	June 1969	June 1971
Vincent P. Huggard (acting)	Feb. 1969	June 1969
Robert A. Brooks	Oct. 1965	Feb. 1969

APPENDIX II

Tenure of office	
<u>From</u>	<u>To</u>

DEPARTMENT OF THE NAVY

SECRETARY OF THE NAVY:

John W. Warner	May	1972	Present
John H. Chafee	Jan.	1969	May 1972
Paul R. Ignatius	Sept.	1967	Jan. 1969
Charles F. Baird (acting)	Aug.	1967	Aug. 1967
Robert H. B. Baldwin (acting)	July	1967	July 1967
Paul H. Nitze	Nov.	1963	June 1967

ASSISTANT SECRETARY OF THE NAVY
(INSTALLATIONS AND LOGISTICS):

Charles L. Ill	July	1971	Present
Frank K. Sanders	Feb.	1969	June 1971
Barry J. Shillito	Apr.	1968	Jan. 1969
Vacant	Feb.	1968	Apr. 1968
Graeme C. Bannerman	Feb.	1965	Feb. 1968

DEPARTMENT OF THE AIR FORCE

SECRETARY OF THE AIR FORCE:

Robert C. Seamans, Jr.	Jan.	1969	Present
Dr. Harold Brown	Oct.	1965	Jan. 1969
Eugene M. Zuckert	Jan.	1961	Sept. 1965

ASSISTANT SECRETARY OF THE AIR
FORCE (INSTALLATIONS AND LO-
GISTICS):

Philip N. Whittaker	May	1969	Present
Robert H. Charles	Nov.	1963	May 1969

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