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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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ENERGY AND MINERALS
DIVISION

B-178205

OCTOBER 26, 1979

The Honorable Charles B. Curtis
Chairman, Federal Energy
Regulatory Commission

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Dear Mr. Curtis:

Subject: The Special Rate Treatment Allowed Natural Gas Pipeline Production Programs (EMD-80-10)

We reviewed certain policies and practices of the Federal Energy Regulatory Commission and its predecessor, the Federal Power Commission, 1/ for regulating natural gas pipeline rates. The Natural Gas Act of 1938, as amended, requires that such rates and rules be just and reasonable. An important goal of the Commission is to assure compliance with the act and an adequate supply of natural gas to consumers. The Commission's general responsibility is to develop, manage, and direct energy regulatory programs and activities assigned to it by statute, executive orders, and the Secretary, Department of Energy. We centered our effort on the Commission rulings which afforded certain pipeline companies financial assistance to conduct natural gas exploration and production programs by allowing such companies to price the gas they produced at special rates.

Commission Opinion Number 568 provides that for leases acquired after October 7, 1969, interstate pipeline companies should price their natural gas at area rates. 2/ This placed the pipeline companies (which previously had priced the gas they produced on a cost basis) on a parity with independent producers of natural gas sold interstate. The opinion also provides, however, that if a pipeline

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1/As of Oct. 1, 1977, Federal Power Commission responsibilities were transferred to the Federal Energy Regulatory Commission.

2/Area rates--fixed by the Commission on the basis of average current production costs, as well as historical costs.

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company can demonstrate "special circumstances" the Commission may allow the company to price the gas it produces on a basis other than the regulated rates. The opinion does not define all of the special circumstances. During our review four natural gas pipeline companies had been allowed special rate treatment under programs approved by the Federal Power Commission.

Prior to the Natural Gas Policy Act of 1978, enacted November 9, 1978, intrastate natural gas prices were substantially higher than interstate gas prices. This disparity has reportedly been the cause of some interstate pipeline companies not being able to obtain sufficient gas supplies and therefore having to develop their own costly exploration and development programs. The Natural Gas Policy Act of 1978 will eventually eliminate this price disparity. Commission staff officials said they have not yet determined what effects the act may have on the companies receiving special rate treatment.

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We obtained information on the special rate programs by examining company and Commission documents and records, and conducting interviews at the Commission and at two of the companies--Northern Natural Gas Company (Northern) in Omaha, Nebraska and Houston, Texas and El Paso Natural Gas Company (El Paso) El Paso, Texas. We selected these two companies for review because they were the largest of the four. We also obtained limited information on the other two companies--Michigan Wisconsin Pipe Line Company and Kansas-Nebraska Natural Gas Company, Inc., from Commission files.

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This report addresses the Commission rulings which permitted pipeline companies special rate treatment for gas they produce (from leases acquired on or after October 8, 1969, pursuant to the Commission-approved exploration and development programs) and the Commission's administration and monitoring of the programs.

INADEQUATE DESIGN AND ADMINISTRATION OF SPECIAL RATE PROGRAMS

The Commission did not provide assurance that its rulings on special rate treatments were just and reasonable or the programs were properly administered. Specifically, the Commission did not

1 --determine the need for applying the special rate treatment to leases on Federal domain and whether such rates would provide the pipelines operating on Federal lands an undue financial advantage in relation to other producers of natural gas for the interstate market;

2 --set limits on the size of all programs, relative to company needs, and the cost companies could charge their customers for gas produced under the programs; or

3 --require adequate reporting or timely evaluation of program results and costs.

Special rate treatment actions based on inadequate information

When requesting special rates for their exploration and production programs, each of the four pipeline companies contended that because intrastate prices for natural gas were higher than interstate prices, they could not (1) compete for enough natural gas in the open market to meet their requirements and (2) risk large sums of stockholders' funds for exploration if the gas they produced had to be sold at regulated interstate rates.

In allowing the special rate treatments, the Commission did not question the need for applying the special rate treatments to leases on Federal domain, such as the Outer Continental Shelf (OCS) leases, where there is no competition with the intrastate market. Also, we found no evidence of any determination having been made by the Commission as to whether the companies could have bought gas from OCS producers at regulated rates to supplement their needs. The Commission unquestionably accepted the companies' contentions that regulated prices would not support high risk exploration, even though other developers of OCS leases were assuming the same risk and selling at regulated prices. Consequently, we believe the Commission had inadequate information to assure that special rate treatment was needed on Federal domain leases and the merits of its actions outweighed the negative consequences.

The special rate treatment (1) helps minimize the financial risk of the pipeline companies by assuring recovery of substantial costs for exploration, development, and production activities through customer charges and (2) gave the companies a financial advantage in relation to other OCS producers, who invested in exploration and development and risked loss if they failed to market enough gas at regulated interstate rates to cover their costs.

Northern and El Paso have spent large sums of money for activities in the OCS. Both companies had acquired offshore leases before being provided special rate treatment by the Commission. Both companies' officials said they would have conducted exploration activities on the OCS in the absence of special rate treatment but on a more limited basis.

We obtained the following information on exploration and development program expenditures from inception through December 31, 1977, at the offices of Northern and El Paso.

	Special Rate Program Expenditures		
Company	Total	Offshore (note a)	Onshore
Northern	$106,537,077	$25,560,052	b/$ 80,977,025
El Paso	162,566,011	46,125,429	116,440,582

a/Expenditures for activities on Federal domain.

b/Includes over $3.3 million for activities for onshore Federal domain.

The portion of the programs devoted to OCS activities by Northern and El Paso represents about 24 and 28 percent, respectively, of their total exploration and development expenditures.

Both companies have increased their natural gas reserves under the programs. Information furnished by El Paso showed an increase in reserves of 619 billion cubic feet (Bcf) for the 4 years ended December 31, 1978, of which 31 Bcf is attributable to the Outer Continental Shelf. Northern showed an increase in reserves of 215 Bcf, as of June 30, 1979, of which 64 Bcf is attributable to the Outer Continental Shelf.

The special rate treatment permits companies to pay lessors higher bonus prices, or overriding royalties to obtain leasehold interests and to pay disproportionate shares of exploration, development, and production costs to compensate partners in these efforts for the higher prices available in the intrastate market. For example, a Northern official in testimony justifying the need for special rates before the Commission said that

> "The Company has also attempted to participate in exploratory prospects submitted to it by outside parties where this gave promise of aiding our gas acquisition efforts. In nearly all cases where we have entered into exploration ventures with other parties, we sought to retain the right to take our share of the gas in kind and also obtain a call upon all or a significant portion of the gas belonging to the partner. Because of our inability to compete with the intrastate market in purchasing gas we have had to assume a higher working interest in the revenue portion of these agreements. This atypical situation is one of the major reasons why our average cost per unit of equity gas has been higher than that incurred by other producers."

Inconsistent program allowances and requirements preclude adequate evaluation

All of the agreements authorizing the special rate programs provided for the customers to pay all or most of the companies' natural gas exploration and development costs. For example, the Commission permits Northern to include in its pipeline rates 75 percent of its annual operating costs and return on investment; in addition, Northern is permitted to recover an additional amount equal to 25 percent of the gas produced annually multiplied by the regulated rates. The agreements were inconsistent in providing for limitations on the size of the programs and on the maximum costs that could be charged to the customers for gas produced under the program. Also, there were no standard reporting requirements regarding program costs and results.

Only the Michigan Wisconsin agreement contained an overall annual limit on the amount that it could spend under its program. This resulted from the Commission having some doubt that Michigan Wisconsin had shown special circumstances when its program was first proposed. Accordingly, the Commission and the company agreed on a settlement limit that would enable Michigan Wisconsin to pursue its exploration program, pending its further justification.

We found no other evidence that the Commission limited the other pipeline companies on total program expenditures which could be included in the pipeline rates established.

The Michigan Wisconsin and Northern agreements established a ceiling on the cost of gas produced that could be charged to their customers under the program. Under both agreements the ceiling cost was set on the basis of alternative fuels. The Michigan Wisconsin agreement appeared to be clear and specific and its application determinable. Michigan Wisconsin reported that its cost for gas produced during the year ended October 31, 1976, exceeded the ceiling cost of alternative fuels and limited its charges to the ceiling cost.

The Northern agreement, however, was vague. For example, it did not state, (1) which alternative fuel was to be used, (2) how or at what point in time a comparison was to be made, or (3) how such comparison was to be computed. The agreement did not require Northern to report separately on its expenditures under its special rate program versus other production programs. As a result, data reported by Northern did not provide the Commission with any basis for comparing the cost of gas produced under the program to the cost of alternative fuels. For 1975, Northern reported costs of $1.74 per Mcf (thousand cu. ft.). However, this cost represented the cost of gas produced under all production programs, not just the special rate program. We obtained from Northern the unit cost of natural gas produced under the special rate program for 1975 of $5.00 per Mcf. Northern also reported the cost of number 2 fuel oil for 1975 of $2.52 per million British thermal units (approximately 1 Mcf).

All of the companies file voluminous information with the Commission in proposals for rate increases. But only El Paso was required to file a separate report on program results each year. For example, one of Northern's rate change proposals showed its annual cost under the program and the amount being charged to its customers, but did not show overall program progress or results.

The Commission staff did not maintain any records to show if or how data reported by the companies was used. For example, Northern's customers paid $13.8 million more over a 6-year period (1972-77) than the value of gas at regulated rates. The company was expanding its production operations and estimates that it will recover an additional $10 million in excess of regulated rates between October 1978-79. However, the Commission staff did not make any analysis to evaluate these additional charges in relation to benefits.

We also obtained data from Northern which showed that the cost to its customers for natural gas produced under the program varied between $7.61 per Mcf in 1973 and $2.25 per Mcf in 1977. Data showing the unit cost to El Paso's customers for gas produced from program inception to 1977 was not readily available. The Northern and El Paso agreements did not require reporting of the above data. We believe the Commission staff needed such data to administer the programs and evaluate the justness and reasonableness of the rates.

We identified similar weaknesses in the Commission's evaluation of program accomplishments in our report, "The Advance Payment Program: An Uncontrolled Experiment" (EMD-78-47, July 10, 1978). The Commission allowed the experimental program to continue for about 5 years without knowing whether the program had resulted in increased supplies of natural gas to the interstate market. We recommended establishment of policy guidelines requiring that any special programs and experiments provide for measuring the results against clearly defined objectives. At that time the Commission Chairman told us that it was not necessary to promulgate specific guidelines. We disagree. We believe our findings in this report re-enforce the merits of our recommendation, and we believe that such policy guidelines are needed.

CONCLUSIONS

The Commission did not adequately determine the need for special rate treatment programs and whether these special rates would provide the pipeline companies an undue advantage over other interstate producers. Also, because the

Commission did not (1) set limits on the size of all programs and on the costs companies could charge their customers for gas produced under the programs or (2) require adequate reporting, the Commission staff had no means of monitoring the progress of programs or of evaluating program results.

COMMISSION STAFF AND PIPELINE COMPANIES COMMENTS AND GAO EVALUATION

A draft copy of this report was submitted to FERC for comment. The Commission did not respond, but we did receive comments from the Commission's staff. El Paso and Northern were provided excerpts from our report applicable to their companies. Comments received from the Commission's staff, El Paso and Northern were considered and changes were made in our report where appropriate. Other pertinent comments and our evaluation are summarized below.

Both companies and the Commission staff contend that the special rate program did not provide the companies with a financial advantage in exploring for natural gas on Federal domain. Northern said the special program provided an opportunity to more actively seek reserves in the OCS, and that, without special rate treatment, it did not have available, nor could it have risked it if it were available, the large amount of capital required to effectively compete for Gulf Coast reserves. El Paso suggested that in discussing financial advantages, we make it clear that we did not find any specific examples of El Paso bidding excessive amounts for off-shore leases, or that it has subsidized its partners in off-shore ventures. El Paso said that as far as it is concerned, these financial advantages exist only in the theoretical sense. The Commission staff agreed that a determination of financial advantage was not made, at least at the time the Commission initially approved El Paso's and Northern's exploration programs.

We do not contend that either El Paso or Northern exercised a financial advantage because we did not examine their competitive bidding practices involving lease acquisitions. Such determinations, however, should have been made by the Commission staff. The special rate treatment allows companies to recover all or most of their operating expenses, and limits losses resulting from unsuccessful explorations. This, in our opinion, is a significant financial advantage to the companies in relation to other producers of gas for the interstate market.

The Commission staff further said that there was no necessity for the Commission to question whether the companies could have bought gas from Outer Continental Shelf producers at regulated rates because both the El Paso and the Northern programs provided for a risk sharing by the customers and the pipelines. We disagree. Because all gas derived from the Outer Continental Shelf is dedicated to the interstate market, at prices regulated by the Commission, we believe it was incumbent upon the Commission to have determined if the companies could have bought gas from Outer Continental Shelf producers before approving an exploration program that would result in a higher unit cost for such gas than that permitted under the Commission's regulated rates.

The Commission staff said that our criticism of the Northern agreement fails to recognize that rigid requirements, such as (1) the alternative fuel to be used; (2) how and at what point in time a comparison was to be made; and (3) how such a comparison was to be computed, could prove illogical. We fail to understand this rationale because the Commission imposed the requirement that Northern limit its customer charges for gas produced to the price of alternative fuels. Accordingly, it is only reasonable that all parties affected by such a requirement have an understanding of how it will be complied with and administered.

The Commission staff maintained that the fact that Northern's customers paid $13.8 million more over a 6-year period than the value of gas at regulated rates was irrelevant because such costs were incurred by Northern prior to the Commission's approval of Northern's special rate program.

We disagree. Although the costs were incurred prior to Commission approval, such approval of Northern's program permitted Northern to keep the additional customer charges collected from program inception.

FERC staff also maintained that the estimated $10 million to be collected in excess of regulated rates between October 1978-79, which GAO said the FERC staff should have considered in comparison to customer benefits, was equally nebulous or inappropriate. They claimed that they could not have known what effect the NGPA might have upon natural gas pricing. We do not understand such rationale. Regardless of the difficulty in determining the estimated costs, we believe it was the Commission's responsibility to evaluate such charges in relation to benefits since Northern's customers would be charged for such costs.

In commenting on the need for program evaluations, the Commission staff said that all the benefits pipeline customers can realize through potential increase in gas supplies is something on which a dollar amount cannot be placed. Therefore, they contend that it is difficult to evaluate the benefits of the special rate treatment program with the increase in customer costs for gas. We agree that such an evaluation is difficult. However, that does not relieve FERC of its responsibility for assuring the cost-effectiveness of its programs.

The fact remains that the special rate program allows pipeline companies to charge rates in excess of the regulated rates. This feature makes it mandatory at the outset to evaluate benefits and costs. Accordingly, the companies should be required to account for their program costs and benefits, in terms of gas produced and progress in developing a viable exploration program. Apparently, this was recognized, in part, by the Commission when it imposed specific reporting requirements on El Paso and limited Northern's unit cost of all gas developed under its exploration programs to the unit cost of alternative fuels.

Although the Commission staff did not address our specific recommendations, they said that the final Natural Gas Policy Act of 1978 (NGPA) pricing regulations, relative to pipeline owned production, could make our recommendations moot. We disagree. The potential effect of the final NGPA pricing regulations relative to pipeline owned production points up the need for having established policy guidelines at the outset. For example, there are no provisions relating to program termination. If these programs should be terminated, an equitable adjustment needs to be considered to compensate pipeline customers for their contributions to the program. In the absence of specific provisions, occurrences such as program terminations become the subject of considerable controversy in arriving at an equitable settlement. In this regard, Northern officials in their reply to our draft report said that the NGPA would not eliminate Northern's need for continuance of the special rate program.

The recommendations which follow are designed to correct weaknesses in the administration of the special rate program, as well as other FERC special programs and experiments. We have recommended in other reports that FERC establish guidelines to assure that program results are measured against program objectives. Our recommendations encourage FERC to correct this generic problem which we have found in all of the special programs we have reported on over the last few years.

RECOMMENDATIONS

We recommend that the Commission

--determine, on the basis of documented cost-benefit analyses, the need for special rate treatments;

--set limits on the size of special rate treatment programs, relative to company needs, and on the costs companies can charge customers for gas produced under the programs; and

--require periodic reporting on program progress and results to facilitate meaningful program evaluations of this and any other special program or experiment.

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As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

Copies of this report are being sent to the Secretary of Energy; the Director, Office of Management and Budget; the Senate Committee on Governmental Affairs; the House Committee on Government Operations; the House Committee on Appropriations; the Senate Subcommittee on Public Works, Committee on Appropriations; and other interested Members of Congress.

We appreciate the courtesy and cooperation extended to our staff during the review.

Sincerely yours,

J. Dexter Peach
Director