BY THE COMPTROLLER GENERAL

Report To The Congress

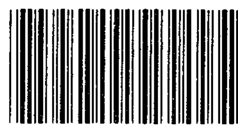
OF THE UNITED STATES

Petroleum Pipeline Rates And Competition-- Issues Long Neglected By Federal Regulators And In Need Of Attention

Regulators have not developed criteria for determining whether pipeline rates are reasonable and making sure that pipeline operators comply with the Interstate Commerce Act. In the absence of such criteria, GAO could not determine the extent to which consumers might have benefited from more effective regulation.

Compared to other profitable companies--federally regulated or unregulated--the owners of many oil pipelines have received higher returns on their stockholders' equity and total capital.

GAO recommends actions that the Attorney General and the Federal Energy Regulatory Commission should take to improve regulation of oil pipelines.



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COMPTROLLER GENERAL OF THE UNITED STATES
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To the President of the Senate and the
Speaker of the House of Representatives

This report discusses the lack of effective Federal regulation of oil pipelines and suggests ways to improve such activities.

We undertook this review at the request of Representative Edward J. Markey and 19 other New England Congresssmen, including the Speaker of the House of Representatives. Because of the significance of this report, we are issuing it to the Congress.

We are sending copies of this report to Representative Edward J. Markey and the other requestors and to the Director, Office of Management and Budget; the Attorney General; and the Chairman, Federal Energy Regulatory Commission.

Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

PETROLEUM PIPELINE RATES AND COMPETITION--ISSUES LONG NEGLECTED BY FEDERAL REGULATORS AND IN NEED OF ATTENTION

DIGEST

This report discusses Federal regulation of oil pipelines. It was prepared at the request of Representative Edward J. Markey and 19 other Congressmen from New England, including the Speaker of the House.

A network of 174,000 miles of oil pipelines crisscrossing the United States provides the most efficient and least expensive means of moving oil. Pipeline transportation costs are estimated to compose 2 or 3 percent of the delivered price of petroleum products.

During 1976--the latest year for which industry-wide data was available--pipelines carried about 5.8 billion barrels of crude oil and over 3.8 billion barrels of petroleum products. This represents 75 percent of the crude oil and 35 percent of the petroleum products transported domestically.

Until October 1, 1977, these pipelines were regulated by the Interstate Commerce Commission. At that time, jurisdiction was transferred to the Federal Energy Regulatory Commission of the Department of Energy.

As common carriers, oil pipelines have been subject to the requirements of the Interstate Commerce Act for over 70 years; however, little was done to regulate these companies effectively. GAO was unable to determine whether the oil pipeline industry has met its common carrier obligations because Federal regulators lacked essential information and had not developed criteria and standards to ensure compliance with the act.

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cover date should be noted hereon.

GAO found:

--Federal regulators have not defined what level of return would be considered reasonable. In the absence of such criteria, GAO could not determine the extent to which consumers might have benefited from more effective pipeline regulation. Many pipeline companies received higher returns to stockholders' equity and total capital than the other most profitable industries--regulated or unregulated. (See p. 7.)

--Allegations of anticompetitive practices by the oil pipeline companies have not been resolved, resulting in almost continuous Federal investigations over the past 15 years. These investigations have been difficult, complex, and costly. The results have been limited. (See p. 33.)

--The Federal Energy Regulatory Commission has not directed its attention to many many oil pipeline common carrier issues and presently has no plans to do so. However, the Commission has attempted to more actively regulate oil pipeline rates since inheriting this authority from the Interstate Commerce Commission. (See p. 38.)

Inadequate regulation has allowed high profits

Compared to other profitable companies--regulated or unregulated--the owners of many oil pipelines have received higher returns on their stockholders' equity and total capital. For example, for 1976, the most profitable publicly held company among Forbes' listing of the largest American businesses would have ranked 26th among oil pipeline companies. The most profitable utility company and natural gas pipeline companies would have ranked 61st and 24th, respectively, in terms of return on stockholder equity. (See p. 8.)

Higher profits realized by many pipeline companies continued because

--the Interstate Commerce Commission did not review the justness and reasonableness of pipeline rates as the act requires (see pp. 12-14) and

--a 1941 Consent Decree, designed to limit dividends pipelines companies can pay their shipper-owners, has failed to limit rates or profits (see p. 15).

Rate review

The Government has not established criteria for determining the justness and reasonableness of oil pipeline rates.

Pipeline tariffs were given cursory reviews and had a low priority relative to other transportation modes. Reviews of tariffs generally were clerical in nature and did not assure that rates were maintained at just and reasonable levels. In 1976, 41 of the 110 regulated oil pipelines had rates of return higher than what was allowed in a number of Interstate Commerce Commission decisions. (See p. 14.)

Ineffective consent decree

The 1941 Consent Decree entered into by the Department of Justice and many of the pipeline companies limited the dividends pipeline companies could pay their shipper-owners. This decree, however, has not limited pipeline companies' rates or profits. The decree resulted from a suit brought by the Department against many of the pipeline companies and charged that dividends paid to shipper-owners were illegal rebates. The decree limited dividend payments to 7 percent of the pipeline companies' valuation.

The use of valuation as a basis for dividends allowed inclusion of debt-financed

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property in calculating the dividend limitation. Before the decree, pipeline companies were financed almost entirely by equity funds provided by their shipper-owners. Today, many pipeline companies have debt equity ratios of 90:10 or higher. This change in pipeline financing made the decree ineffective in controlling dividends to shipper-owners as intended by the Department of Justice and failed to limit rates or profits. (See pp. 15 and 17.)

The decree has not operated as the Department of Justice intended--namely to limit dividends on the basis of equity-financed property. It does not serve a useful purpose, and Department officials said little has been done to enforce it. Further, although pipeline companies must annually report to the Department dividends paid to their owners, controls have not been established to assure that companies subject to the decree are filing and those which are filing do so accurately and completely. (See p. 17.)

Allegations of anticompetitive practices have not been resolved

Federal regulators have not resolved allegations of anticompetitive oil pipeline company practices. Most of the alleged practices have the potential of affecting nonowner shippers, such as independent refiners or marketers. GAO did not determine whether, and to what extent, these practices are used, nor weigh the technical and legal arguments for and against them. The nature and source of the allegations are discussed in chapter 3. Allegations regarding anticompetitive practices have not been resolved because:

--The Interstate Commerce Commission gave low priority to oil pipeline regulation and relied almost entirely on complaints before taking action. (See p. 27.)

--Information needed to ensure that oil pipelines meet their common carrier obligations was not routinely collected. (See p. 28.)

--There were no standards or criteria for evaluating oil pipeline company practices such as scheduling or prorationing procedures, the minimum amounts acceptable for shipment, or access to terminal facilities. In cases for which precedents had been established they were not enforced. (See pp. 29 and 30.)

--The Interstate Commerce Commission did not review nor question carriers' tariff rules and conditions; as a result, pipelines often had considerable discretion in accepting shipments. (See p. 30.)

--A systematic compliance program was not undertaken until June 1976. When begun, the program raised a number of questions about possible anticompetitive, discriminatory, or otherwise unlawful practices but little was done to resolve these questions. (See pp. 31 and 32.)

Because of these factors, GAO was unable to determine whether the oil pipeline industry has met its common carrier obligations.

Although the Interstate Commerce Commission was responsible for regulating oil pipelines as common carriers, its regulation was not adequate to ensure that oil pipelines met their common carrier obligations. Additionally, the Department of Justice's Antitrust Division, the Federal Trade Commission's Bureau of Competition, and the Department of Energy's Economic Regulatory Administration have all investigated alleged anticompetitive practices of oil pipeline

companies. These difficult and costly investigations have been subject to court challenges and delays. Because of each agency's statutory constraints on the disclosure of information outside the agency, information has not been shared.

REGULATION IS IMPROVING BUT MORE AGGRESSIVE ACTIONS ARE NEEDED

The Federal Energy Regulatory Commission has taken more aggressive actions than the Interstate Commerce Commission to regulate pipelines--particularly pipeline rates; however, problems with pipeline regulation continue. (See p. 39.)

The Commission's jurisdiction may need to be extended to include certification of public convenience and necessity and authority over terminal facilities if the Commission is to regulate oil pipelines effectively. Oil pipelines, unlike other common carriers, natural gas pipelines, and public utilities are not required to obtain approval for their routing, capacity, or shipper facilities. (See p. 43.)

Oil pipelines generally are configured by their owners to best suit their needs. A pipeline routed several miles from a nonowner's facilities is, for all intents and purposes, unavailable for use by that nonowner. Furthermore, pipelines controlled by major oil companies generally do not provide common carrier terminal facilities. These facilities at the entrance, destination, and at times between connecting pipeline routes are essential to the interstate pipeline movement of oil. Right of access to terminals is, in effect, right of access to the pipeline systems.

The Interstate Commerce Commission contended that it did not have jurisdiction over pipeline terminals. The Federal Energy Regulatory Commission contends that it may have jurisdiction in some instances, but has

made a formal decision on the jurisdiction issue in only one case. This was done at the request of the owners of a marine terminal facility. No attempt has been made to enforce this authority for other facilities. (See p. 42.)

Unless Federal regulators exercise jurisdiction over pipeline routing, capacity, and terminal facilities, they will be limited in enforcing pipelines' common carrier obligations.

RECOMMENDATIONS

Federal Energy
Regulatory Commision

To assure justness and reasonable rates, the Federal Energy Regulatory Commission should implement rate reform. Criteria should be established for determining the justness and reasonableness of oil pipeline rates and sufficient regulatory procedures implemented to make sure that criteria are followed. Rates of return should provide proper incentives for continued investment in pipelines.

These procedures should include (1) a requirement that both line segment and company-wide rate increases be adequately justified, (2) the use of tariff examiners who fully understand the oil pipeline industry, and (3) an adequate audit process for assuring the validity of data provided by the pipeline companies.

The Commission should strengthen its regulation of petroleum pipeline practices by:

--Collecting adequate financial and operating information on oil pipeline companies, including undivided-interest pipelines, in coordination with the Energy Information Administration.

--Determining whether pipeline terminal facilities are subject to the provisions of the Interstate Commerce Act. If not, the Commission should request legislation

from the Congress to make terminal facilities subject to the same jurisdiction as the pipelines.

--Developing policies and standards for common carrier requirements of oil pipelines and establishing procedures for enforcing industry compliance.

--Determining the best means to assure that all potential users of a pipeline are adequately considered in its routing, sizing, or expansion. The need to extend FERC's regulation through certification of public convenience and necessity should be among the options considered in making such a determination.

Department of Justice

The Attorney General should move to vacate the consent decree because it no longer serves any useful purpose in limiting payments to pipeline owners or controlling pipeline rates. This would remove an unnecessary reporting burden on the pipeline companies and the administrative burden on the Department of Justice.

AGENCY COMMENTS

The Departments of Energy and Justice, the Federal Energy Regulatory Commission, the Federal Trade Commission, and the Interstate Commerce Commission generally agreed with GAO's findings. (See apps. I through V.)

Justice and Energy, however, did express some disagreement with GAO's recommendations. Justice disagreed with GAO's recommendations to vacate the consent decree, contending that it is the only limit, in the absence of rate regulation, on pipeline profits. Justice said, however, that this limit is high and that it permits the earning of some excessive profits. Furthermore, Justice has not enforced the decree and even if it were enforced, it would serve little useful purpose because it applies only to certain

companies and Justice officials have said they have no means of knowing which companies are required to report under the decree. GAO therefore believes the consent decree should be vacated. (See p. 17.)

Energy and Justice took the position that GAO had not demonstrated adequately that certification of oil pipelines would be beneficial. GAO agrees that some further analysis, if completed in a reasonable period of time, would be beneficial in judging the needs and merits of legislation. Accordingly, GAO is recommending that the Federal Energy Regulatory Commission determine the best means of assuring that potential users of a pipeline are adequately considered in its routing, sizing, or expansion. Certification of public convenience and necessity should be among the options considered in making such a determination. The objective of this certification requirement is to govern the adequacy and quality of service provided by the carrier. Other common carriers, except oil pipelines, are required to obtain certification. The Government's licensing of the Louisiana Offshore Oil Port and its pipeline facilities enabled the Federal Government to set conditions on the project to (1) ensure that it would be sized to serve potential users and (2) create a more competitive environment. GAO believes the same benefits are possible for other oil pipelines. (See p. 43.)

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ABBREVIATIONS

DOE	Department of Energy
ERA	Economic Regulatory Administration
FERC	Federal Energy Regulatory Commission
FTC	Federal Trade Commission
ICA	Interstate Commerce Act
ICC	Interstate Commerce Commission
LOOP	Louisiana Offshore Oil Port

CHAPTER 1

INTRODUCTION

The United States is crisscrossed by an extensive network of over 174,000 miles of interstate petroleum pipelines which reach across every one of the contiguous 48 States. There are three types of these pipelines. Crude gathering lines transport crude petroleum from oil fields to central collecting points. Crude trunk lines move crude petroleum from collecting points to refineries. Finally, product pipelines transport refined products, such as gasoline, kerosene, jet fuel, and home heating oil, from refineries to pipeline marketing terminals. From the terminals other transportation modes are used to distribute these oil products to the consumer.

Pipelines are the most efficient, lowest cost overland means of transportation. Pipeline transportation costs are estimated to compose 2 or 3 percent of the delivered wholesale price of petroleum products. This is cheaper than shipping by tankers and barges on many coastal water routes. For example, the pipeline cost to ship a gallon of gasoline from Texas to New York is about 1 cent. However, the cost by ship--the next least costly means--is about 2.5 cents. Because of savings associated with use of pipelines for large-volume, long-distance moves, the use of petroleum pipelines has increased continually.

In 1976, the latest year information was available on an industry-wide basis, pipelines carried 5.8 billion barrels of crude oil and over 3.8 billion barrels of petroleum products through the various trunk lines. Pipelines carried in domestic transportation almost 50 percent of all oil--75 percent of the crude oil and 35 percent of petroleum products. This represents about 24 percent of total intercity freight ton-miles shipped by all transportation modes.

OWNERSHIP OF OIL PIPELINES

Pipeline ownership is dominated by major vertically integrated oil companies. Sixty-two of the 110 interstate pipelines are affiliated with them. Large pipeline systems generally have multiple ownership because of the economies of scale inherent in pipeline operations. In addition, most producers and refiners cannot justify constructing and operating a large-diameter pipeline for their exclusive use.

Multiple ownership, or joint venture, is usually through a stock company or undivided joint interest. A stock company

is a corporation composed of the several owner-companies which own stock in a pipeline company. When equity ownership is shared by these oil companies, their participation in the stock company is generally proportionate to their expected use of the pipeline. Also, oil companies often hold ownership in these joint venture pipeline corporations through their subsidiary pipeline companies. Colonial Pipeline Company, for example, has 10 owners, including both major oil companies and pipeline subsidiaries of other oil companies.

Undivided joint interest pipelines, another form of multiple ownership, have no separate corporate entity, nor is stock issued. Each owner has an undivided interest, as a tenant-in-common, in the pipeline properties. The system is generally operated by one of the participants as an agent. Each owner publishes its own tariffs, accepts shipments, and collects its own revenue. Participation in the undivided interest pipeline is generally proportionate to owners' expected use. The most noted example of this type of ownership is the Trans Alaska Pipeline System.

Independent petroleum pipelines do not have oil companies affiliated with them which produce or refine oil. During 1976, these pipelines transported less than 1 percent of the crude oil and 13 percent of petroleum products moved by interstate pipelines.

OIL PIPELINE CHARACTERISTICS

Oil pipelines have characteristics of natural monopolies. Continuing economies of scale permit a single firm to achieve lower average costs than any smaller firm that might enter the industry. Thus, a single large-diameter pipeline could be classified as a natural monopoly in that it can serve an entire market at lower total cost than two or more firms. Furthermore, no other firm will be likely to enter the market as long as there is capacity in the original pipeline.

Pipelines possess tremendous economies of scale due to pipeline construction and operation costs. As the pipeline diameter increases, the capacity of the pipeline increases faster than construction and operating costs. Therefore, average transportation cost per barrel decreases.

Pipeline construction costs are proportional to the radius of the pipe; however, the flow of oil is proportional to the square of the radius--that is, the area of cross-section. For example, the cost of building a 36-inch pipeline would be about 3-1/2 times that for a 12-inch line. However,

it could carry 17 times the volume. In other words, 17 pipelines, each 12 inches in diameter, would be required to carry the same volume as one 36-inch pipeline.

Pipelines' operating costs are resistant to inflationary pressures because fixed costs often account for as much as 80 percent of the total operating expenses. The variable costs subject to inflation are, therefore, proportionately lower than for other forms of transportation. As an example, available information shows that labor costs amounted to 15 percent of gross revenues during a recent 6-year period for pipelines versus about 45 percent for railroads and trucks and 22 percent for barges. Further, pipelines are able to operate 24 hours a day, 7 days a week, and are almost entirely insensitive to external conditions such as adverse weather and rail, waterway, or highway traffic congestion.

As a result, pipelines are the cheapest overland transport mode for the movement of significant sustained quantities of oil between two points. Pipeline rates in general are approximately one-fifth as high as railroad rates and one twenty-fifth as high as truck rates. Even in coastal areas, where there is competition from large ships, the large-diameter lines (which include most interstate lines constructed in recent years) are equally, if not more, efficient.

FEDERAL REGULATION OF OIL PIPELINES

Although Public Law 95-473 (92 Stat. 1337) revised and reinacted the provisions of the Interstate Commerce Act (ICA), oil pipelines which transport oil interstate, are the only common carriers which remain subject to the act. Pipelines which merely transport oil from their own well to their own refineries for their own use are not considered to be common carriers. The ICA requires that every common carrier pipeline

--provide transportation on reasonable request,

--establish reasonable through-routes with other carriers,

--charge just and reasonable rates,

--have adequate facilities for operating the through-routes, and

--make reasonable rules and regulations for these operations.

Pipelines are also prohibited from giving preference or advantage to any shipper. The Interstate Commerce Commission (ICC) was responsible for enforcing these common carrier pipeline provisions until October 1, 1977. These functions were transferred from ICC pursuant to the Department of Energy (DOE) Organization Act (Public Law 95-91) and are now the responsibility of the Federal Energy Regulatory Commission (FERC).

HISTORY OF PIPELINE LEGISLATION

Oil pipeline regulation is based upon various legislation passed in the last 90 years and which was incorporated into Part I of the ICA. Part I of the ICA was primarily directed at regulating railroads. Pipelines were excluded from many provisions of the ICA, and other provisions were written for railroads, although they might apply to pipelines. Differences between the operations and ownership of oil pipelines and other common carriers such as motor carriers and railroads make pipeline regulation very difficult under existing legislation.

The original Interstate Commerce Act to regulate common carrier commerce (enacted in 1887) was directed at railroads; coverage was extended to oil pipelines later. The act established the Interstate Commerce Commission to administer the law.

Pipeline regulation under the ICA was initiated because of discriminatory and concessionary practices associated with oil transportation at the turn of the century. Major refining companies had constructed trunk pipelines from producing areas to refiners. Independent refiners were unable to finance lengthy pipelines. In addition, the high rates and onerous conditions of transporting oil imposed by the large refineries, through their pipeline subsidiaries, effectively excluded independents from using those lines. Independents had to choose between more expensive rail transportation or selling to the major refiners. This led to the Hepburn Act of 1906, which declared interstate oil pipelines to be common carriers and placed them under ICC's regulatory authority. Therefore, common carrier pipeline companies could be forced to carry oil for independent producers or refiners at just and reasonable rates, thereby breaking up the advantage possessed by the integrated oil companies. Certain service and facilities of railroads, such as terminals and storage, were also brought under ICC's authority in order to control discrimination. The act also gave ICC authority to prescribe carrier rates and regulations if it found existing rates unreasonable or unlawful.

The Hepburn Act also contained the so-called Commodities Clause, which did not apply to pipelines. Railroads which owned coal mines or engaged in the production of other commodities in competition with independent producers had a distinct advantage when shipping over their own rails. By charging high transportation rates, the railroad could undersell and force its competitors out of the market. In this way, a railroad could monopolize production of a particular commodity. To prevent this type of discrimination, the Congress sought in the Hepburn Act to separate the railroad business from other enterprises by prohibiting a carrier from transporting articles in interstate commerce which it had produced or financially backed.

The Mann-Elkins Act in 1910 (36 Stat. 539) empowered ICC to suspend and determine the lawfulness of the proposed changes in any new rate, fare, or classification filed with ICC and placed the burden of justifying new rates on the carrier. To further strengthen its authority, ICC was given the power to fix maximum rates.

The Transportation Act of 1920, among other things, gave ICC control over new railroad construction by requiring that railroads obtain a certificate from ICC that public convenience and necessity required such extensions. This provision, however, was not applied to oil pipelines. Certification of public convenience and necessity is common in public utilities, natural gas pipelines, and offshore pipelines to ensure that proposed services are in the public interest and are not presently provided by others.

SCOPE OF REVIEW

We reviewed and analyzed laws, regulations, court decisions, and regulatory filings and decisions affecting pipelines. We held discussions with officials of ICC, DOE, FERC, the Federal Trade Commission, and the Department of Justice to determine the extent of enforcement of common carrier pipeline requirements. Although we met with representatives of the American Gas Association, the American Petroleum Institute, the Association of Oil Pipelines, and many oil pipeline companies to obtain their views on Federal efforts to regulate oil pipelines, we did not request their formal comments on the report. Additionally, we contacted numerous independent oil marketers and refiners. Also, we reviewed annual financial reports of the oil pipeline companies. We used 1976 as the base year for most information because no later data was available on a industry-wide basis. We believe the 1976 data continues to be relevant.

CHAPTER 2

PIPELINE PROFITS OR RATES

HAVE NOT BEEN ADEQUATELY REGULATED

Compared to the other most profitable companies--regulated or unregulated--the owners of many oil pipelines have received higher returns on their stockholders' equity and total capital. These higher returns are attributed primarily to savings derived from the economies of scale inherent in pipeline transportation. Regulators have allowed these higher levels without questioning their appropriateness. We found that

--the Interstate Commerce Commission has not established criteria for justness and reasonableness of pipeline rates and

--the 1941 Consent Decree has failed to limit rates or profits.

We could not determine the extent to which consumers might have benefited from more effective regulation, because there is no assurance that savings in transportation cost would be passed through to the consumer.

INADEQUATE REGULATION HAS ALLOWED HIGH PROFITS

Federal regulators have not determined what the appropriate profit levels for pipelines should be or what criteria should be applied. The owners of many oil pipelines have received returns on their investment higher than those realized by the other most profitable companies--regulated or unregulated. During 1976, pipelines controlled by oil companies earned $519 million after taxes and paid $357 million in dividends to their parent oil companies.

The ownership structure of the oil pipeline industry has hampered the effectiveness of common carrier regulation. The incentives of a pipeline owned by an integrated oil company are different from those of other common carriers. These pipelines carry commodities for both their owners and the competitors of the owners. This is a unique situation among common carriers or utilities. Other carriers are prohibited by law from transporting their own products. The incentive of pipelines owned by integrated oil companies is to maximize overall profits of their owners, and therefore these pipelines are largely built, controlled, and operated as integral parts of major oil companies.

A common carrier pipeline not affiliated with an integrated oil company increases its revenues and profits by expanding the volume it ships or by increasing its rates. In seeking to maximize its volume, it will actively try to attract as much business as possible from new and existing customers. This can be done by routing and sizing the pipeline to attract the largest number of shippers, providing storage facilities, providing pipeline connections on reasonable terms, and setting rates to encourage potential shippers to use the pipeline.

Measures of profitability

There are two methods which are commonly used to evaluate profits. The first measures the return on owners' investment and the second measures return on total capital from owners and lenders.

The first method compares the rates of the firm's net income (after taxes) to owners' equity. This ratio is referred to as return on equity.

The second method uses a broader definition of investors to include all long-term creditors of a firm. This considers not only equity holders but also the return for the total capitalization of the firm (equity plus the firm's long-term debt). The return on total capital is the firm's net income and the interest payments on the long-term debt.

We used these two indicators (return on equity and return on total capital) to compare the profits of the oil pipeline industry with those of other regulated and unregulated industries between 1971 and 1976. These industries included other common carriers (motor carriers and railroads) which are regulated by ICC, electric utilities, natural gas pipelines, and Forbes' listing of America's largest publicly held companies.

It should be noted that return on equity can be significantly affected by the debt to equity capitalization of a firm. For example, Forbes pointed out that in 1976, Lockheed Aircraft Company was number one in profitability because past losses dissipated its equity capital. This abnormality aside, however, Forbes' profitability list generally includes the same kind of companies--often the same companies--as in past years. Furthermore, in the case of oil pipelines, it must be kept in mind that their parent oil companies often guarantee the heavy pipeline company debt. Some would argue that it is not meaningful to examine return on equity where equity is only part of what the stockholder has at stake in the company.

Our comparisons revealed that pipeline companies were, the most profitable among these industries as measured by returns on equity and second to motor carriers as measured by returns on capital. In 1976, rates of return for many oil pipelines were well above the rates of return for the most profitable electric utility companies, natural gas pipeline companies, and public companies.

For example, the largest petroleum product pipeline enjoyed a return on equity of 121 percent, and 10 other pipelines had returns on equity in excess of 100 percent. Also during 1976, the most profitable company among natural gas pipelines or distributors, utility companies, and publicly held companies had a return on equity of 50 percent. This particular firm was a publicly held, non-regulated company. If ranked with oil pipelines, the electric utility with the highest return on equity would rank 61st in return on equity. The most profitable natural gas pipeline company would rank 34th, and the most profitable public company would rank 26th in return on equity.

Similarly, in 1976, pipeline companies' returns on total capital ranged from deficits to 137 percent. The most profitable firm among the three aforementioned categories, a publicly held company, had a return on capital of 32 percent. The electric utility with the highest return on total capital would rank 84th if ranked with oil pipeline companies. The top natural gas pipeline company and the public company would rank 38th and 8th, respectively.

These statistics reflect returns on equity and total capital for the most profitable electric utilities, gas pipelines, and public companies. Other highly profitable electric utilities, gas pipelines, and public companies would rank much lower.

The following tables illustrate the profitability of oil pipelines by ranking them with the five top-ranking publicly held companies, natural gas companies, and utility companies as measured by return on equity.

Profitability of Oil Pipelines Compared with the Top Five Natural Gas, Utility, and Publicly Held Companies as Measured by Return on Equity, 1976

Number of oil pipelines		More profitable than the average of the top five ranking (note a)
31	(25 outranked the single most profitable publicly held company)	Publicly held companies
37		Natural gas pipelines and distributors
60		Utility companies
8	(7 outranked the most profitable publicly held company)	Publicly held companies
58		Natural gas pipelines and distributors
85		Utility companies

a/Source: "Who's Where in Profitability," Forbes, Jan. 1, 1977.

We also used these two profitability indicators to compare the average returns of the pipeline industry with those of other regulated industries.

Comparison of Average Return on Equity 1971 to 1975

	Average return on equity
	(percent)
Oil pipelines	17.4
Motor carriers, Class I	13.6
Natural gas pipelines	13.5
Privately owned utilities, Classes A and B	9.6
Line haul railroads, Class I	.9

Comparison of Average Return on Capital 1971 to 1975

	Average return on capital (percent)
Motor carriers, Class I	12.2
Oil pipelines (note a)	11.6
Natural gas pipelines	10.3
Privately owned utilities, Classes A and B	5.8
Line haul railroads, Class I	2.7

a/Return on capital for oil pipeline is for the period 1972 to 1975. This percentage does not include the debt associated with the Trans Alaska Pipeline investment because it had not begun generating revenue at this time.

Rates of return have been limited for other regulated industries

As indicated earlier, the Government has not established criteria for determining the justness and reasonableness of oil pipeline rates. However, in a number of recent decisions, regulatory agencies found that rates which allow a 14-percent or less return on equity are reasonable. These include:

--An FPC natural gas pipeline case which found a 13.5-percent return on equity reasonable. 1/

--An FCC case which found a 12-percent return on equity reasonable for a utility company. 2/

1/Natural Gas Pipeline Co. of America, F.P.C. Docket No. RP74-96, Opinion No. 762A (Dec. 6, 1976).

2/American Telephone & Telegraph Co., 57 F.C.C. 2d 960, 972 (1976).

--An ICC decision which found an independent pipeline company's rates reasonable in that they produced a 14-percent return on equity. 1/

--An ICC decision that motor carriers would be limited to a 14-percent return on equity. 2/

The table which follows shows how the pipelines currently compare with these possible percentages of return on equity. In 1976, for instance, 61 (or 55 percent) of the 110 regulated pipeline companies received revenues greater than that necessary to yield a 14-percent return on equity. Of these 61, 31 pipelines yielded a 40-percent return or more and 11 exceeded 100 percent.

Pipelines by affiliation	Percentage return on equity: 14 or less	15-20	21-40	41-60	61-80	81-100	Over 100
Major oil companies	20	7	13	4	3	8	7
Nonmajor oil companies	24	4	4	3	1	1	4
Independent	5	2	-	-	-	-	-
Total	49	13	17	7	4	9	11

If pipeline rates had been limited so as to allow a return on equity of no more than 14 percent, overall pipeline rates and revenues would have been reduced by over $300 million in 1976. A 16-percent return on equity would have resulted in a $215-million reduction; and an 18-percent return would have resulted in a $127-million reduction. Although these amounts seem high, they represent only a small part of total pipeline revenues which exceeded $2.1 billion in 1976.

1/Petroleum Products, Williams Brothers Pipeline Co. Initial decisions at 21 (June 6, 1974).

2/I.C.C. Investigation and Suspension Docket No. M-29772, decided Nov. 27, 1978.

The preceding table is also useful in comparing oil pipeline profitability by affiliation. As shown by the table, the independent pipeline companies are by far the least profitable in terms of return on equity. In 1976, the most profitable independent pipeline had a 17.5-percent return on equity. That year, 39 out of 62 (over 60 percent) of the major oil company affiliates and 14 out of 41 (over 30 percent) of nonmajor oil company affiliates had greater returns on equity than the most profitable independent pipeline company. The largest independent pipeline company had a return on equity of 13 percent compared to the largest major oil company affiliate, with a return of 121 percent.

High profits and rates continue

Despite longstanding economic regulation, pipeline companies have been allowed to enjoy profits higher than those of the other most profitable industries. High pipeline profits have continued because (1) ICC did not review rates for justness and reasonableness, and (2) the 1941 Consent Decree has failed to limit rates and profits.

ICC did not review rates for justness and reasonableness

One intent of regulations affecting oil pipelines has been to curb their monopoly power by limiting rates to just and reasonable levels. However, when oil pipelines were under its authority, ICC's tariff review process failed to assure that pipeline rates for transportation of oil were just and reasonable.

The method used by ICC (and now FERC) to determine the rate base for oil pipelines is referred to as valuation. It uses the value of all properties owned and used by oil pipelines in their common carrier services. Valuations are updated annually to reflect the effects of inflation, and an arbitrary 6-percent "going concern value" is added. This was intended to serve as the basis for measuring allowable earnings.

Between fiscal years 1970 and 1977, oil pipelines filed 14,500 proposed tariffs. Of those, 99.6 percent became effective as proposed. This tariff acceptance rate was higher than for any other type of common carrier reviewed by ICC.

The Interstate Commerce Act requires that pipelines establish just and reasonable rates. Under the act, ICC had to determine whether rates were just, reasonable, and

lawful. Oil pipelines publish their rates in tariffs filed with ICC (now with FERC). After publication of the rates, pipelines had to follow them exactly. Proposed rates required a 30-day notice to ICC and the public. During this time, the proposed tariff was subject to protest by shippers and others.

We were told by an ICC tariff examiner that pipeline tariffs were given a cursory review and had a low priority relative to other transportation modes. Other ICC officials also commented on the low priority given to pipeline regulation. In 1974 ICC instituted a "Consumer Group" to protect the interests of consumers who otherwise would not be aware of provisions which might adversely affect them. Pipeline tariffs, however, were not subject to this particular consumer-oriented tariff review process.

Tariff examiners at ICC were not specifically assigned to review pipeline filings but instead reviewed all types of common carrier filings. ICC officials said that the volume of tariffs submitted for review prohibited careful examination of each filing. Reviews generally were clerical in nature and included checking that all tariffs from a particular carrier were numbered consecutively, that a carrier's name was correct, and that rates were stated clearly. If a tariff passed this review, it became effective 30 days after the filing date.

ICC tariff examiners said that as a rule of thumb, rate increases in excess of 7 percent annually would be considered excessive. However, the examiners also said that they did not routinely calculate rate increases as part of the tariff review. Further, oil pipelines were not required to submit cost justifications supporting proposed rate increases. Without these justifications, ICC tariff examiners could not determine the effect of proposed rate increases on a company's rate of return. This prevented examiners from determining if pipelines were making unreasonable profits.

ICC made several decisions affecting allowable levels of return on both crude oil and petroleum product pipelines. Two decisions--Reduced Pipe Line Rates and Gathering Charges, 243 I.C.C. 115 (1940) and Minnelusa Oil Corp., et al., v. Continental Pipe Line Co., et al., 258 I.C.C. 41 (1944)--allowed an 8-percent return on valuation for crude oil pipelines. Two others--Petroleum Rail Shippers' Association v. Alton & Southern Railroad, et al., 243 I.C.C. 589 (1941), and Petroleum Products, Williams Brothers Pipe Line Company, supra--allowed a 10-percent return on valuation for pipelines transporting petroleum products.

ICC might have used these precedents for judging justness and reasonableness of pipeline rates. These decisions were not followed by the oil pipelines, nor did ICC take any action to enforce them. For example, in 1976, of 110 regulated oil pipelines:

--12 crude lines exceeded 8 percent return on valuation

--19 petroleum product lines exceeded 10 percent.

--10 lines shipping both crude and petroleum products exceeded 10 percent.

These 41 pipelines represent over a third of the regulated oil pipelines. Such lack of effective review and consistent application of decisions by ICC contributed largely to the high profits realized by oil pipeline companies.

ICC officials told us that the Commission reviewed only those tariffs which were protested by persons affected by them even though it has authority to investigate pipeline rates on its own initiative. ICC officials said that they did not have enough personnel to evaluate pipeline rates for reasonableness.

Only one industry-wide rate review has been undertaken. In that 1940 case, the rates and charges of 21 pipeline carriers were found to be excessive and unreasonable and the pipelines were ordered to reduce their rates.

We believe that relying on protests is not appropriate for regulating oil pipelines. Oil pipelines were created primarily to serve their owners--the major oil companies--who have no reason to protest. Moreover, the lack of complaints does not prove an absence of excessive rates.

The 1941 Consent Decree has not limited rates or profits

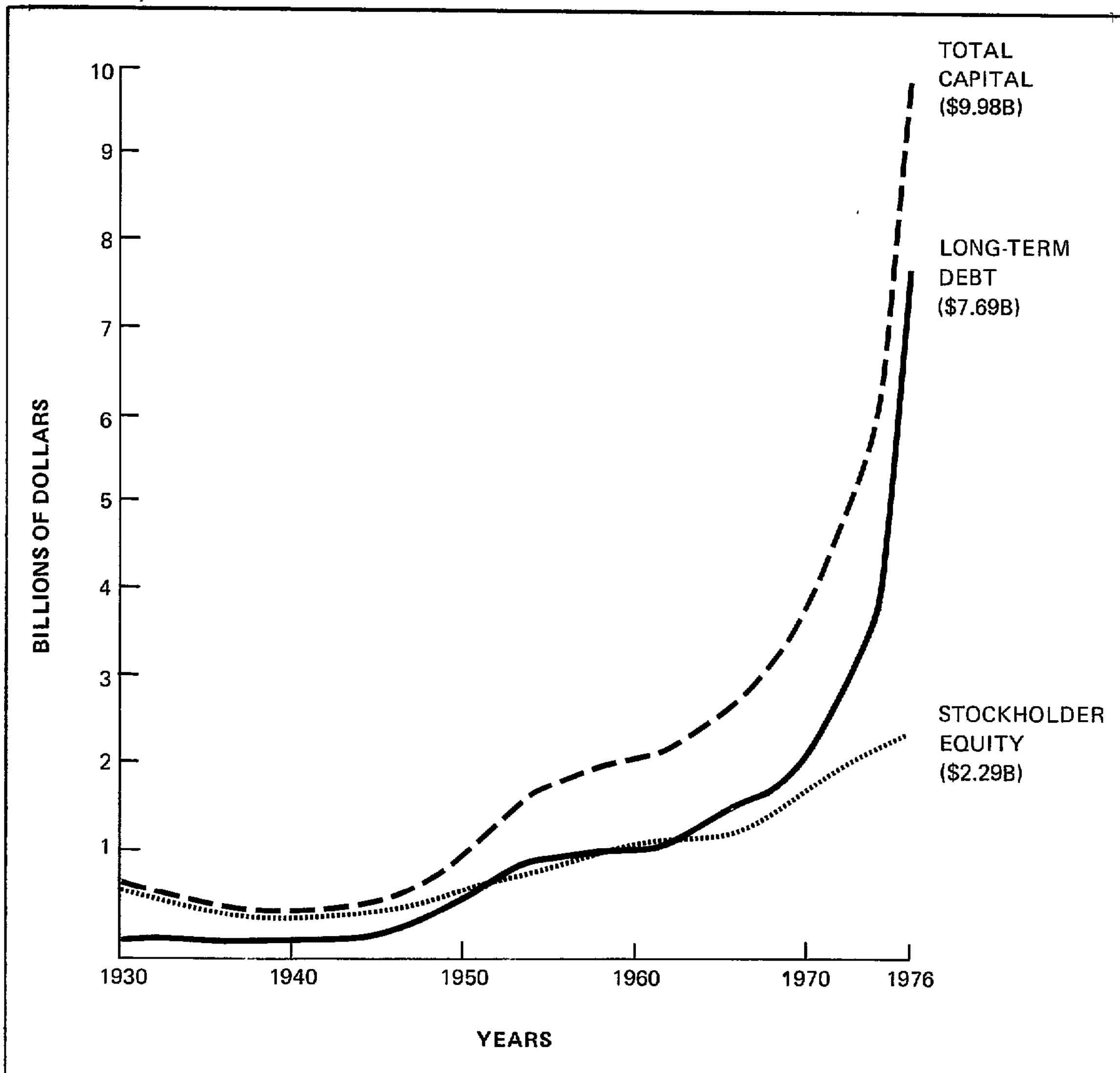
On December 23, 1941, the Department of Justice entered into an agreement with 20 major oil companies and 59 pipeline companies in an attempt to discourage high rates by limiting financial returns to pipeline owners. The agreement, referred to as the 1941 Consent Decree, resulted from a suit brought by the United States against these companies, United States v. the Atlantic Refining Co. (C.A. 14060, DC, DC) charging that dividends paid to shipper-owners constituted illegal rebates. Since that time, the decree has been ineffective in limiting rates or profits of the pipeline companies and Justice has done very little to enforce its provisions.

The consent decree stipulated that dividends paid by defendant pipeline companies to their shipper-owners would not be unlawful rebates if they did not exceed 7 percent of ICC's valuation of the pipelines' property. It was thought that limiting owners' possible financial return from the pipelines would reduce their incentive for setting excessively high rates. However, the decree has failed to operate as Justice intended. As a result, the owners have reaped high returns on equity from the pipelines.

The wording of the decree caused problems in interpretation. Most importantly, the decree was unclear as to whether the limitation applied only to the companies' investment in the pipeline or some other basis. The decree uses the term "valuation," not "investment." The pipelines interpreted this to allow inclusion of debt-financed property in the base for calculating the 7-percent dividend limitation. As a result, Justice on October 11, 1957, filed several motions with the Court challenging this interpretation of the decree. In 1959, the Supreme Court ruled in United States v. the Atlantic Refining Co. et al., 360 US 19, that the language of the decree was clear and did not permit the reading of current valuation to mean only the equity owners' investment. Moreover, the Court criticized Justice for taking 16 years before making its formal charge. As a result of this ruling, the decree was ineffective when the shipper-owner investment was only a small part of the total property.

Moreover, the decision upheld the pipelines' practice of including both equity and debt in the dividend limitations, thus encouraging maximum debt financing. Debt financing in the oil pipeline industry has increased sharply since the 1941 decree.

Before the decree, pipelines were funded almost entirely from equity funds provided by their shipper-owners. Investments in oil pipelines from outside sources were rare. In 1940, oil pipelines had outstanding capital stock of over $260 million and the total indebtedness was under $21 million. This debt was attributed to only eight companies. By 1976, 75 of the 110 pipeline companies had long-term debt totaling $7.69 billion and total equity of $2.29 billion. Many pipelines have debt-equity ratios of 90:10 or higher. This move toward debt financing greatly increases the return on equity. This change in pipeline financing made the consent decree ineffective in controlling dividends to shipper-owners and also pipeline rates. The table below reflects this trend toward heavy debt financing with minimal equity contribution.



For example, if a $100-million pipeline were 90-percent debt financed it could pay $7 million in dividends to its stockholders who had invested only $10 million. This is an exceptional 70-percent return on an initial $10-million equity investment. If the decree had applied to the owners' capital stock investment, dividends would have been limited to $700,000.

Justice's Antitrust Division enforcement of the consent decree includes initiating reviews or modifications to the decree, and monitoring the payment of pipeline dividends. Pipelines subject to the decree must annually report to Justice the dividends paid to their owners. The filing of such information with Justice was intended to ensure that the amount of dividends paid to pipeline owners did not exceed the consent decree limitation.

Justice has not established controls necessary to assure that companies subject to the decree are filing and those which are filing do so accurately and completely. For example:

--Lists of companies required to report are not maintained. Justice officials contended that they have no means of knowing which pipeline companies are required to report. This information, however, could be obtained from the companies' financial statements submitted annually to FERC.

--Decree filings only receive a cursory review. Justice does not reconcile or check data submitted by the companies against the companies' financial reports or valuation figures furnished by FERC.

--The accuracy of decree filings cannot be reasonably assessed by Justice. The deadline for filing reports to Justice is April 15 for the preceding year, whereas the valuations of pipeline property are not determined by FERC until at least December of the same year. Neither Justice nor FERC officials were aware that pipeline valuations were not computed by FERC until 9 months after the decree filings.

--The format for reporting dividend information to Justice was not standardized until 1961. However, Justice has not issued instructions on how to file such information.

We found that at least six companies that are required to file had not done so in the past 2 or 3 years. The responsible Justice official was unable to explain why these companies were not complying with the reporting requirements of the decree. A number of Justice officials said the decree filings did not serve a useful purpose and that little was done to enforce the decree.

SAVINGS IN TRANSPORTATION
COSTS COULD BENEFIT CONSUMERS

Many petroleum companies own and operate petroleum pipelines to support their own refinery and marketing needs. Advantages accrue to such shipper-owners because (1) they have access to the lowest cost overland means of transportation and (2) they can dictate routing, sizing, and expansion of their pipelines, and the positioning of input and offtake points.

If pipeline usage is not available, some crude and petroleum products must be transported to the marketplace by more expensive transport modes. Justice officials contend that the market price generally reflects this higher cost of transportation. This allows the pipelines' shipper-owners to benefit from the difference in transportation costs.

For example, if the pipelines' cost advantage over tanker shipments into the market is 50 cents per barrel and some tankers are being used, then the market price will reflect that higher transportation cost for the market's incremental supply. Those fortunate enough to ship though the pipeline rather than by tanker will benefit by 50 cents per barrel more than those shippers who must use the more expensive tankers.

The magnitude of the gains to the shipper-owners who behave in this manner will depend on their share of the market and their ability to use the pipeline for transportation as opposed to more expensive modes of transportation. That is, they pay the same tariff rate as any shipper; however, those revenues in excess of actual transportation costs are returned to them as dividends. Nonowner shippers, by contrast, do not receive dividends because the tariff reflects their actual transportation costs.

The minimum amount which pipelines will accept for shipment, lack of storage and terminal tankage, and routing of pipelines can operate as obstacles to the use of shipper-owner pipelines. If this occurs, the nonowner shippers have to resort to more expensive transport modes, which in turn translates into higher market prices.

An example of the additional cost of using more expensive transportation modes was provided to us by the Justice Department. About 121 million barrels of petroleum products were transported from the Gulf States to the Middle Atlantic States by tankers during 1976. Justice estimated shipping by tanker,

since there was not available pipeline capacity, resulted in a $44.6 million misallocation of transportation services.

If nonowner shippers could increase their use of pipelines, their transportation costs would be reduced and consumers could benefit if these savings were passed along through reduced marked prices. Also, as discussed earlier in this chapter, such savings are already showing up as profits to the shipper-owners.

As discussed in chapter 3, some of the present practices are alleged to be anticompetitive and harmful to nonowners who attempt to use common carrier pipelines. Also, in this regard, the question remains whether such profits are reasonable and in the best interest of the consumer. Because criteria for determining the justness and reasonableness of these profits have never been established, this question cannot be answered.

CONCLUSIONS

Federal regulators have not controlled pipeline profits and rates. Oil pipelines' high profits over past years have continued because (1) ICC did not review and investigate the justness and reasonableness of rates charged by the pipeline companies and (2) the 1941 Consent Decree has not worked as originally intended. Pipelines are the most efficient and least expensive method of overland oil transportation. This has provided high profits for pipeline owners indicating that consumers have not fully benefited from the lower costs of transportation. The shipper-owners are at a distinct competitive advantage because they pay only actual transportation costs, and those revenues in excess of expenses are returned to them as dividends. Nonowner shippers, by contrast, pay the full tariff rate and do not receive dividends.

Many pipeline companies have enjoyed returns on equity and total capital higher than those realized by companies in other regulated and nonregulated industries. This situation exists despite longstanding economic regulation, and laws which were enacted in an effort to control rates charged and earnings generated from pipeline transportation.

--In 1976, the returns on equity of at least 31 oil pipelines surpassed those of the average top 5 most profitable publicly held companies, natural gas pipelines and distributors, and electric and utility companies. Many were even more profitable than the most profitable firms in these industries.

--Recent regulatory decisions affecting natural gas pipelines, utilities, and in one instance, oil pipelines, determined that a 14-percent return on equity was reasonable. However, in 1976, 61 of the 110 regulated oil pipelines had returns on equity in excess of 14 percent (31 of these exceeded 40 percent and 11 were over 100 percent).

--Rates charged by oil pipelines in 1976 could have been reduced by as much as $300 million if recent decisions affecting other regulated industries had been applied to oil pipelines.

CHAPTER 3

ALLEGATIONS OF ANTICOMPETITIVE PRACTICES HAVE NOT BEEN RESOLVED

A number of anticompetitive practices by oil pipelines have been alleged in recent congressional hearings, complaints to ICC and FERC, and investigations by the Department of Justice and the Federal Trade Commission (FTC). These allegations and issues remain unresolved. This is in spite of ICC's and now FERC's authority to regulate pipelines as common carriers. The lack of adequate regulatory agency enforcement and adequate information makes it impossible to determine the extent of problems in the pipeline industry. Most of these alleged practices have the potential of affecting nonowner shippers, such as independent refiners or marketers. We did not determine whether, and to what extent, these practices are used, nor weigh the technical and legal arguments for and against these practices. We are presenting them to indicate the concerns and unanswered questions about oil pipelines' practices which Federal regulators have not resolved.

OIL PIPELINE OPERATIONS HAVE POTENTIAL FOR ANTICOMPETITIVE PRACTICES

The transportation of oil by pipeline is not only the most efficient, lowest cost overland mode, but it also serves as a vital link between the production fields, the refineries, and ultimately the consumer. The majority of these pipelines, however, are controlled by vertically integrated firms which have their own oil supplies, transportation systems, refineries, and marketing outlets. The incentive of these vertically integrated oil companies is to maximize overall corporate profits, not just the profits of their pipeline subsidiaries. As such, it stands to reason that their pipeline subsidiaries would be operated in support of this profit maximization goal. Pipelines independent of oil company ownership, however, increase profits and revenues by expanding the volume it ships or by increasing its rates.

Nonowner shippers (i.e., independent refiners and retailers) wanting to use the pipelines are vulnerable to a variety of practices which could inhibit their ability to compete effectively. Such practices would, however, violate common carriers' duties to furnish transportation upon reasonable request and not to give advantage to or discriminate against any shipper.

Some of the practices alleged to be anticompetitive and harmful to nonowners who attempt to use common carrier pipelines are listed below.

--Large-diameter pipelines have imposed high minimum requirements for the amount of oil which will be accepted for shipment.

--Storage facilities at input and delivery points are not readily accessible.

--Pipelines are routed and sized for the anticipated needs of owners.

--High transportation rates and the methods used to set rates give shipper-owners cost advantages over other shippers.

--Prorationing methods favor large shippers.

--Product specifications are unclear and sometimes too restrictive.

These practices are discussed below.

<u>High minimum tenders</u>

The minimum tender is the minimum amount of oil that a pipeline will accept for shipment. Technical reasons for minimum tenders include

--the relative size of adjacent shipments of different product in the pipeline which commingle and

--the problems caused by monitoring and switching segregated batches.

One can understand the problems small batches might create, considering that a 36-inch pipeline pumping at a speed of 50,000 barrels an hour carries 1,000 barrels past a given point in only 72 seconds.

Pipeline owners have been accused of using very high minimum-tender requirements as a method of avoiding service to nonowner companies and thus not fulfilling the common carrier requirements. At one time, minimum tenders of 100,000 barrels were common requirements of crude oil pipelines. Independent producers, however, did not have the necessary facilities to store 100,000 barrels. Therefore, they could not take advantage of pipeline transportation.

ICC decisions in the 1940s provided guidelines for minimum tenders. It decided that minimum tenders over 10,000 barrels for crude oil or 25,000 barrels for petroleum products would be unreasonable. These standards, however, have not been enforced by ICC or FERC. They said the minimum-tender standards applied only to the pipelines which had been parties to these ICC decisions. Complaints about higher minimum-tender requirements would have to be judged on a case-by-case basis. We found 13 pipelines which have minimum tender requirements greater than these standards. ICC officials were unable to explain or justify why some pipelines were allowed to establish these larger tender requirements.

Access to terminal and storage facilities

Independent shippers need access to terminals and storage facilities to use a pipeline. Storage tanks are required where the oil enters the pipeline so that the shipper can tender enough oil to the pipelines. Tanks are also required at delivery points so that oil can be taken off the pipeline.

Generally, pipelines do not provide tanks at these points. Tanks are usually owned by large-volume shippers or owners of the pipeline. As a result, companies without tanks must solicit space from potential competitors who own tanks, or they must purchase or construct their own at substantial cost. This may be especially burdensome for small independent marketers who are trying to expand to compete with the owners of terminal facilities in their area.

Pipeline routing and sizing decisions

Decisions on the route and size of a pipeline can be a more subtle way of denying pipeline access to many potential shippers. For instance, a pipeline routed several miles from a nonowner's facilities may, for all intents and purposes, be unavailable to nonowners because of the high cost of providing connecting lines. Similarly, a pipeline may be sized for the anticipated needs of owners only. The Department of Justice concluded such undersizing occurred in planning the capacity of the Louisiana Offshore Oil Port (LOOP)--a pipeline related facility and its onshore pipeline system. Justice recommended that the Department of Transportation impose conditions in the LOOP license which would require expansion of capacity as needed. This recommendation was adopted and conditions for capacity expansion were included in the license. Justice also produced evidence that one oil company became a part owner in LOOP because it feared being excluded from its use. Accordingly,

the license contains many provisions intended to assure that all shippers, regardless of whether or not they were owners of LOOP, are treated equally.

High transportation rates

It has been alleged that oil companies owning pipelines have an advantage over independent producers, refiners, and marketers by maintaining high pipeline rates. The vertically integrated oil company with ownership in the pipeline would not be affected by the high rates because part of the transportation charges are returned as dividends from the pipeline corporation. As a result, the shipper-owner of a pipeline has a transportation cost advantage. Furthermore, in addition to the advantage of shipping at cost, shipper-owners receive a profit on all nonowner shipments. Thus, the nonowner is indirectly contributing to his comparative disadvantage.

The way rates are set to different delivery points along the line is another rate discrimination issue. Pipelines cannot charge more to an intermediate point than to a farther point. However, in setting other rates, they have great flexibility. They have been accused of using this flexibility to set unreasonably high rates to points where independent marketers compete with integrated oil companies. In such cases high transportation costs would cut into the independents' profits and reduce their chances of price competition. Meanwhile, the pipeline could keep low rates to areas served primarily by the oil companies which own the pipeline. This gives the shipper-owners high profits in an area not jeopardized by price-cutting competitors.

Prorationing methods

Shipper requests for transportation may exceed the pipeline system's capability at certain times. At such times, the pipeline company must prorate the amounts that different shippers can transport. Pipeline prorationing is done either on a historical or current-tender basis. The former uses each shipper's past record of shipments to allocate space on the pipeline. The current-tender approach allocates amounts based on shippers' expected tenders.

Occasional shippers, especially small shippers, suffer more of a disadvantage because they have not established a record of previous shipments. Also, if this method is used, a small shipper cannot significantly expand his shipments to take advantage of new business opportunities.

The alternative to historical prorationing--the current-tender approach--also has problems. These include:

--Some shippers tender more oil than they have to assure themselves of space on the pipeline.

--Shippers who consistently support a pipeline get no benefit from this method of allocating space.

Pipelines' prorationing methods are often not defined in their published tariffs. The uncertainty of pipelines' prorationing procedures creates problems for small shippers because it impedes their planning and scheduling and because their customers may be unwilling to accept the unpredictability of delivery. Many tariffs have vague and indefinite prorationing rules which generally state that the pipeline would allocate capacity so that shippers were not discriminated against.

Product specifications

Pipelines require that oil shipped through a line conform to certain specifications to avoid contaminating other shipments. If specifications are too restrictive, independent shippers may have trouble meeting them. On the other hand, product specifications may not be specific enough. For example, a refiner may need a special type of crude oil for his refinery, but a common stream of various grades may degrade it into an unusable type crude for his operation.

REGULATION HAS NOT ENSURED THAT OIL PIPELINES OPERATE AS COMMON CARRIERS

Shippers, congressional committees, and others have alleged anticompetitive pipeline practices; however, Federal regulators have done little to resolve or answer these charges. Although ICC was responsible for regulating oil pipelines as common carriers, its regulation was not adequate to ensure that oil pipelines met their common carrier obligations. Additionally, three Federal agencies have investigated antitrust and competitive activities related to oil pipelines. These are the Department Justice's Antitrust Division, the Federal Trade Commission's Bureau of Competition, and the Department of Energy's Economic Regulatory Administration (ERA). The efforts of these agencies in investigating competitive activities of oil pipelines have been expensive and have done little to resolve the allegations surrounding pipeline companies' practices.

We are unable to say whether the oil pipeline industry has met its common carrier obligations because of the lack of essential information and also because ICC lacked criteria and standards as to what constitutes compliance with the ICA. Similar frustration was expressed by the U.S. Court of Appeals in a recent oil pipeline rate case, (Farmers Union Central Exchange, et al., v. Federal Energy Regulatory Commission and the United States of America, No. 76-2138). The court cited the lack of established precedent for deciding upon the reasonableness of oil pipeline rates and said:

> "[We] are at something of a loss to know what to look for should we resort to the public record. The lack of viable precedents in this area and thus of some semblance of established ratemaking theory undercuts any confidence we have that we can make a 'reasonableness' determination in the absence of some significant assistance from the agency formerly charged with making that determination in the first instance."

ICC did not do enough to ensure that pipelines comply with the requirements of the ICA. For example:

--ICC gave low priority to oil pipeline regulation.

--Adequate information was not collected to ensure common carrier compliance.

--Standards were not developed for pipeline company practices.

--Tariff rules and conditions were not reviewed.

--ICC's compliance surveys of oil pipelines were ineffective.

ICC's oil pipeline regulation was passive

ICC officials repeatedly told us that pipeline regulation was not emphasized at ICC. ICC was a reactive agency, generally relying upon shippers' complaints; many officials said only problems raised by complaints would be dealt with.

Such an approach, however, does not work well in this industry. In a pipeline rate case decided in 1940 (Reduced Pipe Line Rates and Gathering Charges, 243 I.C.C. 138), ICC acknowledged that shippers and owners are often the same and that complaints were unlikely. The ICC decision stated in part:

> "* * * No shipper or potential shipper of crude oil has appeared to complain that such rates are unreasonable or otherwise unlawful. We have no shipper testimony. The reason is clear; * * * normally the oil company is in substance and effect both shipper and carrier. Although the respondent pipelines hold themselves out in their tariffs to carry for all, and although in the eye of the law they are common carriers, the record indicates that their facilities are relatively infrequently used by other than the large oil refineries or those with whom they are affiliated."

In contrast to pipelines controlled by shipper-owners, pipelines not affiliated with oil companies have been the subject of more complaints. For example, although there are only 7 pipelines not affiliated with oil companies, 20 of the 42 rate cases considered for suspension by ICC between January 1969 and October 1977 resulted from protests filed by shippers on these independent lines.

An ICC official said that self-initiated reviews might have been more desirable because of the special circumstances of the oil pipeline industry. However, between January 1969 and October 1977 only 1 of the 42 rate cases was initiated by ICC. Another official said that if jurisdiction for pipelines had remained with ICC, it might have begun self-initiated investigations.

Relying on complaints fails to recognize the disincentives for a small shipper to complain against a pipeline company or its parent oil company upon whom the shipper might depend for transportation or other services.

The representative of two independent shippers told us that fear of reprisals from the pipelines or their parent oil companies prevented shipper complaints. He also said that small shippers might not be aware of their rights or the ways in which they are discriminated against. Therefore, they may not know that they can complain or what they

can complain about. For instance, they may not have enough information on pipeline operations such as prorationing methods or the appropriateness of product specifications. This lack of information stems from ICC's failure to require pipelines to publish this detailed information.

More information needed to ensure common carrier compliance

The ICA gave ICC the power and duty to inquire into the business of the oil pipelines and to keep itself informed of the manner in which their business was conducted. ICC could collect information it deemed necessary to enforce the act. ICC, however, did not routinely collect information which would enable it to assure that oil pipelines were complying with the common carrier requirements of the ICA. For instance, ICC did not routinely collect information on

--operations of undivided-interest pipeline systems,

--location, size, ownership, rules, and charges for use of terminal facilities connected to pipelines,

--rules for scheduling shipments, especially in cases in which more oil was tendered than could be shipped and prorationing was required,

--identification of shippers on the pipeline, their relationships to the pipeline company, and the quantities shipped by each, and

--justification for minimum-tender or delivery quantities or restrictive product specifications.

It was not until 1976--70 years after the passage of the Hepburn Act--that ICC required pipelines under its jurisdiction to provide information on shippers using the pipelines. This one-time request for information was for a congressionally requested investigation of possible anticompetitive pipeline practices. The usefulness of the information is somewhat limited because it includes only items such as names of shippers and their relationships to the pipeline company, quantities shipped, and the locations of facilities. ICC did not require submission of the pipeline's operational rules regarding prorationing and access to terminals nor justification for minimum tenders.

Virtually nothing is known about undivided-interest pipeline systems

Federal regulators know little about the operations and financial dealings of the undivided-interest pipeline systems. Each owner of an undivided interest in these pipelines publishes its own tariffs, accepts shipments, collects its own revenues, and records its proportionate share in each owner's consolidated financial reports. Because financial and operating data are buried in overall corporate activities of the owners, there has been no effective regulation of these pipeline systems.

There were 29 such systems (not including the Trans Alaska Pipeline) operating over 7,000 miles of pipeline as of December 31, 1976. The operators of these pipelines, usually the owner with the largest ownership share, report only the pipeline mileage. Data is not reported on the amount of oil shipped, the users of the system, the financial structure, revenues, expenses, or profitability of the pipeline. It is therefore virtually impossible for regulators to assess the justness and reasonableness of the systems' rates or whether they are operating as common carriers as required by law.

Standards needed for evaluating oil pipeline company practices

ICC did not have written standards or criteria for evaluating oil pipeline practices. There were no guidelines on lawful scheduling or prorationing procedures, product specifications, tenders, or access to terminals. ICC officials said they relied on complaints from shippers to disclose discriminatory practices. Another official, however, said that because of ICC's limited authority, a highly integrated oil industry, and the fact that most pipeline shipments are made by pipeline owners, it is not surprising that ICC had extremely few protests and complaints.

In the Farmers Union case the court cited the lack or precedent for ratemaking as hindering the court's ability to determine reasonableness of rates. Standards, criteria, regulations, and guidelines consistently enforced are needed to regulate pipelines. The ICA requires "just and reasonable" rates but the statute does not specify what constitutes reasonable or unreasonable. The law prohibits "undue preference and advantage" but does not define these terms.

Rate of return standards for oil pipelines were not established until the 1940s. (See p. 13.) These standards

went unchallenged, unreviewed, and unchanged until 1972 when a group of shippers complained about rates charged on an independent pipeline.

Guidelines for minimum tenders resulted from ICC decisions in the 1940s. It was decided that minimum tenders of over 10,000 barrels for crude oil or 25,000 barrels for petroleum products would be unreasonable. These standards, however, were not enforced. ICC officials said these minimum-tender standards applied only to the pipelines which had been parties to these ICC decisions, and would have to be judged on a case-by-case basis.

Tariff rules and conditions were not reviewed

ICC's tariff review process did not address substantive issues but instead concentrated on procedural and clerical matters such as whether tariffs are numbered consecutively, change symbols are included, company names are proper, and prescribed time frames for filing are met. ICC officials said they did not review rate filings for justness and reasonableness for any common carrier because ICC's resources were limited and it would place an evidentiary burden on the carriers. ICC also did not review the pipelines' rules and regulations which are part of the published tariffs.

Pipelines must file tariffs showing rates and charges for transportation, available privileges and facilities, and regulations which affect the services offered. Carriers may not refund charges or provide any shipper with privileges or facilities not specified in the tariffs. The purpose of this requirement is to prohibit advantageous or discriminatory treatment of shippers. Tariffs must be definitely worded and strictly observed.

Imprecisely worded tariffs allow the carrier discretion to discriminate among its shippers. Tariffs place the charges and rules of a carrier on public record for regulatory and public evaluation for compliance with the ICA. Further, tariffs provide a written standard for comparison with carriers' actual performance. Carriers may not provide any service not specified in a posted tariff.

We found other tariff rules and regulations which were not always explicit. They often give pipelines considerable discretion, as shown in the following examples of tariff provisions.

--"* * * Deliveries must be made in quantities of not less than 2,500 barrels each except that carrier

may have the option to deliver smaller quantities when, in the opinion of the carrier the delivery of smaller quantities is practical."

--"If total volume for shipment during any one month exceeds the pipe line delivery capacity for such month, Petroleum Products offered by each shipper for transportation will be transported in such quantities and at such times to the limit of capacity so as to avoid discrimination among shippers."

--"Carrier will specify the quantity to be originated to Carrier in one continuous movement from a single origin."

--"Carrier will not make a delivery of less than 1,000 barrels of crude petroleum at any destination point on its trunk lines except when necessitated by dispatching contingencies and except where a smaller delivery is authorized by an individual tariff or consent by the Carrier."

--"* * * If the oil tendered for transportation differs materially in character from that usually produced in the field and being transported there from by the pipe line, then it shall be transported under such terms as the shipper and pipe line may agree or the Commission may require."

--"Carrier reserves the right to refuse to accept products which are not compatible with the carrier's facilities or the products of other shippers."

Compliance surveys of oil pipelines were ineffective

Although ICC was responsible for regulating oil pipelines for over 70 years, it did not have a systematic compliance program until June 1976. About 20 compliance surveys were conducted between June 1976 and October 1977. Although these surveys raised numerous questions about possible anti-competitive, discriminatory, or otherwise unlawful practices, very little was done to resolve them. This was due primarily to ICC's lack of knowledge and expertise regarding pipeline matters.

The following are some issues raised by ICC compliance personnel which were not resolved by ICC:

--Whether pipeline companies can create separate storage and terminal companies without publishing charges for the use of these facilities in their tariffs, or whether pipelines may be allowed to build facilities for a parent company to operate.

--Whether indefinitely written tariff provisions violate the ICA. One ICC investigator found several ambiguously written tariff provisions which he noted could allow a carrier to give service to one customer and deny it to another.

--Whether administrative and other services provided to a pipeline company by a parent company for compensation should have been awarded based on competitive bids. Section 10 of the Clayton Act (15 U.S.C 20) requires that common carriers which have overlapping officials with other companies must bid competitively on contracts over $50,000. An ICC investigator found that a pipeline had a $233,000 accounting services contract with its parent oil company. The chairman of the oil company's executive committee did not know if the contract was subject to the above requirement, but said that such situations are common between pipelines and their parent companies.

FEDERAL ANTITRUST ACTIVITIES

As mentioned, three Federal agencies have investigated antitrust and competitive activities related to oil pipelines: The Department of Justice's Antitrust Division, the Federal Trade Commission's Bureau of Competition, and the Department of Energy's Economic Regulatory Administration. These investigations are difficult, complex, and costly. Further, they have been subjected to many court challenges and delays. There are also statutory constraints on the disclosure of information outside each agency, which has hampered the sharing of data. To date, these agencies have done little to alleviate or resolve alleged anticompetitive practices by oil pipeline companies.

Department of Justice

The Justice Department has investigated and studied the competitive practices of oil pipelines for many years; however, only recently has it achieved limited success. Justice had frequent changes in policy and professional personnel, which made sustained investigations of oil pipeline companies difficult. Efforts were costly and time consuming, and the benefits of the investigations have been uncertain.

Justice investigated five pipelines between 1963 and 1976 for specific antitrust violations. Two of the cases involved potential pipeline mergers. The companies terminated the proposed mergers upon notice that Justice would sue them. Justice could not tell us how much staff time or money it spent on these two cases.

The remaining three cases have been costly and time consuming and have not achieved the goal of identifying prosecutable anticompetitive behavior. These cases are discussed below.

--The investigation of Colonial Pipeline Company began in 1963 after being transferred from FTC, and did not end until April 1976. Justice contended that the pipeline was constructed and operated so that competitors of the owners were foreclosed from using it. Although Justice officials could not give us the cost of this investigation, they estimated that it was a "very substantial" amount. It was reviewed and assessed by at least five different Assistant Attorneys General and their advisors, consultants, and economists. Thirteen years after the case was opened it was closed because the inquiry was too dated to be the basis of a lawsuit.

--The investigations of Olympic Pipeline Company, which began in 1966, and Explorer of Pipeline Company, which began in 1968, were still open in June 1979. These investigations were undertaken to determine whether nonowners of these pipelines were foreclosed from using them. Justice officials could not give us cost data for these cases. They did say it has cost a substantial amount to date. At present it is unclear what the outcome of these investigations will be.

Justice officials said they are working toward rate reform in the pipeline industry, by intervening before various regulatory agencies. For example, Justice participated in ICC proceedings to suspend the initial rates filed by the eight owners of the Trans Alaska Pipeline System. Justice and ICC protested that these rates were unreasonably high and would produce excessive returns on the owners' equity investments in the pipeline. ICC subsequently suspended the proposed rates and established lower interim rates. Justice is also intervening in a FERC proceeding to reform the methods for determining pipeline rates. Justice has proposed an alternative rate base for oil pipelines and a revised rate of return formula which it argues would lower pipeline rates.

The Department of Justice proposed that the license for the Louisiana Offshore Oil Port to operate a deepwater port include provisions to ensure competition. The Secretary of Transportation incorporated most of these provisions when the license was issued. Justice officials expressed reservations about this approach, however, citing the difficulty of monitoring and enforcing these rules. They expressed concern about applying these competitive rules to a nationwide pipeline network with multiple input, output, and interconnection points. According to Justice, such rules could represent regulatory burdens for implementation or enforcement. Competitive rules have an advantage over divestiture of the pipelines from the oil company owners, however, because those pipelines presently operating in a competitive manner would be largely unaffected by these rules.

Justice's present efforts are largely directed at industry-wide rate reform rather than antitrust investigations of particular pipelines, although the two open pipeline investigations are being reviewed. Additionally, Justice is continuing economic and legal studies of the pipeline industry; advising Federal leasing, permitting, or licensing authorities; and providing testimony on the potential anticompetitive impact of oil pipelines.

Federal Trade Commission

FTC has had more limited experience with oil pipelines than Justice. Although FTC is responsible for assuring that unfair methods of competition are not used by industry, common carriers such as oil pipelines are specifically excluded from FTC jurisdiction. Two recent FTC cases involving oil companies, however, have included issues related to the effects of oil pipelines on competition.

In 1973, FTC charged that the acquisition of Clarco Pipeline Company by Amerada Hess Corporation in 1971 lessened competition and created a monopoly in the purchase and transportation of crude oil. FTC was successful in obtaining a consent order under which Amerada Hess agreed to divest itself of Clarco Pipeline Company.

In January 1972, FTC began an investigation of the major oil companies entitled Exxon Corporation, et al., to determine if they had monopolized and maintained an uncompetitive market structure. FTC issued its complaint against these oil companies on July 18, 1973. More than 100 of the 449 "principal facts" listed in the complaint dealt with pipelines. FTC considered Colonial Pipeline Company of great importance to its investigation and requested the documents previously

obtained by the Department of Justice. Justice refused to make documents obtained in its pipeline investigations available to FTC because of statutory constraints on disclosing such information unless authorized by the companies which submitted the documents. FTC attempted to obtain voluntary access to these documents from the companies but was refused. FTC, therefore, had to subpoena these same documents from the companies. It was November 1976, however, before a limited subpoena was issued which requested, among other things, the same information these companies had previously given to Justice.

FTC's attempts to gather more current and detailed information have met with much resistance from the defendant oil companies, including court challenges by the defendants. According to FTC, the first such documents, including those relating to transportation, were screened by FTC's complaint counsel in April 1979. This case is not expected to go to trial until 1982. As of May 1979, about $11.5 million had been obligated for this case and an FTC official estimated that about $7-8 million had been spent.

Economic Regulatory Administration

ICC's investigation of common carrier oil pipelines was delegated to ERA in accordance with the Department of Energy Organization Act (42 U.S.C. 7101 et seq.). ICC had ordered this investigation in February 1976 and stated that ownership and control of oil pipelines by their shippers may substantially lessen competition or create a monopoly. All common carrier pipelines were made respondents to these hearings.

Many of the companies did not respond to ICC's initial request for information. The others submitted incomplete information. Finally, an order from an Administrative Law Judge directed the companies to provide the information and stated that it would be treated confidentially. ICC believed, however, that the responses from the companies did not provide enough relevant data to analyze the pipelines' structures, operations, and markets. Accordingly, ICC sent another set of questions to the pipeline companies on June 7, 1977.

ERA has done little with this investigation, and has been trying to decide how to conduct it. ERA has also been looking into its authority regarding the anticompetitive aspects of oil pipelines and is considering requesting that DOE place this authority with FERC.

CONCLUSIONS

Although common carrier oil pipelines have been subject to the Interstate Commerce Act for over 70 years, very little has been done to regulate them. ICC's reliance on complaints before acting and the low priority given to regulating pipelines contributed to this. It is not surprising that allegations of anticompetitive practices continue, given the ownership of the pipelines and the overall profit maximization incentives of their owners. Oil pipelines are, for the most part, built, controlled, and operated as integral parts of major oil companies.

ICC did not adequately regulate oil pipelines as common carriers. Specifically, it did not ensure that pipelines

--provide services upon reasonable request,

--treat all customers without discrimination, and

--charge a reasonable price for services performed.

The lack of regulatory agency enforcement and adequate information made it impossible for us to determine the extent of problems within the pipeline industry. This regulatory deficiency stems from ICC's failure to collect adequate information on oil pipeline operations so that it might develop expertise in this industry and detect potential violations of common carrier obligations. ICC also failed to develop policies, standards, and precedents which could have been used to evaluate pipeline operations and practices. In the one instance in which standard minimum-tender requirements were established, they were not enforced, although minimum acceptable tenders were published in the tariffs approved by ICC.

Further, ICC relied upon complaints rather than self-initiated monitoring procedures to ensure industry compliance with common carrier obligations. ICC justified its laxity by a number of factors, including

--lack of resources,

--weak legislation, and

--few complaints.

Several Federal agencies have investigated anticompetitive and antitrust issues related to oil pipelines. These investigations are difficult, complex, and costly. To date,

these agencies have done little to resolve the allegations of anticompetitive practices. The Department of Justice, FTC, and ERA are each investigating the anticompetitive aspects of oil pipelines under their separate legislative authorities. Because of each agency's distinct requirements for judicial and administrative proceedings and the statutory constraints on disclosing data outside the agency, information has not been shared. Each agency has, therefore, had to collect its own information.

CHAPTER 4

FERC IS IMPROVING OIL PIPELINE REGULATION

BUT MORE AGGRESSIVE ACTIONS ARE NEEDED

FERC has been more active in regulating oil pipelines than ICC had been. FERC has taken steps to (1) determine the justness and reasonableness of oil pipeline rates, (2) evaluate the current valuation process, (3) develop financial auditing procedures, and (4) resolve shipper complaints and proceedings transferred from ICC. Despite these efforts, however, problems with pipeline regulation continue. Further, existing legislation may not give FERC enough authority to regulate oil pipelines adequately.

FERC'S ACTIONS TO EXERCISE ITS NEW AUTHORITY

FERC, on February 10, 1978, established the Oil Pipeline Board to administer most of its oil pipeline regulatory functions. The board comprises representatives from FERC's Offices of Pipeline and Producer Regulation, General Counsel, and Chief Accountant. The decisions of the Board have the same force and effect as if made by FERC. The Board reviews oil pipeline tariffs and decides whether to accept or suspend and investigate these tariffs; it determines pipeline valuations and issues yearly valuation reports. It may also prescribe a uniform system of accounts for oil pipeline carriers.

In addition to the Oil Pipeline Board, FERC has assigned tariff examiners to review the justness and reasonableness of oil pipeline tariffs, including proposed rates. Also, FERC, in contrast to former ICC practices, requires cost justification for rate increases over 7 percent. In reviewing oil pipeline tariffs which propose rate changes, tariff examiners calculate the rate change percentage for each route affected by a proposed tariff rate filing. If the average proposed rate increase is over 7 percent, the examiner requests "complete cost justification" from the company proposing the rate. While this practice may be effective in keeping annual increases to 7 percent or less, it does not ensure the justness and reasonableness of existing rates.

If the Oil Pipeline Board decides to suspend a tariff, it can do so for up to 7 months. During this time, FERC can investigate the proposed increase. For example, on June 30, 1978, the Board, on its own motion, suspended proposed rate increases by three companies ranging from 14.2 percent to 24.7 percent. These suspensions affected a total of 20

companies and 114 tariffs, in that some proposed rate changes were on joint routes with connecting carriers.

FERC did not have oil pipeline tariff examiners between October 1977 and February 1978, and over 1,000 tariffs filed during that time were not adequately reviewed. Most became effective as proposed by the pipelines. Further, FERC has not adequately defined what cost data should be included to justify rate increases over 7 percent. As a result, companies find it hard to comply with this requirement. Often they ask for clarification by FERC as to what constitutes complete cost justification. Further, the format used by FERC for the cost justifications is not the same as that used in the oil pipelines' Uniform System of Accounts. This difference adds to the pipelines' difficulty in completing the justifications.

PROBLEMS CONTINUE WITH PIPELINE REGULATION

Although FERC has been more active in reviewing pipeline rate tariffs, it has not looked into many other common carrier issues. For instance, FERC has not made tariff provisions more specific either for prorationing or product specifications. Moreover, neither the tariff examiners nor the Board is clear about the adequacy and fairness of minimum tenders. Because the standard for minimum tenders was set at a time when pipelines were much smaller, that standard may no longer be appropriate. Officials of oil pipeline companies argue that acceptance of small shipments does not allow the extremely complex and highly automated systems of the new, large-diameter lines to function efficiently.

We found one case in which a high minimum-tender requirement was rejected by the Board and subsequently lowered by the filing pipeline. The Oil Pipeline Board, however, does not consider minimum tenders a major issue and has not attempted to develop a consistent policy.

FERC officials said common carrier obligations of oil pipelines would generally be enforced on the basis of complaints. For example, complaints against pipelines have been filed with FERC on common carrier issues such as tariff changes or prorationing arrangements which may favor an owner-shipper over a nonowner shipper. In one case, the Oil Pipeline Board decided not to investigate a challenged rate change, even though the Board has supported increased scrutiny of rate filings.

At this time, FERC does not plan self-initiated surveys to determine pipelines' compliance with common carrier obligations. We believe such surveys should be made. FERC's Office of Enforcement is just now being organized and staffed and has not yet pursued the question of oil pipeline regulation. The head of this Office said electric utilities and natural gas pipelines presently have higher priorities.

FERC's Office of the Chief Accountant is responsible for auditing pipeline companies' books and records, annual reports, and valuation reports to see if they adhere to the Commission's accounting, reporting and related regulations. This Office does not specifically audit whether a pipeline is operating as a common carrier. However, we were told that if the audits disclosed evidence of violations such information would be forwarded to FERC's Office of General Counsel or to its Office of Enforcement.

As of August 17, 1978, FERC had audited four oil pipeline companies. FERC staff found arrangements they considered questionable related to oil terminal facilities owned by "non-jurisdictional" companies. In particular, certain transportation routings between two pipelines require using terminal facilities owned by companies not subject to FERC jurisdiction. In this instance, the potential shipper had to arrange with the terminal operator to use its connecting facilities before the pipeline company would accept a shipment. This involves a separate transportation charge for the shipper which is not published in the tariff nor subject to FERC review. This raised two questions:

--Should joint rates which include charges for terminal services be published in the tariff?

--Should the terminal operator, who provides essential services for movement of oil interstate, be subject to FERC regulation as a common carrier?

FERC officials stated that such an arrangement for using terminal facilities was fairly common in the pipeline industry but that it was possibly in violation of tariff requirements. Accordingly, FERC's Office of General Counsel recommended that the Oil Pipeline Board regulate these terminals as common carriers and that charges for use of these facilities be included in published tariffs. However, no action had been taken as of May 1979.

In a separate action on April 19, 1979, FERC asserted its jurisdiction over the marine terminal facilities owned and operated by PACTEX. Other origin and destination terminals

which pose similar questions, however, are not presently being addressed by FERC. Also, other questions about common carrier compliance such as minimum-tender requirements, prorationing policies, and non-discrimination issues are presently receiving little attention. FERC officials said their current priorities are directed at pipeline industry financing and rate-setting practices.

FERC officials said that their most immediate problem was the lack of information they have on oil pipeline operations and practices. FERC is also hampered because its personnel do not have experience in evaluating oil pipelines. Furthermore, FERC lacks a body of regulatory precedent by ICC on which to base new decisions.

Nevertheless, FERC appears to be attempting to regulate pipelines with more vigor and in greater depth than ICC. We are unable, at this time, to determine what impact FERC's actions will have on the effectiveness of pipeline regulation. Unfortunately, FERC's lack of personnel and expertise is causing it to fall back on ICC's previous practice of relying on complaints to identify potential violations. We believe regulation of petroleum pipelines needs to be strengthened through self-initiated actions.

EXISTING LEGISLATION MAY NOT GIVE FERC ENOUGH AUTHORITY TO REGULATE PIPELINES ADEQUATELY

Differences between oil pipelines and other common carriers such as motor carriers and railroads made regulating pipelines under the ICA very difficult. For instance, numerous common carrier requirements of the ICA did not apply to pipelines. Certain provisions of the act were written for railroads, although some of them might have applied to oil pipelines.

ICC officials said enforcing the ICA more vigorously would not resolve numerous issues raised regarding pipelines. These officials further believed it was inappropriate to regulate pipelines as common carriers because they are generally built, controlled, and operated as integral parts of major oil companies. One official said that aggressive regulation of pipelines as part of the fully integrated oil industry would have no effect on consumer prices.

Others, including the Department of Justice, the Federal Trade Commission, and the Subcommittee on Antitrust and Monopoly, Senate Committee on the Judiciary, have also concluded

that existing legislation is inadequate to resolve the competitive problems of the oil pipeline industry. First, the laws and regulations controlling oil pipelines may not be comprehensive enough to prevent anticompetitive practices. Second, the existing structure of the industry may undermine the possibility of true common carrier service because profit incentives for shipper-dominated pipelines differ from those for other common carriers.

More comprehensive jurisdiction appears desirable

To regulate pipelines effectively, Federal regulators need jurisdiction over all facilities which are integral to pipeline operations. They should also control sizing and routing of pipelines.

Terminal facilities

Pipeline terminals are not presently subjected to regulatory control. Terminal facilities at the entrance, destination, and, at times, intersection of pipeline routes are essential to interstate pipeline movement of oil. ICC, however, contended that it did not have jurisdiction over pipeline terminals.

Pipelines controlled by major oil companies generally do not provide common carrier storage and terminal facilities. Access to pipelines, therefore, is dependent upon a shipper's ability to arrange for terminal facilities. Because of the large capital investment required to furnish tanks at input and delivery points, this can be undertaken by only large volume regular shippers on the pipeline who are often owners of the pipeline. Smaller independent refiners, dealers, or marketers without terminal facilities must prevail upon potential competitors with such facilities in order to accommodate their shipments and thereby use the pipeline.

Right of access to terminals is, in effect, right of access to the pipeline systems. Without jurisdiction over terminal facilities, Federal regulators are limited in enforcing pipelines' common carrier obligations. There have been no regulatory decisions by ICC on the obligation of pipelines to provide storage or terminal facilities which would make pipelines more useful to nonowner shippers. Although FERC is considering its jurisdiction over intermediate terminals used as connecting points between joint route pipelines, it has not addressed the delivery or input terminals. On April 19, 1979, at the request of PACTEX Pipeline Company, FERC asserted jurisdiction over its marine terminal facilities.

Sizing and routing of pipelines

Oil pipelines, unlike other common carriers, natural gas pipelines, and public utilities, are not required to obtain approval for their routing, capacity, or shipper facilities. These other common carriers, are required to obtain a certificate of public convenience and necessity before building or extending their facilities. One of the objectives of this certification requirement is to govern the adequacy and quality of service provided by the carrier.

Not being subject to this requirement, oil pipelines, however, are generally configured by their owners to best suit their needs. A pipeline routed several miles from a nonowner's facilities is, for all intents and purposes, unavailable for use by that nonowner.

In the case of one offshore oil terminal and its related pipeline facilities, LOOP, prior licensing enabled the Federal Government to set conditions on the project to (1) ensure that it would be sized to serve potential users and (2) create a more competitive environment. These same benefits are possible for other common carrier oil pipelines as well. Presently, the Federal Government does not have information on the economic justification for oil pipeline routing or sizing, either before or after the fact.

RATE AND RATE BASE REFORM IS BEING CONSIDERED

FERC assumed ICC's ongoing investigation of oil pipeline rates and rate base. The investigation concerning rates was instituted as a rulemaking proceeding; however, it has been over 4 years since the proceeding began yet no definitive measure has resulted.

The rulemaking proceeding is a general evaluation and reconsideration of the methodology of regulating crude oil and petroleum product pipelines. The proceeding was started on August 28, 1974, by ICC. Initially, it was to determine whether any modifications were necessary in the methodology ICC used to conduct valuations of pipeline common carrier property. On December 18, 1975, ICC expanded the proceedings to include an examination of the proper rate of return for pipelines. Since that time, there have been several postponements and delays.

While FERC has not yet expressed its views formally, the Department of Justice has argued that FERC should (1) abandon the "outmoded and cumbersome" fair value rate

base concepts in favor of depreciated original cost rate regulation such as that used for the natural gas pipeline industry and (2) set rate of return standards that allow a fair and reasonable return. On April 3, 1978, FERC held proceedings aimed at concluding the rate regulation issues. During that time, Justice presented the following proposals to FERC to expeditiously resolve the issues in question.

--Quickly establish a workable, fair, and industry-wide framework for oil pipeline rate regulation--one that conforms to law and is consistent with national energy and transportation policies.

--Replace the current valuation rate base since it is seriously deficient.

--Modify or reform the current rate base methodology. Justice concluded that an original-cost rate base would be vastly superior to the present methodology.

--Establish rate of return guidelines on the rate base which is adopted. The existing rate-of-return constraints should be replaced with more specific guidelines closely geared to the rate base, even if original cost is not adopted.

--Promptly resolve the stated issues by informal rulemaking.

As of December 1978, FERC had not taken any final action regarding the rate and rate base reform issues. Further, the need to expedite the proceeding has not only been expressed by Justice but the oil pipelines as well. Both hold the view that the uncertainty over possible substantial changes in ratemaking methodology could delay pipeline construction or expansion. Further, we believe that whatever method of rate regulation is adopted, proper incentives for continued investment in oil pipelines must be provided.

CONCLUSIONS

FERC acquired almost of all ICC's authority for regulating common carrier oil pipelines. It has been more active, at least on rate questions. However, it has not addressed a number of other common carrier obligations and presently has no plans to do so. Like ICC, FERC has said it will respond to complaints about potential violations. FERC officials said present data submitted by pipeline companies is inadequate to assess the reasonableness of rates or compliance with common

carrier obligations. Further, the resolution of its proceedings on rate and rate base reform is uncertain at this time.

Even if existing legislation were enforced, serious common carrier problems might continue in the pipeline industry. Terminal facilities are an integral part of pipeline operations; however, common carrier regulations have not been applied to these facilities. Therefore, independent shippers without such facilities must rely on their competitors for use of necessary entrance and exit pipeline terminal facilities if they wish to ship products by pipelines. ICC's authority to have regulated carrier terminal facilities as essential parts of the common carrier pipelines may or may not be supported by the wording of the Interstate Commerce Act. Further, FERC has not determined its position on the regulation of terminal facilities.

Current legislation does not require oil pipelines to obtain certificates of public convenience and necessity before instituting new services, constructing new facilities, or changing pipeline ownership, although this is required of others, such as railroads and natural gas pipelines. Such certification may be necessary to assure that a pipeline will be sized, routed, or expanded to provide potential shippers--and eventually the final consumer of petroleum products--the benefits of this low-cost transportation mode. However, in light of the unresolved allegations concerning such issues, more must be done to test the substance of these allegations by gathering information on pipeline practices. In its comments on the report DOE said that its Office of Competition is designing a survey to test various aspects of the oil pipeline undersigning theory. This survey is being coordinated with Justice and FTC and is intended to provide definitive data on oil pipelines' competitive practices. The type study planned would help in determining the necessity of certification.

CHAPTER 5

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS

As common carriers, oil pipelines have been subject to the requirements of the Interstate Commerce Act for over 70 years; however, very little has been done to effectively regulate these companies. Federal regulators lacked essential information and had not developed criteria and standards to ensure compliance with the act. As a result:

--Many pipeline companies have enjoyed higher returns to stockholders' equity and total capital than the other most profitable industries--regulated or unregulated.

--Allegations of anticompetitive practices have not been resolved, resulting in almost continuous Federal investigations over the past 15 years.

--FERC has not addressed many oil pipeline common carrier issues and presently has no plans to do so.

The incentives of an oil pipeline controlled by vertically integrated oil companies are different from those of other common carriers or even an independent pipeline company. The incentive of pipelines owned by integrated oil companies is to maximize overall profits of their owners, and they are generally built, controlled, and operated as integrated parts of major oil companies. A common carrier oil pipeline not affiliated with an integrated oil company increases its revenues and profits by expanding the volume it ships or by increasing its rates. In seeking to maximize its volume, it will actively try to attract as much business as possible from new and existing customers. This can be done by routing and sizing the pipeline to attract the largest number of shippers; providing storage facilities; providing pipeline connections on reasonable terms; and setting rates to encourage potential shippers to use the pipeline.

During 1976, the latest year for which industry-wide data was available, the most profitable publicly held company, as measured by return or equity, would rank only 26th among oil pipeline companies. Further, the most profitable utility company and natural gas pipeline companies would rank 61st and 34th, respectively.

These high profits realized by many pipeline companies have continued because

--ICC did not review rates for justness and reasonableness and

--the 1941 Consent Decree has failed to limit profits and rates.

Pipeline tariffs were given cursory reviews by ICC and had a low priority relative to other transportation modes. Reviews of tariffs were generally clerical in nature and did not assure that rates were just and reasonable. Although there were a number of ICC decisions affecting allowable rates of returns for pipeline companies, these were not enforced. In 1976, 41 of the 110 regulated oil pipelines had rates of return in excess of what was allowed in those decisions.

In 1941, the Department of Justice and many of the pipeline companies entered into a consent decree limiting the dividends pipeline companies could pay their shipper-owners to 7 percent of the pipeline's valuation. The decree, however, has not limited pipeline companies' rates or profits. The decree allowed pipeline companies to include debt-financed property in calculating the dividend limitation. Before the decree, pipeline companies were financed almost entirely by equity funds provided by their shipper-owners. Today, many pipeline companies have debt equity ratios of 90:10 or higher. This change in pipeline financing made the decree ineffective in limiting rates or profits.

The decree has not operated as the Department of Justice intended. It does not serve a useful purpose and Department officials said little has been done to enforce the decree. Further, the Department has not established controls to assure that companies subject to the decree are filing annually as required and that those which are filing do so accurately and completely.

The Government has not established criteria for determining the justness and reasonableness of oil pipeline rates. Recent regulatory decisions affecting other regulated industries such as communications, utilities, and trucking found rates reasonable when they provided stockholders with a 14-percent return on equity. However, in 1976, 61 of the 110 regulated pipeline companies had profits in excess of 14 percent (31 had returns in excess of 40 percent and 11 exceeded 100 percent).

If the decisions mentioned above had been applied to oil pipelines during 1976, rates could have been reduced by as much as $300 million. A 16-percent return on equity

would have resulted in a $215-million reduction; an 18-percent return would have resulted in a $127-million reduction.

Shipper-owner oil companies are at a distinct advantage because they pay only actual transportation costs when they use the pipelines they own. That is, they pay the same tariff rate as any shipper, but receive dividends from the pipeline company. Nonowners, by contrast, pay the full tariff rate and do not receive dividends. If nonowner shippers could increase their use of pipelines, their transportatation costs would be reduced and consumers would benefit if these savings were passed along through reduced market prices.

Federal regulators have not resolved the numerous allegations of anticompetitive oil pipeline company practices. Allegations have not been resolved because:

--ICC gave very low priority to oil pipeline regulation.

--Information needed to ensure that oil pipelines meet their common carrier obligations was not routinely collected.

--There were no standards or criteria for evaluating oil pipeline company practices, such as scheduling or prorationing procedures, the minimum amounts acceptable for shipment, or access to terminal facilities. In cases for which precedent had been established, such as for minimum amount acceptable for shipment and rates of return, they were not enforced.

--ICC did not review and question carriers' tariff rules and conditions, and as a result, pipelines often had considerable discretion in accepting shipments.

--A systematic compliance program was not undertaken until June 1976. When begun, the program raised a number of questions about possible anticompetitive, discriminatory or otherwise unlawful practices, but very little was done to resolve these questions.

The Department of Justice's Antitrust Division, the Federal Trade Commission's Bureau of Competition, and the Department of Energy's Economic Regulatory Administration have all investigated alleged anticompetitive practices of oil pipeline companies. These difficult and costly investigations have been subjected to court challenges which have caused delays. To date, these agencies have done little to resolve the allegations of anticompetitve practices of oil pipeline companies.

FERC has attempted to more actively regulate oil pipeline rates than ICC had previously. However, it has not addressed many of the allegations of anticompetitive practices and presently has no plans to do so. Like ICC, FERC plans to respond to complaints about potential violations rather than undertake self-initiated actions. Also, resolution of its proceedings on rate and rate base reform is uncertain at this time.

Furthermore, FERC's jurisdiction may need to be extended to include certification of public convenience and necessity and authority over terminal facilities if it is to effectively regulate oil pipelines. Certificates of public convenience and necessity are not required for oil pipelines. Without this, there is no assurance that pipelines will be routed, sized, or expanded to provide potential shippers--and eventually the consumer--the benefits of this transportation mode. A determination regarding the need to extend FERC's regulation through certificates of public convenience and necessity will depend, to some extent, on the results of further study of pipeline practices. Terminal facilities are an integral part of pipeline operations, but they have not been subject to Federal regulation. Right of access to these facilities is necessary before a shipper can use the pipeline.

RECOMMENDATIONS

Federal Energy Regulatory Commission

In order to assure justness and reasonableness of rates and help assure that owners of oil pipelines are not reaping excessive profits, we recommend that the Federal Energy Regulatory Commission implement rate reform. Criteria should be established for determining the justness and reasonableness of oil pipeline rates and sufficient regulatory procedures implemented to assure that the criteria are followed. Rates of return should provide proper incentives for continued investment in pipelines. These procedures should include (1) a requirement that both line segment and company-wide rate increases be justified, (2) the use of tariff examiners who fully understand the oil pipeline industry, and (3) an adequate audit process for assuring the validity of data provided by the pipeline companies.

We also recommend that FERC strengthen its regulation of petroleum pipeline practices by:

--Collecting adequate financial and operating information on oil pipeline companies, including information on

undivided-interest pipelines. This should be coordinated with the data collection responsibilities and efforts of the Energy Information Administration.

--Determining whether pipeline terminal facilities are subject to the provisions of the Interstate Commerce Act. If it is determined they are not presently subject to the act, FERC should request appropriate legislation from the Congress which would make terminal facilities subject to the same jurisdiction as pipelines.

--Developing policies and standards for common carrier requirements of oil pipelines, and establishing procedures for enforcing industry compliance. Specific standards should be applied uniformly and include the following areas:

--Clear and not unduly restrictive product specifications.

--Well-defined standards for pipeline prorationing policies,

--Uniform minimum tender and delivery standards.

--Explicit and comprehensive tariff rules regarding operating practice and charges for services.

--Determining the best means to assure that all potential users of a pipeline are adequately considered in its routing, sizing, or expansion The need to extend FERC's regulation through certification of public convenience and necessity should be among the options considered in making such a determination.

Department of Justice

We recommend that the Attorney General move to vacate the consent decree because it no longer serves any useful purpose in limiting payments to pipeline owners or controlling pipeline rates. This would remove an unnecessary reporting burden on the pipeline companies and the administrative burden on the Department of Justice.

CHAPTER 6

AGENCIES' COMMENTS AND OUR EVALUATION

Comments on this report were received from the Departments of Energy and Justice, the Federal Energy Regulatory Commission, the Federal Trade Commission, and the Interstate Commerce Commission. These comments (with the exception of Senator Kennedy's petition for pipeline divestiture which was included by FTC as an attachment to its comments), have been included in their entirety as appendixes I through V. Certain agency comments are no longer relevant because of changes made to the report. In addition to comments discussed in this section, agency positions are included in the text of individual chapters to the extent practical and appropriate.

DEPARTMENT OF ENERGY

DOE acknowledged that there was a need for interagency cooperation in rate setting, rate review, controlling profits, and pipeline regulation. DOE said that although the proposed report contained useful material, the following comments should be considered before issuing the final report.

DOE said that FERC is in the midst of proceedings which will change the way oil pipelines are regulated, illustrating that FERC is taking an active approach in regulating the oil pipeline industry. We believe this is adequately addressed in chapter 4 where we point out that FERC has been more active in regulating oil pipelines than ICC had been. However, existing legislation may not give FERC enough authority to adequately regulate the oil pipeline industry.

DOE also said its Office of Competition is designing a survey to test various aspects of the oil pipeline undersizing theory. This survey is being coordinated with the Department of Justice and FTC and is intended to provide definitive data on oil pipelines' competitive practices. Further, DOE stated that it has established an Office of Energy Transportation Policy to coordinate departmental policy and action on pipelines and other energy transportation modes. We applaud these efforts but withhold comment until their effectiveness has been demonstrated.

DOE also believed that more analysis is needed to support legislation at this time to require certificates of public convenience and necessity in order to regulate the construction, extension, expansion, and acquisition of pipelines, as well as other new services. Consequently, DOE did not agree with our proposal for legislative action.

Other common carriers, except oil pipelines, are required to obtain such certification prior to building or expanding their facilities. Further, in the case of the Louisiana Offshore Oil Port and its related pipeline facilities, prior licensing enabled the Federal Government to set conditions on the project to (1) ensure that it would be sized to serve potential users and (2) create a more competitive environment. We believe these same benefits are possible for other common carrier oil pipelines as well.

We agree with DOE that some further analysis, if completed within a reasonable period of time, would be beneficial in judging the need and merits of legislation. Consequently, we are recommending that FERC determine the best means of assuring the adequacy and quality of service provided by pipelines rather than recommending that the Congress enact legislation at this time to require certification.

DEPARTMENT OF JUSTICE

Justice took exception to our conclusion that the consent decree does not serve a useful purpose. It said that lacking effective rate of return regulation, the consent decree provides the only limit on the profits earned by pipeline companies. Justice admitted, however, that this limit is quite high and that it permits some excessive profits.

As discussed earlier, however, the consent decree has not operated as Justice intended. High rates can be maintained so long as profits are not paid out and high rates can be set in one segment and offset with low rates in other comparable segments. Further, Justice officials said little had been done to enforce the decree. Only certain pipeline companies, their subsidiaries, and successors were subject to the 1941 Consent Decree. Justice officials said that they have no means of knowing which companies are presently required to report. Justice has not established controls to ensure that companies subject to the decree are filing annually as required or that those which are filing do so accurately and completely.

We therefore maintain our position that the consent decree does not serve a useful purpose and should be vacated to remove an unnecessary reporting burden on the pipeline companies, and that more effective rate reform be implemented.

Justice contends that we imply it has abandoned the competitive rules approach to resolving pipeline problems. No such implication is intended or made. We state only that Justice officials have expressed reservations about the approach, citing the difficulty of monitoring and enforcing these rules. Justice had further expressed concern about applying competitive rules to a nationwide pipeline network with multiple input, output, and interconnection points. We believe Justice's position on this matter is presented fairly and accurately in the report.

Justice said that the proposed report implied that the Trans Alaska Pipeline System case was only before the Interstate Commerce Commission and has already been concluded. While we acknowledge that we did not mention the myriad of court hearings related to this case, our point is that Justice actively participated in the proceedings which resulted in the establishment of lower interim rates.

Justice said that the proposed report has not shown that certification of oil pipelines would assure potential shippers the benefits of pipeline transportation, and they believe there are significant problems which should be addressed before petroleum pipelines are subjected to the cost of this additional level of regulation. This point was also raised by DOE and is addressed in our response to their comments.

FEDERAL ENERGY REGULATORY COMMISSION

The Chairman, FERC, said that the proposed report was a good effort which will improve the public's understanding of the issues surrounding oil pipelines. He said that his ability to fully react to our recommendations was limited because many of the issues are contained in proceedings before the Commission.

The Chairman suggested that certain points deserved added emphasis in our report. He pointed out that electric and natural gas utility regulation tends to have a more direct and immediate impact on ultimate consumers than is the case with oil pipelines. He also said that because regulated oil pipeline costs represent a much smaller share of the final cost of most petroleum products than the regulated segments of natural gas and electric utilities, the benefits of oil pipeline regulation to the consumer are considerably smaller than for other regulated energy forms. Furthermore, the Chairman said there is no assurance the benefits of oil pipeline regulation will be passed on to consumers.

We agree there is no absolute assurance that the benefits of more effective oil pipeline regulation would accrue directly to the consumer. We continue to believe, however, that consumers could benefit if oil pipeline transportation cost savings were available to non-owner shippers as a result of more effective regulation.

The Chairman said there are important differences between the statutory purposes of electric and natural gas utility regulation and that of oil pipelines. He said that the Federal Power Act and the Natural Gas Act are fundamentally intended to protect final consumers from unjust or unreasonable prices. He added that this purpose was also embodied in the Interstate Commerce Act although protection of shippers from concessionary and discriminatory practices by integrated oil companies was more prominent in oil pipeline legislation. He concluded that the nature of the oil pipeline industry and its relationship to final customers suggest that the regulatory objectives comparable to oil pipelines may differ from the objectives of natural gas or electric utility regulation.

We continue to believe that final consumers can benefit from more effective pipeline regulation. We agree that the prevalent features of oil pipeline legislation have been directed at assuring equitable access to all shippers at just and reasonable rates. If this were assured, we believe final customers would benefit as well.

Regarding our conclusion on the need to extend jurisdiction to terminal facilities, the Chairman, FERC, said that, in an order issued April 19, 1979, the Commissioner asserted FERC's jurisdiction over the marine terminal facilities owned and operated by PACTEX. This has been acknowledged in the report.

FEDERAL TRADE COMMISSION

FTC's comments were submitted by the Director of its Bureau of Competition. They were not approved by the Commission and did not necessarily reflect the views of the Commission or any individual Commissioner. FTC's comments were related primarily to the actions it is taking in response to Senator Kennedy's petition that FTC issue rules which would prohibit major oil companies from owning oil pipelines. These comments are presented in their entirety in appendix IV and are not addressed here because they relate to divestiture rather than regulation as a means of resolving allegations of anticompetitive pipeline company practices.

FTC's other comments were of a factual or technical nature and have been incorporated in the final report where appropriate.

INTERSTATE COMMERCE COMMISSION

ICC commented that, for many years, its regulation of oil pipelines was limited and more should have been done. ICC further said that given the current power of the petroleum industry and high prices, increased regulatory activity is warranted.

ICC said the report should be clarified to indicate that the justness and reasonableness of rates were not reviewed on the Commission's own initiative but were reviewed upon complaint. ICC further stated that complaints were a questionable remedy in the pipeline industry where 90 percent of the pipeline owners were also shippers.

We believe these comments are appropriately addressed throughout the report. Other comments were of a technical nature, and where appropriate they were considered in preparing the final report.

UNITED STATES DEPARTMENT OF JUSTICE

WASHINGTON, D.C. 20530

Address Reply to the
Division Indicated
and Refer to Initials and Number

MAY [illegible]

Mr. Allen R. Voss
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Voss:

This letter is in response to your request for comments on the draft report entitled "Petroleum Pipelines: More Effective Regulation Needed."

The Department takes exception to the report's conclusion that enforcement of the Consent Decree serves no useful purpose. It does serve a useful purpose. Lacking effective rate of return regulation, the Consent Decree provides the only limit on the profits earned by pipeline companies. While we agree that this limit is high and that it permits the earning of some excessive profits, we submit that it is the only effective limit now in place and that the Consent Decree should remain until an effective system of rate regulation is established by the Federal Energy Regulatory Commission (FERC).

The report correctly states that DOJ officials are working toward rate reform in the pipelines industry by intervening before various regulatory agencies and in a FERC proceeding to reform the methods for determining pipeline rates. Further, the DOJ has also proposed an original cost rate base for oil pipelines and a revised rate of return formula which will lower pipeline rates.

The report inaccurately gives the impression that the Trans Alaska Pipeline System (TAPS) case was a proceeding before the Interstate Commerce Commission only and has already been concluded. In fact, the TAPS proceeding before FERC is ongoing, and the Department continues to participate actively in it. TAPS may prove to be a major FERC precedent on the regulation methodology for pipeline rates.

It should also be noted that as a result of the Department's proposing that a licence to operate a deepwater port include provisions to ensure competition, the Secretary of Transportaton incorporated most of these provisions before issuing the license. The report, however, states that "DOJ officials" expressed reservations concerning the usefulness of the competitive rules approach in resolving the pipeline problem. It implies that DOJ has abandoned the competitive rules solution. This is not correct and should be clarified. The Department continues to utilize the competitive rules solution.

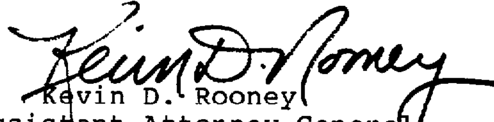
The report states that since oil pipelines are "generally configured by their owners to best suit their needs," pipeline facilities may often be unavailable for use by a non-owner. GAO recommends that petroleum pipelines be required to obtain certificates of public convenience and necessity, the same as natural gas pipelines, and concludes that this certification process would provide assurances that a pipeline would be sized, routed or expanded to provide potential non-owner shippers with the benefits of pipeline transportation. The Department believes that the report has not demonstrated that certification of petroleum pipelines would in itself solve these problems.

While the certification process would permit Federal intervention into the design of pipelines, certification alone may not effectively prevent capacity restriction or undersizing. For example, where most shippers are owners of the pipeline and not sellers downstream, they will continue to have a common interest in assuring that some oil travels by a more expensive mode. Moreover, the competitive problem does not result solely from decisions on the physical diameter of the pipeline. Rather, the pipeline owners have numerous other opportunities to either expand or contract capacity. These latter decisions can also result in undersizing but may be beyond the certification process.

While the Department has not finally concluded that the certification process would be an ineffective means of regulation, we believe that there are significant problems which should be addressed before petroleum pipelines are subjected to the cost of this additional level of regulation.

We appreciate the opportunity to comment on the draft report. Should you desire any additional information, please feel free to contact us.

Sincerely,



Kevin D. Rooney
Assistant Attorney General
for Administration

Department of Energy
Washington, D.C. 20545

May 9, 1979

Mr. J. Dexter Peach, Director
Energy and Minerals Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Peach:

We appreciate the opportunity to review and comment on the GAO draft report entitled "Petroleum Pipelines: More Effective Regulation Needed."

The draft report points out the need for interagency cooperation on rate-setting, rate review, and the basis for controlling the profits earned. DOE also recognizes the need for interagency cooperation on pipeline regulations.

Although the draft report does contain useful material, we believe that the comments discussed below should be considered before issuance of the final report.

The Federal Energy Regulatory Commission is in the midst of proceedings which will change the ways petroleum pipelines are regulated. These proceedings, FERC Docket No. OR78-1 and Docket No. OR79-1, et al, illustrate that FERC is taking an active approach to the regulation of the petroleum pipeline industry.

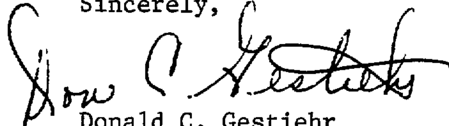
DOE's Office of Competition is designing a survey to be sent to all oil pipelines in order to collect data to test various aspects of the petroleum pipeline undersizing theory. This survey which is being coordinated with the Department of Justice and the FTC should result in definitive data on oil pipeline competition practices.

DOE has established an Office of Energy Transportation Policy to coordinate departmental policy and action pipelines and other energy transportation modes.

Also, we feel that more analysis is needed to support GAO's recommendation that Congress enact legislation to reguire certificates of public convenience and necessity in order to regulate the construction, extension, and acquisition of pipelines, as well as other new services.

We appreciate your consideration of these comments in the preparation of the final report and will be pleased to provide any additional comments you may require.

Sincerely,



Donald C. Gestiehr
Director
GAO Liaision

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D. C 20426

OFFICE OF THE CHAIRMAN

May 3, 1979

Mr. J. Dexter Peach
Director
Energy and Minerals Division
U.S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Peach:

The General Accounting Office's draft report on regulation of petroleum pipelines is, I believe, a good effort that will improve the public's understanding of the issues surrounding oil pipelines. As the draft report indicates, many of these issues are contained in proceedings before the Commission, thereby limiting my ability to fully react to your recommendations. But because these issues are indeed important, I would like to suggest a few points that may deserve added emphasis in your report.

The regulatory regime applicable to oil pipelines differs significantly from that applicable to natural gas pipeline or electric utility regulation. In general, electric and natural gas utility regulation tends to have a more direct and immediate impact upon ultimate consumers than is the case with oil pipelines. Electric and natural gas utilities are generally regulated at the point of generation (production), transmission, and distribution. Under this regime the consumer is assured that the benefits of regulation will flow through to the point of final sale. These same assurances do not apply in the case of oil pipelines.

Utility-type regulation covers more than half of the delivered price of electricity and natural gas, whereas oil pipeline costs represent a much smaller share of the final cost of most petroleum products. For example, while the average delivered price of electricity to residential customers was 4.4 cents per kilowatt hour in 1978, the unregulated fuel component of such cost was only 1.7 cents, so that 61 percent of the delivered price was regulated at the state or Federal level. In contrast, petroleum pipeline

costs comprise 4 or 5 percent of the delivered price of petroleum products. Accordingly, the benefits of oil pipeline regulation to the consumer, are considerably smaller than for other regulated energy forms. Moreover, there is no means of assuring that these benefits will be flowed through to consumers at the point of final sale. Consequently, oil pipeline regulation may have a more significant impact on intra-industry income distribution than on total consumer costs of petroleum products.

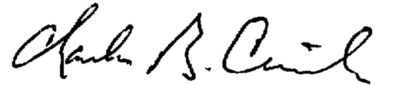
There are also important differences between the statutory purposes of electric and natural gas utility regulation versus that for oil pipelines. The Federal Power Act and the Natural Gas Act are fundamentally intended to protect final consumers from unjust or unreasonable prices which may be imposed upon them by utilities which have been given virtual monopoly status. This purpose is also embodied in the Interstate Commerce Act as well, but an equally important purpose of that Act is to protect shippers from discriminatory and concessionary practices by integrated oil companies. The allocation aspects of oil pipeline regulation are far more prominent than in the legislative directives creating federal regulation of electric and natural gas utilities.

I think it would be helpful to your readers to point out in the final report that the nature of the oil pipeline industry and its relationship to final customers suggest that the regulatory objectives comparable to oil pipelines may differ from the objectives commonly understood as applicable to natural gas or electric utilities.

While the Commission is in the process of reviewing the question of the appropriate ratemaking standards that should be applied to the oil pipeline industry, it comes to this task with the same observation made by the GAO, namely, that oil pipelines are an extremely efficient mode of transportation. Any restructuring of oil pipeline regulatory practices must take into account the potential impact of such a change on incentives to construct or expand oil pipelines.

With respect to your conclusions on the need to extend jurisdiction to terminal facilities, you should be aware that the Commission, in an order issued on April 19, 1979, in Docket No. OR78-10 asserted jurisdiction over the marine terminal facilities owned and operated by PACTEX.

Sincerely,



Charles B. Curtis
Chairman

FEDERAL TRADE COMMISSION
WASHINGTON, D. C. 20580

BUREAU OF COMPETITION

May 9, 1979

Mr. Gregory J. Ahart
Director
Human Resources Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Ahart:

This is to acknowledge receipt of your draft report to Congress entitled "Petroleum Pipelines: More Effective Regulation Needed." As Director of the Bureau of Competition, which has substantial and direct interest in the competitive effect of petroleum company ownership of petroleum pipelines, I am responding to your request for Federal Trade Commission comments on this draft report. */ The purpose of this letter is to inform you that the FTC is involved in several areas of activity concerning the competitive aspects of petroleum pipelines other than the adjudicative activity mentioned in the draft report.

One recent area of activity which relates directly to the subject matter and context of the draft report is the January 4, 1979, petition filed by Senator Kennedy seeking Commission promulgation of a rule declaring oil company ownership of petroleum pipelines of certain classes to be an unfair trade practice or unfair method of competition. (Copy attached). Senator Kennedy's petition is based on the assertion that oil company ownership of petroleum pipelines harms the public interest in two ways: (1) consumers pay higher prices for petroleum products, such as gasoline, because pipeline ownership affords oil companies monopoly power; and (2) competitors of oil companies that own petroleum pipelines cannot compete on an equal basis because they do not have equal access to the pipelines.

The petition notes that in passing the Hepburn Act in 1906, which subjected petroleum pipelines to federal common carrier regulation, Congress recognized that petroleum

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*/ Because an adjudicatory matter relating to the competitive structure of the petroleum industry (<u>Exxon Corp.</u>, Dkt. 8934) will eventually come before the Commission for a decision, these comments reflect only the views of the Bureau of Competition. They have not been approved by the Commission and do not necessarily reflect the views of the Commission or any individual Commissioner.

pipelines are natural monopolies. The petition asserts that federal common carrier regulation of oil company owned petroleum pipelines has been a failure, ensuring neither equitable tariff rates nor reasonable access for all potential shippers; and that it is impossible for the current pipeline regulatory scheme to be effective in restricting the exercise by oil company pipeline owners of their natural monopoly power. The petition further asserts that by restricting pipeline capacity, oil company pipeline owners could force some part of downstream demand to be met by less efficient, higher-cost transportation alternatives, such as smaller-diameter pipelines, barges or tankers. The oil company pipeline owner could then price its products in the downstream market to reflect the higher-cost transportation. The integrated oil company would thereby have evaded common carrier rate regulation designed to ensure that the cost efficiencies of pipeline transportation are reflected in consumer prices.

In calling for divestiture of petroleum pipelines from oil companies, the petition warns that truly effective petroleum pipeline capacity regulation by the federal government would be extremely difficult and would put "the government into the business of second-guessing investment decisions." Such a "drastically expanded scheme for pipeline regulation" would be inadvisable, the petition asserts, and divestiture of petroleum pipelines from oil companies would present the best solution to the problems of effective rate regulation of petroleum pipelines and equal access to pipelines by all potential users. Petition at 8, 11-12.

The petition for rulemaking recognizes the authority of the Federal Trade Commission under Section 5 of the Federal Trade Commission Act, 15 U.S.C. §45, "to prohibit 'unfair methods of competition in or affecting commerce.'" The petition further states that the Commission has jurisdiction to address oil company ownership of oil pipelines:

> While pipelines themselves are exempted from the Commission's jurisdiction to the extent they are common carriers as defined in Section 5(a)(6) of the FTC Act, parent companies of such carriers are not exempt. The Commission may proceed against parents and affiliates of, or parties acting in concert with, persons exempted from the Commission's jurisdiction.

Petition at 1-2.

The petition states that the FTC has the authority pursuant to Section 6(g) of the FTC Act to issue rules defining unfair methods of competition, violations of which would constitute violations of Section 5 of the FTC Act, (_citing_ _National Petroleum_

Because the issues involved in the petition are exceedingly complex and the subjects of much current debate, the Bureau staff has concluded that formal action on the petition should follow an opportunity for comment by members of the public. In addition, the advice of experts on matters relevant to the petition will be solicited by the staff. The staff has accordingly recommended that the Commission publish in the Federal Register a Notice of Opportunity to Submit Comments on the Petition, allowing interested parties 120 days in which to make known their views concerning the petition. To facilitate public comment, the staff has provided in the notice a series of questions relating to specific matters raised directly or implicitly in the petition. The Bureau's recommendations are now before the Commission for its consideration.

Should the Commission approve the Bureau's recommendation, we intend to work closely with the staffs of the Antitrust Division of the Department of Justice and the Office of Competition of the Department of Energy, insofar as our role as an independent federal agency will permit.

The views and expertise of the Department of Justice on pipeline issues would be a focal point in an FTC rulemaking proceeding, should one be instituted. Moreover, it is our understanding that William C. Lane, Jr., Director of DOE's Office of Competition, announced at the April 1979 API Pipeline Conference that DOE is aware of the possibility of rulemaking at the FTC and intends to undertake empirical research into issues raised for and against pipeline divestiture. Specifically, Mr. Lane stated:

> Working with industry trade groups and various companies within the industry, we think we can carry out a two phased detailed study into Justice's capacity restriction assertions and, hopefully, advance the level of insight to a much higher degree.

Given the interest at DOJ and DOE in the topic of pipeline divestiture, an interdisciplinary approach by Government agencies would appear to be the most efficacious way of examining the merits and demerits of that issue.

Refiners Association v. F.T.C., 482 F.2d 672 (D.C. Cir. 1973), cert. denied, 415 U.S. 951 (1974)), and that "[b]ecause the debate over the competitive consequences of petroleum pipeline ownership by integrated oil companies will involve predominantly issues of competitive theory, with disputes of fact playing a less significant role, rulemaking rather than adjudication is the most efficient way to address this question." Petition at 2.

Finally, the petition states that the question of whether divestiture for competitive purposes can be ordered in an administrative rulemaking proceeding was dealt with by the Supreme Court in FCC v. National Citizens Committee for Broadcasting, ___ U.S. ___, 56 L. Ed. 2d 697, 98 S. Ct. 2096 (June 12, 1978). That case, Senator Kennedy contends, established "a clear precedent for dealing with industry-wide structural problems through rulemaking." Petition at 3.

Senator Kennedy's petition is based, in part, on a comprehensive report by the staff of the Senate Subcommittee on Antitrust and Monopoly, published in June, 1978. This report concerns economic and competitive problems posed by oil company ownership of pipelines.

Other bodies, both private and public, have recently addressed the subject covered in the Kennedy petition. The adequacy of current petroleum pipeline regulation, the arguments for and against oil company divestiture of pipelines, and proposals for regulation of pipeline ownership were also matters addressed in a conference sponsored by the American Enterprise Institute for Public Policy Research in March 1979. In January of this year Senator Birch Bayh of Indiana introduced a bill that would prohibit oil producers, refiners, and marketers from owning oil pipelines. Entitled the "Petroleum Industry Competition Act of 1979" (S. 82), the bill is virtually identical to S. 2387, introduced by Senator Bayh in the 94th Congress.

Senator Kennedy's petition and the allegations contained therein already have stimulated vigorous debate among businessmen, economists, and public interest representatives. The staff of the Bureau of Competition has received numerous submissions either supporting or opposing the petition. Senator Howard M. Metzenbaum, Representative Morris K. Udall, and Assistant Attorney General for Antitrust John Shenefield support the Kennedy petition. Senators Strom Thurmond, Paul Laxalt, Orrin Hatch, Alan Simpson and Ted Stevens, and Representative James Broyhill have indicated their opposition to one or more aspects of the petition. In addition, unsolicited comments have been received from diverse groups such as the U.S. Chamber of Commerce and the Consumers Energy Council of America.

As for other pipeline competition matters, the Federal Trade Commission also has the responsibility to advise the Secretary of Transportation on the competitive effects of deepwater ports. The staff of the Bureau of Competition is currently engaged in an analysis of such a facility sponsored by the Texas Deepwater Port Authority, an agency of the State of Texas. A license application is pending at the Department of Transportation and a decision with respect to the license is expected in August of this year. Pursuant to the Deepwater Port Act of 1974, P.L. 93-627, the Federal Trade Commission will submit a report to the Secretary of Transportation prior to that date assessing the competitive effects that could result from issuance of a license to the Texas Deepwater Port Authority.

In addition, Title V of the Public Utility Regulatory Policies Act of 1978, P.L. 95-617, provides for review by the Federal Trade Commission of proposed pipelines to deliver crude oil from the West Coast of the United States to the northern tier and inland states. The Commission may report directly to the President on the competitive effects of such crude oil delivery systems. The staff of the Bureau of Competition is actively engaged in gathering information from the companies that have applied to construct and operate these pipelines. The staff will review the proposals in order to determine their effect on competition and consistency with the antitrust laws, and make appropriate recommendations to the Commission for its consideration.

While we recommend changes in the thrust of the draft report to reflect the above information, the following specific comments in the report should be changed in the interest of accuracy: Page 56. The first full paragraph should be changed to reflect the receipt of "substantive company documents." The *Exxon* respondents were ordered in October 1978 to turn over all documents subpoenaed in 1978, and respondents have agreed to comply. The first such documents, including those relating to transportation, have already been screened by FTC complaint counsel in April 1979. The paragraph is also inaccurate in reporting that over $11.5 million had been spent by the FTC on the *Exxon* case. This figure derives from the information previously provided Alan Shilepsky by our staff. The figures identified therein as "Expenditures" were defined to include monies that have been obligated to the *Exxon* case in addition to those actually spent. A review of FTC records indicates

GAO note: Page numbers in these appendixes refer to the draft report and may not correspond to this final report.

that actual expenditures since 1973 are considerably below the totals appearing on the 1978 chart provided to Mr. Shilepsky. In particular, a large portion of the $11.5 million figure represents money for program contracts appropriated, but not yet spent because of previous delays in discovery. Those delays have now been resolved and it is believed that the appropriated monies will be spent in the next year.

These views have been orally communicated by Ronald B. Rowe, Assistant Director, Bureau of Competition, to Mr. Gerald Elsken, the Assistant Director of the Energy Regulations Board, on April 30, 1979. If you have any further questions, Mr. Rowe will be pleased to answer them and to provide any further assistance you may need. Mr. Rowe may be reached at 724-1441.

Very truly yours,

Alfred F. Dougherty, Jr.
Director
Bureau of Competition

Attachment

(See p. 51.)

Interstate Commerce Commission

Washington, D.C. 20423

OFFICE OF THE CHAIRMAN

May 7, 1979

Mr. Henry Eschwege
Director
Community and Economic Development
Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Eschwege:

Thank you for giving the Commission the opportunity to comment on your draft report to Congress entitled "Petroleum Pipelines: More Effective Regulation Needed."

Upon reviewing your report, I agree that, for many years, the Commission's regulation of oil pipelines was limited, and that more could and should have been done. Without defending the Commission's regulation of the pipelines, however, I feel that some clarification is needed in the report to put the Commission's program in historical context and note the regulatory climate of its development.

This letter should not be construed as a stamp of approval by the present membership of the Commission of either the valuation standards used in the past or the Interstate Commerce Commission's earlier regulatory policies in general. Indeed, at the time the Commission's jurisdiction over petroleum pipelines passed to the Federal Energy Commission, the Commission was aware of and beginning to address many of the problems brought out in the draft GAO report. At that time, for example, we had recently suspended the Trans Alaska Pipeline rate filings, a proceeding of enormous regulatory and monetary importance. In addition, a general investigation of valuation and rate of return standard was underway, and other investigations of rate filings and complaint proceedings were pending.

While the Commission's decisions in the 1940's indicated a clear understanding of the structure and conduct of the pipeline industry, there was no program to carry that understanding into effective regulation. Where, however, a substantial question concerning the justness and reasonableness of a rate was presented, the Commission undertook an investigation and resolved the question using the standards

the Commission then thought to be appropriate. To avoid misunderstanding, the draft report could be clarified to indicate that the justness and reasonableness of tariff rates was not reviewed by the Commission on its own initiative, but was reviewed upon complaint. Complaints, however, were a questionable remedy in the pipeline industry where 90 percent of the pipeline owners were also shippers.

The report might be improved and reflect more fairly on our regulatory predecessors if it reflected the circumstances of the earlier period of pipeline regulation. Pipeline rates per barrel declined during the postwar period and remained at a stable, low level until the 1973 embargo. During this time, the overall cost of petroleum to the consuming public was low, and from the earliest days one of the regulatory transportation questions was whether the railroads should be protected from very low petrodeum pipeline rates. Large-scale investigations and administrative proceedings involving questions of prorationing, minimum tenders, terminal access, and the like may not have seemed to the members, or to the oversight Committees of Congress, to be warranted regulatory activities in that economic climate. A program of actions tending to hold down petroleum pipeline rates and profits clearly would be well supported today but possibly thought less important in the 1940's and 1950's.

I think the final report should take note that prior to 1977 the Commission did take a number of actions to correct, redirect, and improve its regulation.

The Commission instituted a general investigation concerning the valuation process and the rate of return standard: Ex Parte No. 308, Valuation of Common Carrier Pipelines. Evidence in this proceeding was being received at the time of the transfer of jurisdiction.

Also under way at the time of the transfer was a general investigation into the possible anticompetitive effects of oil company ownership of pipelines: Ex Parte No. 308 (Sub-No. 1), Investigation of Common Carrier Pipelines. In this proceeding, the Commission was seeking data on many of the same problem areas that are discussed in the draft report. Although procedural actions inhibited development of an accurate, complete record early in this proceeding, an interlocutory appeal seeking reversal of an Administrative Law Judge's denial of discovery was granted by the Commission prior to the transfer of jurisdiction.

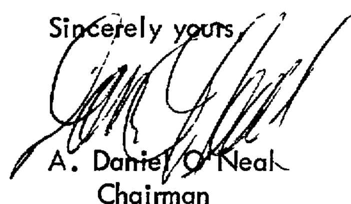
The Commission's 1970's concern and activity in the pipeline area is also demonstrated by the actions taken in contemplation and resolution of the initial rate filings of the Trans Alaska Pipeline System. Well before construction was complete, the Commission had undertaken a massive audit of construction costs. Once the rates were filed, the Commission considered written and oral argument in this highly controverted proceeding. It then set maximum interim rates at a level substantially below what had been proposed, and was upheld by the Supreme Court.

I am left with the impression on page 53 of the draft report that DOJ's intervention in the TAPS case was at least the major determinative government explication of the arguments for rates lower than those proposed . It may not have come to your staff's attention that this Commission's staff developed all of the data placed in the record by the government. Our Bureau of Investigations and Enforcement also filed a brief and orally argued the case based upon the data it presented. DOJ submitted the same information because it was supplied by BIE. To the extent that that data was persuasive to the Commission, and later to any reviewing Court, it reflects credit that should be given to the ICC staff.

I take personal exception to the statement at page 42 that the "Chairman of the ICC said the lack of complaints implied there were no problems with pipeline regulation." I do not, and so far as I know, have never taken that position and, indeed, have frequently stated the contrary point of view.

With regard to current regulation, your proposals envision, among other things, expanded reporting requirements and a program of government-initiated substantive tariff review. Given the current power of the petroleum industry and high prices, we agree that increased regulatory activity is warranted.

Sincerely yours,



A. Daniel O'Neal
Chairman

(See GAO note, p. 68.)

(308390)

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