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STATEMENT OF

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Before the

COMMITTEE ON INTERIOR AND INSULAR AFFAIRS

UNITED STATES SENATE

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Mr. Chairman, members of the Committee, I appreciate the opportunity to appear before you to discuss the mandatory petroleum allocation and price programs under the Emergency Petroleum Allocation Act of 1973 and the alternatives before us when the Act expires later this year.

Since my statement is rather lengthy and detailed, I shall attempt only to summarize it briefly and ask that the entire statement be placed into the record.

The statement consists of three principal parts. The first part describes events that led up to the Act and the factual environment that existed at the time the Act was passed. We think this background knowledge is necessary to understand why the Act contained certain provisions. It also contains a brief description of the creation of the FEA.

The second part presents a description of our regulations with emphasis on several significant aspects -- namely, the current allocation program, including the old oil allocation program, and the principal features of the price control program. This description provides a framework within which to view the success of FEA in complying with the requirements of the Act.

The third part describes in general terms the problems that have emerged from the application of the Emergency Petroleum Allocation Act to a much changed supply situation. I have included several examples to illustrate how the provisions of the Act and our regulations that derive from them may be inconsistent with and counterproductive to the goals of the Act and of the various programs which the President and several leading members of Congress in both parties are advocating to deal with our current energy problems. This part also describes our proposal to solve many of these problems through the phasing out of controls on old oil and the elimination of the two-tier price system for crude oil.

With regard to the specific questions raised in your May 12 letter, time was too short to prepare comprehensive written responses. However, my colleagues and I are prepared to address any of these questions which the Committee desires to pursue at this time.

Briefly, in November 1973, when the Act was passed, we faced a severe shortage of crude oil and petroleum products caused by the Arab oil embargo and a set of circumstances which threatened both substantial dislocation in the availability of petroleum products and severe pressures on the market position of independent marketers and refiners. The principal aims of the Act were to meet the Nation's priority petroleum needs first, to distribute the remaining available products equitably, and at equitable prices, among all remaining consumers, and to do both in ways that would preserve the competitive viability of the independent segments of the industry. To prevent prices from rising to unconscionable levels as a result of the shortage situation, the Act authorized the President to control prices under a general approach of dollar-for-dollar pass-through of increased product costs. Overall, the Act gave us the necessary authority to meet the shortage conditions that existed in the first half of 1974 with minimum impact upon the Nation while preserving the market position of the independent segments of the petroleum industry.

While this country still faces a critical energy problem, the dimensions of that problem are far different from what they were in 1973. There is no longer a general shortage either of crude oil or petroleum products, with the possible exception of propane. Crude oil is freely available in the world market, albeit at high prices. Worldwide refinery capacity has increased and, as a result of the higher prices, total demand has declined. This has created, once again, surplus refinery capacity. Independent marketers are finding the major companies receptive to running their refineries at higher throughput rates to achieve lower unit costs and selling the surplus. Independent marketers are now finding supplies readily available. Stock levels are near record highs. Competition has reduced most dealer and supplier margins to below the maximum levels allowed by the Act. In short, in many ways, the market has returned to near the "normal" conditions that prevailed in 1972. For the most part, controls are no longer necessary (except perhaps on a standby basis) to assure adequate fuel supplies for priority users and independent marketers and to protect consumers from price increases resulting from acute shortages.

The principal distortion now remaining results from our two-tier crude oil pricing system. Imported oil, "new" and "released" oil, and "stripper" oil sell for roughly twice the cost of price-controlled "old" oil. Consequently, some refineries that have much higher input costs because of a disproportionate dependence on uncontrolled oil have difficulty competing effectively with those with lower input costs. To rectify this situation, the FEA put into effect a crude oil entitlements program that has the effect of reducing the disparities among crude oil costs that are created by the two-tier price system. In addition, FEA recently proposed the gradual phase out of controls on old oil prices which, if adopted, will eliminate this market distortion and thereby allow the present regulatory structure to be greatly simplified.

Currently, we are encountering a number of anomalies created by a law written for shortage conditions operating in a market characterized by adequate or even surplus supplies of the products covered by the statute. Daily we receive additional evidence that indicates that the EPAA and our regulations are creating distortions and unintended results. Many independent marketers, for example--a group that the

EPAA was specifically designed to protect--now feel that the regulations designed to protect them are actually harming them under today's conditions.

For instance, the Independent Fuel Terminal Operators Association, in a statement before this committee on April 28, 1975, testified that they were becoming increasingly concerned at the proliferation of unnecessary, conflicting, and confusing regulations that are stifling competition and -worst of all - threatening the survival of independent marketers. They stated that they were being strangled by red tape, inundated in forms, and baffled by a maze of regulations. They urged that this was clearly not what Congress intended, and they suggested a change in direction and emphasis to establish a more limited allocation program that would eliminate the rigidities and inequities of the existing program and permit a greater play of market forces for the benefit of consumers and independent companies. They recommended that the EPAA be amended to authorize FEA to maintain a program on a standby basis that was based on sales to carefully designed classes-of-trade and to geographic regions, rather than on company-to-company sales as in the current program.

In the same view, The President of the National Oil Jobbers' Council (NOJC) stated on May 5, 1975:

"...As for our survival, recent experience suggests that the shield which these regulations were to provide has become an unacceptable burden. The administrative burden was acceptable when shortages prevailed, but today it (the shield) no longer serves a useful service and should be replaced."

Similarly, FEA's wholesale Advisory Committee, meeting in Seattle on March 5, 1975, voted unanimously to support the following motion:

> "That while surplus of supply exists, the Wholesale Advisory Committee supports the principal of return to a free marketplace economy as rapidly as possible with de-allocation and product price deregulation."

It is becoming increasingly obvious, therefore, that the segments of industry that our allocation laws and regulations were designed to protect now feel that government regulations are now contributing more to the problem than to its solution. In short, a regulatory program designed to cope with a temporary severe shortage is not well suited to an extended period of adequate supply.

We now have underway in the agency a general re-examination of the Emergency Petroleum Allocation Act and the current mandatory allocation and price control programs. We are studying the feasibility of a simplified allocation program that could be adopted on a standby basis, and expect to recommend to the Congress in the near future such legislation as may be necessary to accommodate the Act to current market conditions and the overall national energy program ultimately agreed to by the Congress and the President.

Clearly, any decision on the future of the current mandatory allocation program must be taken in the context of our actions to create the financial incentives necessary to augment domestic production, as well as the program we adopt to achieve reductions in demand.

Mr. Chairman, with your permission, I will discuss the major problems inherent in the Allocation Act and the proposal to phase out controls on old oil, and will submit for the record our entire statement that elaborates more fully on these general points and try to respond to your questions.

Thank you.

I. Conditions Which Led to the Enactment of the Emergency Petroleum Allocation Act of 1973

A. Events Leading to a Shortage of Refinery Capacity

During the four years from mid-1969 to mid-1973, the United States experienced an extraorindary hiatus in the construction of new refinery capacity. A series of events combined to cause this moratorium.

First, in November 1969 Congress passed the Tax Reform Act of 1969, which eliminated the 7 percent tax credit for new refinery construction and reduced the depletion allowance from 27-1/2 percent to 22 percent. These changes had the effect of increasing income taxes paid by the oil industry during the following year by about $500,000,000.

Second, in 1969 the President established a Cabinet Task Force to consider changes in our oil import policy. Many in the industry feared that import controls would be removed and that the U.S. would be flooded with cheap foreign oil. 1969 closed with considerable uncertainty concerning our oil import policy. A number of capital investment decisions were deferred. In 1970 the Cabinet Task Force recommended an increase in imports, but the President deferred making a decision. Thus, refiners remained uncertain as to whether adequate supplies of new crude oil would be available to fill new capacity.

Third, in 1970 interest rates increased and the stock market fell. As a consequence, during 1970 many refiners deferred capital expenditures where possible.

Finally, in response to the Clean Air Act and the National Environmental Policy Act of 1970, the Administration established the Environmental Protection Agency. The EPA announced rules for cooling water discharges and air emissions, which had the effect of increasing refinery costs, and commenced hearings on removing lead from gasoline, thus creating uncertainty concerning final gasoline specifications. Refinery engineers faced an unusual predicament. Not only did they not know exactly what crude oil would be available for new refineries because of the uncertainty of our import policy, but they also did not know what product specifications would be required. The year closed with considerable uncertainty, and refinery expansion decisions again were delayed.

In early 1971 conditions appeared to be improving. It became obvious that the government was not going to flood the domestic market with imports, and a picture of likely EPA product specifications began to emerge. However, in August 1971 the President froze prices. With increased refinery costs due to environmental controls and refinery margins frozen, the industry once again postponed investments for new refinery capacity, investing its money instead in modifications of existing refineries to meet EPA standards.

In 1972 Texas and Louisiana peaked in production and it became obvious that any new refineries would have to use foreign feedstocks. However, the existing oil import controls essentially prevented obtaining such feedstocks. Financial conditions had improved, the investment tax credit had been restored and the industry was beginning to be seriously concerned about the adequacy of domestic refinery capacity, but the uncertainty concerning governmental import policies continued to defer new refinery investments.

In early 1973 Phase III of the Economic Stabilization Program was implemented, which substantially lessened the restrictive character of existing price controls. In April, the President removed mandatory oil import quotas, replacing them with a fee system. Within two months the industry announced plans for 2,000,000 barrels per day of new refinery capacity.

B. The Effects of a Shortage of Capacity on Independent Refiners and Marketers

Refinery expansions generally occur in large increments, creating for the companies involved temporary excess capacity for the period immediately following construction. However, to minimize unit costs, refiners generally attempt to run their refineries at near capacity. Therefore, periods of rapidly increasing refinery capacity are particularly advantageous for independent marketers, since they can ordinarily find large refiners willing to sell them surplus products at low prices in order to utilize their excess capacity. Consequently, during the rapid expansion of refinery capacity in the late 1950's and 1960's, the independents thrived and many new operators entered the business.

By 1971 it became obvious that the country would face a refinery capacity shortage if demand continued its upward trend without major new capacity additions. It was predictable that within a few years the supply of refined petroleum products available to independents would diminish. A number of independent marketers recognized their potential supply problem and made long term supply contracts with major refiners at prices above spot market rates. However, many did not, and they realized the seriousness of their predicament only in late 1972 or early 1973, as they became unable to obtain adequate supplies of products.

The independent marketers had one source of supply in addition to the excess supplies of the major integrated refiners: independent refiners. Unfortunately, at a time when the independent marketer needed him most, the independent refiner was having troubles of his own. The independent refiner traditionally purchased crude oil from major pipeline companies owned by major oil companies. Few had their own production or purchased crude oil in the field from independent producers. They were assured adequate supplies of crude oil by the policies of state regulatory commissions that maintained crude production at levels sufficient to meet demand of all refiners at current market prices.

As noted, in 1972 Texas and Louisiana production reached its peak. The United States surplus crude production capacity thereafter disappeared, and independent refiners began to experience difficulty obtaining domestic crude oil from traditional sources. Many were forced either to reduce refinery throughput and curtail supplies to their customers (*i.e.*, the independent marketers), thus further exacerbating the supply problems of independent marketers, or to compete with the major oil companies in the market for domestic and imported crude oil.

C. Changes in the Crude Oil Supply and Price Picture in 1973

The effect on prices was predictable. The many small and independent refiners entering the crude oil market in late 1972 and early 1973 increased prices at the well head for crude oil produced by domestic independent producers. During the same period world crude prices were also increasing. An oil pipeline was accidentally broken in Syria while the Suez Canal remained closed since the Arab-Israeli war of 1967. This forced oil to be diverted around the Cape of Good Hope to reach southern European markets. Simultaneously, tankers capable of carrying both grain and crude oil were diverted to carry grain to Russia. As a result, a tanker shortage developed, tanker rates soared and landed costs increased, putting further pressure on U.S. prices, which by this time were increasing rapidly.

Pressures from the above conditions came to a head almost simultaneously and forced a series of governmental responses. As noted, import quotas were lifted in April 1973, with a fee system being substituted for them. In May 1973 a voluntary allocation program was initiated for crude oil. In June a price freeze was ordered and in August more permanent petroleum price rules were adopted by the Cost of Living Council. Propane and distillate stocks were low and, to avoid possible shortages, the Government ordered a mandatory allocation program for these products, effective October 3 and November 1, 1973, respectively.

There was never an opportunity, however, to determine whether these new programs would work. In early October the "Yom Kippur" war broke out in the Middle East, an embargo was imposed on the United States and other countries by the oil producing Arab countries, and the country was suddenly faced with the possibility of further drastic shortages in crude oil supplies and further spiralling of petroleum costs. In this crisis atmosphere, Congress passed the Emergency Petroleum Allocation Act in November, 1973.

D. General Provisions of the Emergency Petroleum Allocation Act of 1973

Considering the drastic conditions that existed in the fall of 1973, the drastic measures taken by the Congress in the Emergency Petroleum Allocation Act were generally appropriate. The supply picture at that time and the likely short-term consequences were spelled out by Congress in Section 2(a) of the Act as follows:

> "(1) shortages of crude oil, residual fuel oil, and refined petroleum products caused by inadequate domestic production, environmental constraints, and the unavailability of imports sufficient to satisfy domestic demand, now exist or are imminent;
>
> "(2) such shortages have created or will create severe economic dislocations and hardships, including loss of jobs, closing of factories and businesses, reduction of crop plantings and harvesting, and curtailment of vital public services, including the transportation of food and other essential goods; and
>
> "(3) such hardships and dislocations jeopardize the normal flow of commerce and constitute a national energy crisis which is a threat to the public health, safety, and welfare and can be averted or minimized most efficiently and effectively through prompt action by the Executive Branch of Government."

Congress spelled out in very simple terms in Section 4(a) of the Act the extraordinary and mandatory authority it was giving to the President to deal with the crisis. Section 4(a) provides that:

"(a) Not later than fifteen days after the date of enactment of this Act, the President shall promulgate a regulation providing for the mandatory allocation of crude oil, residual fuel oil, and each refined petroleum product, in amounts specified in (or determined in a manner prescribed by) and at prices specified in (or determined in a manner prescribed by) such regulation. Subject to subsection (f), such regulation shall take effect not later than fifteen days after its promulgation. Except as provided in subsection (e) such regulation shall apply to all crude oil, residual fuel oil, and refined petroleum products produced in or imported into the United States."

In Section 4(b)(1), Congress specified, as objectives which must be met to the maximum extent practicable in the mandatory allocation and pricing program established by Section 4(a), the following:

"(A) protection of public health, safety and welfare (including maintenance of residential heating, such as individual homes, apartments, and similar occupied dwelling units), and the national defense;

"(B) maintenance of all public services (including facilities and services provided by municipally, cooperatively, or investor owned utilities or by any State or local government or authority, and including transportation facilities and services which serve the public at large);

"(c) maintenance of agricultural operations, including farming, ranching, dairy, and fishing activities, and services directly related thereto;

"(D) preservation of an economically sound and competitive petroleum industry; including the priority needs to restore and foster competition in the producing, refining, distribution, marketing, and petrochemical sectors of such industry, and to preserve the competitive viability of independent refiners, small refiners, non-branded independent marketers, and branded independent marketers;

"(E) the allocation of suitable types, grades, and quality of crude oil to refineries in the United States to permit such refineries to operate at full capacity;

"(F) equitable distribution of crude oil, residual fuel oil, and refined petroleum products at equitable prices among all regions of the United States and sectors of the petroleum industry; including independent refiners, small refiners, non-branded independent marketers, branded independent marketers, and among all users;

"(G) allocation of residual fuel oil and refined petroleum products in such amounts and in such manner as may be necessary for the maintenance of exploration for, and production or extraction of, fuels, and for required transportation related thereto;

"(H) economic efficiency; and

"(I) minimization of economic distortion, inflexibility, and unnecessary interference with market mechanisms."

Congress further required, in Section 4(b)(2) of the Act, that in specifying prices (or in prescribing the manner for determining them) the President must provide for the use of a single date in computing the base prices of crude oil, residual fuel oil, and refined petroleum products at all levels of marketing and distribution, and that the President must provide for a dollar-for-dollar pass through of net increased product costs to all marketers and distributors at the retail level. Section 4(c)(1) requires the President to allocate supplies so that small and independent refiners and marketers are assured their proportionate share of their 1972 supply levels.

Finally, Section 4(g) of the Act makes it clear that the requirements of the Act are mandatory and that the President cannot exempt crude oil, residual oil or a refined pertroleum product from price or allocation controls unless he finds that there is no shortage of such oil or product, that exempting such oil or product will not have an adverse impact on the supply if any other oil or product, and that further regulation of that oil or product is not necessary to carry out the Act. Moreover, before any amendment exempting an oil or product may become effective, the President must submit the amendment and his findings to the Congress. If either House of the Congress passes a resolution disapproving the amendment within five sessional days following its submission, the amendment shall not take effect.

E. Creation of the Federal Energy Administration

At the time of the passage of the Emergency Petroleum Allocation Act, price control authority over the petroleum industry and the rest of the economy as well was exercised by the Cost of Living Council, which had discretionary price and allocation authority pursuant to the Economic Stabilization Act of 1970. There was also in existence an agency known as the Energy Policy Office, responsible principally for advising the President and the Cost of Living Council on matters involving energy.

Promptly upon the passage of the Emergency Petroleum Allocation Act, the President issued Executive Order No. 11748, which established in the Executive Office of the President the Federal Energy Office ("FEO"). That Executive Order delegated to the FEO all of the President's authority under the EPAA and the Defense Production Act of 1950 insofar as it relates to the production, conservation, use, control, distribution and allocation of energy. Moreover, the Chairman of the Cost of Living Council was directed to delegate to FEO such authority as the Council had which related to energy matters, which was done on December 26, 1973. The President appointed William E. Simon, then Deputy Secretary of the Treasury, to be the first Administrator of FEO.

An FEO staff, composed of a few energy experts scattered throughout the government, was quickly assembled and set to work to meet the tight timetable established by Congress in Section 4(a) of the EPAA for promulgating allocation and pricing regulations. Those regulations became effective on December 27, 1973, with full implementation occuring on January 15, 1974, and, as explained in further detail below, have undergone continuous revision since then.

On May 7, 1974, Congress enacted the Federal Energy Administration Act of 1974 , Public Law 93-275, which created the Federal Energy Administration as an Executive branch agency outside of the Executive Office of the President. This Act was implemented by the President on June 27, 1974 with the issuance of Executive Order No. 11790, which transferred the functions of the FEO to the FEA. The Federal Energy Administration Act expires by its own terms on June 30, 1976.

II. Description of the Current FEA Pricing and Allocation Regulations

A. Price Regulations

1. BACKGROUND CONCEPTS

FEA price regulations are derived from those Cost of Living Council price regulations specially designed to deal with the petroleum industry, in accordance with the Phase IV economic sector-by-sector approach to price regulations, which were placed in effect on August 19, 1973, following a 60-day freeze on prices throughout the economy. Upon the transfer of authority to the Federal Energy Office, under the Stabilization Act and the Allocation Act, the CLC petroleum regulations (6 CFR Part 150, Subpart L) were incorporated by reference into FEO price and allocation regulations issued on December 27, 1973, and were republished as Part 212 of Title 10, Code of Federal Regulations, in the Federal Register of January 15, 1974.

The FEO regulated prices of crude oil and petroleum products until April 30, 1974, under the joint authority of the Stabilization Act and the Allocation Act. In recognition of the April 30, 1974 expiration of the Stabilization Act, the FEO amended the scope of its price regulations to exclude certain petroleum products, such as asphalt, that are not within the scope of products regulated under the Allocation Act (i.e., "crude oil, residual fuel oil, or refined petroleum products").

Currently, the price regulations are divided into three basic sets of rules -- for producers, refiners, and resellers (wholesalers) and retailers. The regulations are structured in this way because of the different characteristics and varying degrees of complexity that exist at each level of the petroleum industry.

2. PRODUCERS

Under FEA regulations, crude oil produced in the United States is either exempt from FEA regulations as to its first sale, or subject to a "two-tier" pricing system under which crude oil is priced at either a ceiling price or the current market price, as further described below.

a. The Two-Tier Pricing System

The present two-tier pricing system for domestically-produced crude oil, which was first imposed by the Cost of Living Council, is the single most important aspect of the price regulations relating to producers.

The relevant background to this action began in 1959, when in response to significantly lower foreign crude oil prices that threatened the domestic petroleum production industry, the United States imposed a quota system on foreign oil imports. By the 1970's, however, increased U.S. demand for crude oil caused imports to rise despite the quotas.

As U.S. dependence on cheaper foreign crude oil increased, domestic demand failed to cause any significant increase in domestic prices. The quota system had not generated domestic prices high enough to halt significantly the decline in domestic crude oil production.

After the world crude oil supply tightened and the OPEC countries raised their oil prices substantially in 1973, the U.S. experienced more and more substitution of expensive foreign crude oil and petroleum products to offset the shortfall in domestic supplies.

Thus, in August 1973, when the Cost of Living Council devised a system of price controls for the petroleum industry, it concluded that, while most domestically-produced crude oil had to be subjected to ceiling price controls to minimize the inflationary impact of worldwide oil price increases, certain domestically-produced crude oil required an exemption from ceiling prices to encourage domestic production over the long run. It was necessary that the regulatory scheme maintain the proper balance between the promotion of increased supplies and the moderation of prices.

The solution was the two-tier pricing system for domestic crude oil. Under this system, FEA has imposed a ceiling price on domestic crude oil produced from a given property when production is at or below the level of production from the same property in the same month of 1972, denominated "old" oil. This ceiling price is basically the May 15, 1973 posted price plus $1.35, or about $5.25 per barrel on the average. */ Crude oil produced in excess of 1972 production levels from the same property (i.e., "new" oil) is not subject to a ceiling price and each barrel of new oil produced releases a barrel of old oil (i.e., "released" oil) from a ceiling price. Thus, for example, if a particular property produced 10,000 barrels in January, 1972 and 11,000 barrels in January 1974, 9,000 barrels would have to be sold at the FEA-imposed ceiling price, and 2,000 barrels (1,000 barrels of "new" oil plus 1,000 barrels of "released" oil) could be sold at the free market price.

Also exempted from price controls in the Allocation Act is the first sale of crude oil produced from "stripper well" leases (i.e., oil produced from properties that produced less than 10 barrels per well per day during the preceding calendar year).

Because the two-tier pricing system results in varying crude oil costs to refiners, depending on which domestic producers or importers supply them, it was necessary for FEA to adopt a crude cost equalization program, which is discussed

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*/ More specifically, under Section 212.73(b) of FEA regulations, the ceiling price for a particular grade of domestic crude oil in a particular field is (i) that highest posted price for that grade of crude oil at that field on May 15, 1973 or, in the absence of such a price, the posted price for comparable crude oil at the nearest field on that date, plus (ii) a maximum of $1.35 per barrel.

in detail below in connection with FEA Crude Oil Allocation Regulations.

b. Imported Crude Oil

FEA regulations exempt from ceiling price limitations the first sale into U.S. commerce of imported crude oil because imposing ceiling prices on the first sale of imports into U.S. commerce would result in substantial reductions, if not the elimination, of such imports at a time when the nation still depends on imported petroleum for one-third of its demand. In addition, any rule that would prevent a refiner (or reseller) from recouping what it had to pay to acquire the imported product would conflict with § 4(b)(2) of the EPAA, which provides for a dollar-for-dollar pass-through of increased costs of petroleum products at each level of the distribution chain.

A significant element in FEA's price regulations on imported oil is its regulation of "transfer prices." Under Section 4(a) of the Allocation Act, FEA is required to promulgate a regulation for the allocation of petroleum "at prices specified in (or determined in a manner prescribed by) such regulation." This regulation applies to all petroleum "produced in or imported into the United States" (emphasis added).

FEA regulations permit refiners to pass forward to customers their increased product costs on a dollar-for-dollar basis. For imported products and crude oil, these increases are measured by incre~~es in "landed costs," that is, the cost of crude oil or pr~~uct landed in the United States. For arms-length transactions the price paid is, of course, an actual cost to the purchaser.

A problem arises, however, in computing the landed cost in transactions between affiliated entities since the parties are not dealing at arms-length. In such transactions, the landed cost or "transfer price" charged by the foreign producer to its U.S. affiliate may be variously computed, and companies naturally choose methods that for tax or other legitimate business reasons are most advantageous to their collective enterprise.

If, however, the transfer price between a foreign producer and its U.S. affiliate is accepted for the determination of landed costs, the profits of the affiliated entities as a whole could be increased by raising the transfer price. Profits would be higher for the international affiliate due to the higher transfer price, but the U.S. affiliate will not necessarily suffer a corresponding decrease in profitability because FEA regulations would permit it to recover the higher transfer price through higher domestic prices. There is, therefore, an obvious incentive for transfer prices to be increased in order to maximize overall profitability, but attendant thereto is the corresponding harm to U.S. consumers in the form of higher prices.

The price regulations that FEO inherited from the Cost of Living Council established two sets of limitations on transfer pricing. First, the regulations required companies to compute landed costs in transactions between affiliates by use of the "customary accounting procedures generally accepted and consistently and historically applied by the firm concerned." Second, to provide for situations in which those accounting procedures might not accurately reflect costs, the regulations enabled the administering agency to look behind a company's accounting procedures. This provision, now § 212.83(f) of FEA's price regulations, provides in part as follows:

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

To avoid abuses in this regard, the FEA, following two extended rulemaking proceedings, issued regulations that prescribe the standards for establishing transfer prices and the standards that the FEA shall use to disallow or reallocate landed costs pursuant to § 212.83(f).

The regulations allow companies to establish transfer prices at arms-length levels. This is a market-oriented standard that attempts to treat affiliate prices in a fashion analagous to third-party pricing. The arms-length standard corresponds to the method that many companies have traditionally used in calculating transfer prices, and it is similar to the standard used by the IRS (although the IRS has not computed transfer prices for the years in question). A "net costs" method, which would have essentially limited the foreign production affiliate's margin per barrel to that of May 1973, was rejected because, among other reasons, it might have created a disincentive for production companies to export crude oil to the U.S. and might have materially lessened the ability of the U.S. to attract sufficient petroleum supplies during emergency periods.

3. REFINERS

a. Dollar-for-Dollar Passthrough of Increased Product Costs

The price regulations applicable to refiners reflect the dollar-for-dollar product cost passthrough concept of the EPAA.

(1) Base Prices

A refiner is limited in the prices it may charge for petroleum products to an amount that represents (1) the refiner's lawful May 15, 1973 selling price to a class of purchaser for that product plus an amount that represents the increase over May 1973 levels in the cost of crude oil and refined petroleum products purchased for resale by that refiner, plus (2) under certain circumstances, some of the increased costs of doing business (other than increased costs of crude oil), such as increased labor, marketing or utility costs. The first component is termed the "base" price; base prices may be increased to reflect increased product costs. The second component of price is termed "non-product costs"; prices may be increased above base prices to reflect certain increased non-product costs, subject to a profit margin limitation. These concepts were promulgated originally in the Cost of Living Council regulations and were subsequently adopted by the FEO.

On increased product costs, the regulations set forth a method for each refiner to compute the total dollar amount of its increased refined petroleum product and crude oil ("product") costs in each month, and a method for allocating those increased product costs to prices of certain products or product categories in the following month.

(2) Profit Margin Limitation

As previously noted, increases in eight specific types of non-product costs may also be passed through and reflected in a refiner's prices, but only if the refiner does not, in the fiscal year in which those costs are passed through, exceed its base period profit margin. "Profit margin" is defined in the regulations as a firm's profits expressed as a percentage of that firm's sales, and the base period consists of any two fiscal years, other than the current one, beginning after August 15, 1968.

b. <u>Carry Forward of Unrecouped Increased Product Costs, "Banks"</u>

If refiners were required to raise prices immediately to reflect increased costs of crude oil, or forfeit the opportunity to recover increased costs at a later time, pressure to raise prices would be very strong. Also, certain refiners that incur costs unevenly on a month-to-month basis would simply be unable to pass through all of their increased costs in a particular month in the next succeeding month.

Thus, FEA regulations are designed to permit some flexibility in the allocation of costs.

Product costs that are not recovered in one month may be carried forward and used, within certain limitations, in calculating prices in subsequent months until such costs are recovered.

c. <u>Equal Application of Increased Costs Among Classes of Purchaser</u>

FEA regulations require generally that refiners apply increased costs to increase prices equally among classes of purchaser of a particular covered product. Differences in weighted average May 15, 1973 selling prices among classes of purchaser are generally reflected in like differences in current lawful selling prices for that product among those classes of purchaser. A principal function of the class of purchaser concept is to preserve the price distinctions among classes of purchaser that customarily existed under free market conditions. To achieve the objective of making covered products available at equitable prices, FEA regulations require a seller to group together customers that are similarly situated and to compute a weighted average of the seller's May 15, 1973 selling prices in sales to those customers. Sellers are thus required to maintain a single lawful price for a product to all customers that fall into a particular class, rather than having to establish individual maximum lawful prices to individual customers.

On August 30, 1974, FEA promulgated an emergency amendment to Part 212 of its Mandatory Petroleum Price Regulations (39 FR 32306, September 5, 1974) revising § 212.83(d) and providing a limitation on the amount of unrecovered increased product costs that a refiner may carry over after September 1, 1974. The change sets forth specifically the interrelation between the carryover of costs provision and the requirement for equal application of increased product costs among individual classes of purchaser. If a refiner chooses not to allocate all costs available to compute the maximum lawful price for a given product, but still applies the costs so allocated equally to the prices charged to each class, he may carry over those costs not applied. However, for each product, the recoupment of increased product costs will be calculated on the assumption that the largest amount of increased product cost added to the May 15, 1973 selling price and included in the price charged to any class of purchaser was equally applied to the May 15, 1973 prices and included in the price charged to all classes of purchaser, without regard to whether such prices were actually charged. Thus, if as a result of market conditions, a refiner elects to forego the addition of such increased product costs to increase the selling price to a class of purchaser, those increased costs cannot be recovered subsequently, to the extent that a greater amount of increased costs have been added to the unit price of any other class.

Under prior regulations, the difference between the price charged and the maximum lawful price represented unrecouped costs, which could be carried for later recoupment. Recognizing that, to some extent, refiners had been precluded from increasing prices for their products because of long-term fixed-price contracts, this treatment was continued for prices so restricted by contracts entered into on or before September 1, 1974. However, in order to ensure that this treatment of fixed-price contracts did not become a means by which sellers could avoid the intent of the price regulations to maintain price differentials between classes of purchasers, contracts entered into after September 1, 1974 were not exempted from these amended carryover provisions. Thus, costs that a refiner is unable to recoup through price increases because of fixed-price term contracts entered into after September 1, 1974 cannot be carried forward for recovery in later months.

Additionally, the regulations governing the carry-forward of unrecouped increased product costs by refiners have been amended to limit the application of increased product costs that are not recouped in the first month in which they are available for passthrough and that are carried forward for use in a subsequent month. Under this amendment, the amount of such costs that may be used to increase prices in a single month above those charged in the immediately preceding month is limited to a dollar amount equal to ten percent of a refiner's total amount of unrecovered increased costs as of October 31, 1974, or as of the end of any month thereafter, whichever is higher.

This limitation was imposed because of FEA's concern that large amounts of accumulated costs provide the potential for drastic price increases if short term supply problems arise.

d. Special Treatment of Certain Products

The refiner's cost allocation formulae set forth in the regulations recognize that refiners traditionally have not accounted for increased crude oil costs by assigning costs to each of the many products that they refine in precise proportion to the amount of crude oil required to produce the product. Supply and market conditions may dictate that a certain product will receive more than its volumetrically proportionate share of costs; concomitantly, these same considerations may dictate that other products receive less than their volumetric share of costs. The flexibility to increase and decrease prices of products relative to one another serves to provide refiners with incentives to increase the refinery yield of those products for which demand is greatest relative to other products. The overall passthrough limitation of the refiner's formulae assures that a refiner will recoup no more than its total increased product costs across its entire refinery output. Non-product costs must be allocated to products in the same proportions as product costs.

For certain petroleum products, however, for a variety of reasons, FEA regulations provide special limitations on the mechanism for passing through increased product costs. These limitations have changed from time to time to reflect changing conditions and considerations.

(1) Special Product Rule

A "special product" rule was initially promulgated by the Cost of Living Council, when short supplies were imminent and disproportionate passthrough of increased product costs on special products was a real possibility. Since the defined "special products" -- gasoline, No. 2 heating oil and No. 2-D diesel fuel -- were a significant portion of refinery output as to which demand appeared to be relatively inelastic, restriction to a proportional passthrough of increased costs on these products was deemed to be appropriate. Further, the special products represented the overwhelming share of petroleum products purchased directly by individual consumers. Propane, which is a basic fuel for home heating and cooking, was originally excluded from "special products" status by the Cost of Living Council because propane traditionally had been underpriced and accordingly was in short supply. As refiners began allocating increased costs to propane, prices for propane rose much more quickly than prices for other products, and FEA therefore amended its regulations to protect propane purchasers, many of whom had no alternate form of fuel for home heating needs, from disproportionate cost passthroughs.

(2) Current Cost Allocation Rules

Under current FEA regulations, proportionate shares of increased product costs are calculated separately for No. 2 oils (that is, No. 2 heating oil and No. 2-D diesel fuel), for general refinery products (that is, all covered products other than No. 2 oils, gasoline, and crude oil), and for gasoline. The treatment of gasoline, which was originally a "special product" has, however, been modified. Increased costs allocable to No. 2 oils or to general refinery products may now be reallocated to gasoline. No increased costs may be reallocated to No. 2 oils or to general refinery products from any other product category. Except with respect to propane, which retains its "special product" status, refiners may continue to allocate increased costs as they determine among products within the general refinery products category which includes such products as residual fuel oil and aviation fuels. In this manner, the general refinery products category is not permitted to bear, overall, a disproportionate share of increased costs, while at the same time a measure of pricing flexibility among the products within that category is preserved.

Finally, refiners that did not sell unleaded gasoline on May 15, 1973 are permitted currently to price unleaded gasoline at no more than one cent per gallon over the price for leaded gasoline having the same or nearest octane number.

(3) Gasoline Prices under the Import Reduction Program

As announced in the notice accompanying the proposed regulations issued by FEA on January 17, 1975, the President has determined that it is in the national interest to achieve a reduction in demand for petroleum products, thereby to reduce the dependence of this country on imports of foreign crude oil and petroleum products. A program to begin achievement of this objective was announced in the President's State of the Union message to the Congress. Some changes already have been made in the regulations, and others have been proposed.

Continuing analysis and review of that program and of the options that are likely best to reduce this country's reliance on imported petroleum, with the minimum hardship to the nation's people and its economy, have led FEA to tentatively conclude that a larger share of the increased costs of petroleum should be allocated to the prices of gasoline than to the prices of other petroleum products. Since more gasoline is consumed in the United States than any other single petroleum product, a given percentage increase in the price of motor gasoline would likely result in a greater reduction in consumption than would result from applying the same percentage price increase to any other petroleum product. A reduction in demand can also be expected to result in part from the fact that gasoline may be the only petroleum product the use of which remains largely discretionary.

Also, unlike other petroleum products such as residual fuel oil -- whose domestic prices are at or near world prices -- domestic gasoline prices remain far below world prices. Prices for products other than gasoline, such as certain petrochemical feedstocks, residual fuel oil, and aviation fuel, have risen far more quickly during the past several years than have gasoline prices. FEA believes that in the future gasoline, therefore, ought to bear a greater share of increased costs.

In response to comments concerning the hardship to electric utilities and their customers caused by disproportionately large increases in residual fuel oil prices, further direct restraints have also been proposed on the passthrough of increased costs to residual fuel oil.

(e) Natural Gas Liquids

Propane is produced both from crude oil and from natural gas, with approximately 30 percent of the domestically produced propane derived from crude oil and 70 percent from natural gas. About 10 percent of the propane used in the United States is imported. Other liquid products produced from natural gas and subject to FEA regulations are butane and natural gasoline.

The Cost of Living Council's Phase IV petroleum price controls, which were effective in August, 1973, and form the basis for FEA's current price regulations, did not distinguish between propane derived from crude oil and propane derived from natural gas. By virtue of the fact that "refiner" was defined broadly in the regulations to include gas processors as well as crude oil refiners, all propane, including that derived from natural gas, was subject to the same price rules. These price regulations were designed with crude oil refiners in mind, however, and were not well suited to regulate natural gas processors.

Propane prices became a controversial issue in the closing months of 1973 and the first months of 1974, at a time when prices rose dramatically from historic levels. During that time, propane was treated under the refiner price rules as one of the many products to which refiners could allocate increased product costs in any amounts they wished to determine maximum lawful selling prices. This treatment was intentionally adopted to allow propane prices to rise and thereby to provide an incentive to increase supplies of propane, which were seriously short at that time. This price rule, together with a tight supply situation for propane, permitted a disproportionate "loading" of increased crude oil costs on to propane prices. Propane prices rose rapidly during the fall of 1973, creating strong pressures to revise the original CLC rule. Because FEO determined that prices had risen higher than necessary to encourage sufficient supply, FEO issued a Special Propane Rule in January, 1974, which restricted the amount of increased product costs that could be assigned to propane prices to that proportion of the total increased product costs incurred by a refiner in any twelve-month period, which that refiner's sales of propane bore to its total sales of all covered products in the same period.

The Special Propane Rule brought propane prices down somewhat, and seemed to have stabilized them. However, beginning in June and July of 1974, propane prices began to increase once again. In response to the likelihood of further increases with the approach of the heating season, the FEA issued in August an Emergency Amendment to the Special Propane Rule that expressly dealt with the fact that some propane is derived from natural gas while other propane is derived from crude oil. The Emergency Amendment to the Special Propane Rule further restricted the amount of increased product costs that could be assigned to propane produced from crude oil, so that the amount of increased costs of crude oil that could be used to justify higher propane prices was limited to that proportion of a refiner's increased cost of crude oil equal to the percentage that the sales volume of propane <u>derived from crude oil</u> was to the total sales volume of all covered products derived from crude oil. The Emergency Rule further provided that, with respect to natural gas liquids, only the increased costs of natural gas liquids purchased from unaffiliated entities could be used to justify increased prices of propane. This was done because, under FEA price regulations, there should not have been significant increased costs since May 1973, as to natural gas liquids obtained from affilitated entities.

When the Emergency Amendment was issued, the FEA acknowledged that its price rules did not address the production of natural gas liquid products, including propane, from natural gas in an appropriately specific manner, and the FEA therefore indicated that it would propose more specific rules in the near future on this subject. On September 10, 1974, proposed rules specifically designed to cover prices of natural gas liquids and natural gas liquid products were published. Following receipt of written comments and hearings on this proposal, a final rule was issued.

The basic determination with respect to the new price rules for natural gas liquids and natural gas liquid products (propane, butane, and natural gasoline) was that, consistent with the FEA price regulations generally and with the requirement of Section 5(b)(11) of the Federal Energy Administration Act of 1974, the new regulations would continue to limit propane prices to historic levels, while providing a means of allocating the actual increased costs of producing propane from natural gas to the lawful prices that could be charged for the product.

The principal features of the revised cost-based system now in effect with respect to the pricing of natural gas liquids are:

(1) the continuation of May 15, 1973 as the reference point from which increased costs and lawful prices are to be

determined, but with a permitted adjustment of May 15, 1973 selling prices of natural gas liquid products at the first sale level to at least 8.5 cents per gallon for propane, 9 cents per gallon for butane, and 10 cents per gallon for natural gasoline;

(2) provision for the addition of up to .5 cent per gallon to May 15, 1973 selling prices to reflect increased non-product costs incurred in processing natural gas liquids;

(3) provision for the addition of an increment to May 15, 1973 selling prices to account for actual increased cost of natural gas shrinkage attributable to the production of natural gas liquids since that date;

(4) provision for the increased costs attributable to propane to be applied selectively (with appropriate safeguards for independent marketers) among classes of purchaser to increase propane prices for sales to different classes of purchaser;

(5) a requirement that refiners who process natural gas liquids exclude revenues that represent recovery of increased costs of crude oil from the revenues received in the sale of natural gas liquid products, for the purpose of determining net-back payments to royalty owners or producers; and

(6) a price rule for natural gas liquids extracted in gas processing facilities constructed after the effective

date of the new regulations, which provides an incentive for the construction of such facilities by permitting somewhat higher prices to be charged for products produced in new plants.

4. RESELLERS AND RETAILERS.

a. Dollar-for-Dollar Pass Through of Increased Product Costs

(1) Product costs

Resellers (wholesalers) and retailers are restricted in the prices they may charge for petroleum products to an amount that reflects their May 15, 1973 prices, plus an amount that reflects, on a dollar-for-dollar basis, increases in their cost of the product since May 1973. Increased costs are computed on the basis of the difference between the current weighted average unit cost of the product in inventory and the weighted average unit cost of the product in inventory in May 1973, and must be passed through on a product-by-product basis. In other words, increased product costs may not be reallocated among products by resellers or retailers.

(2) Non-product costs

In addition, in recognition of increased non-product costs, the regulations permit specified per gallon increases in prices charged for certain products by resellers and retailers, to cover non-product cost increases. The amount of the increase permitted depends upon the type of product, the level of distribution, and the volume of product sold. These price increases to cover increased non-product costs were granted on an industry-wide basis because the large number of businesses involved made impracticable the firm-by-firm approach used for the limited number of refiners. For the same reason, resellers and retailers are not subject to a profit margin limitation.

b. Carry Forward of Unrecouped Increased Product Costs, "Banks"

If resellers were required to raise prices immediately to reflect increased product costs, or forfeit the opportunity to recover increased costs at a later time, pressure to raise prices would be very strong. Also, certain resellers that incur costs unevenly on a month-to-month basis would simply be unable to pass through all of their increased costs in a particular month in that month due to the severe price distortions this would create.

Thus, FEA regulations, for resellers as for refiners, are designed to permit some flexibility in the allocation of costs.

Product (but not non-product) costs that are not recovered in one month may be carried forward and used, within limitations essentially identical to those imposed on refiners, in calculating prices in subsequent months until such costs are recovered.

c. Equal Application of Increased Costs Among Classes of Purchaser

FEA regulations require generally that resellers apply increased costs to increase prices equally among classes of purchaser of a particular covered product. As for refiners, differences in weighted average May 15, 1973 selling prices among classes of purchaser are generally reflected in like differences in current lawful selling prices for that product among those classes of purchaser.

On August 30, 1974, FEA promulgated an amendment to §212.93(e), parallel to that issued the same day for refiners, precluding the carryover of increased costs not recouped because of an unequal application of such costs to the prices charged different classes of purchaser. As with the refiner rule, there is an exception to this rule where a lesser amount of increased product costs has been applied to one class of purchaser under a fixed price term contract entered into prior to September 1, 1974.

d. Lease Provisions

FEA regulations provide that the rent charged for real property used for the retailing of gasoline may not exceed that charged on May 15, 1973. However, because FEA authority to control rents is no longer derived from the Economic Stabilization Act, but rather from its authority to control prices of petroleum products, this provision applies only to those leases to which all parties are refiners, resellers, or retailers.

B. Allocation Regulations

1. General Background

The Emergency Petroleum Allocation Act of 1973 provides specific temporary authority for the allocation of crude oil, residual fuel oil and refined petroleum products to deal with shortages or distribution dislocations of these products. Broadly speaking, FEA has exercised its authority through two allocation programs -- one for crude oil and one for the refined products.

Both crude oil and refined petroleum products are allocated pursuant to the Mandatory Petroleum Allocation Regulations. These regulations, as issued in final form on January 14, 1974, were designed to provide the basis for mitigating the effects of the product shortage caused by the Arab embargo. Upon the termination of the embargo, adequate crude oil supplies became available such that for the 1974-1975 winter and subsequently, refined products other than propane have no longer been in short supply.

In spite of ample product supplies, the Act requires FEA to continue the allocation program with respect to all products unless a particular product is exempted from regulation in accordance with procedures set forth in the Act. FEA has, however, adjusted the initial January 14, 1974 regulatory program to reflect increased supplies. For example, some allocation levels, which determine the amount of fuel a purchaser is entitled to purchase for a certain use, have been increased. In the event of new shortages, FEA would take action to amend its regulations to reflect such shortages. Thus, for example, some allocation levels which have been increased would be reduced.

Section 4(g)(2) of the Act provides a basis for exempting a particular product from allocation controls when the product is in plentiful supply. FEA's efforts to exempt residual fuel oil from controls in the summer of 1974 on the basis that ample supplies existed met such determined opposition that it was concluded that exemptions from the allocation regulations would not be possible until the effects of the two tier price system for crude oil could be neutralized or eliminated. Under the Act, of course, allocation controls would be reimposed upon a product which had been exempted if shortages were to reoccur.

2. Crude Oil Allocation Programs

There are three primary programs by which crude oil is allocated under the Mandatory Petroleum Allocation Regulations. First, domestic crude oil supply relationships existing on December 1, 1973 have been frozen to ensure continuing supplies to small and independent refiners and to provide a supply base for calculation of buy/sell list amounts. Second, an allocation program, known as the buy-sell program, has been established among refiners to provide access to crude oil supplies for small and independent refiners. This program is generally designed to protect the competitive viability of small and independent refiners and to assure adequate supplies of refined products in all geographic regions on an equitable basis. Third, the entitlements program is designed to provide all refiners with equal access to low priced domestic old crude oil to mitigate widely divergent feedstock costs among refiners resulting from the two tier price system. The programs are discussed more fully below.

a. December 1, 1973 Supplier/Purchaser Freeze

The supplier/purchaser rule for domestic crude oil is set forth in 10 CFR §211.63 and basically provides that all supplier/purchaser relationships in effect under contracts for sales, purchases and exchanges of domestic crude oil on December 1, 1973, shall remain in effect for the duration of the mandatory allocation program.

The supplier/purchaser freeze as of December 1, 1973 (the December 1 rule) does not apply to the first sale of crude oil from a stripper well lease (over which FEA has no jurisdiction for this purpose) nor to mandatory sales under the buy/sell list. In addition, as to new and released crude oil only, the freeze may be broken if a new purchaser outbids the present purchaser.

The decision to adopt the December 1 rule was made for four principal reasons.

First, the December 1 rule helped to maintain intact most of the pre-existing national distribution system for domestic crude oil, which was threatening to disintegrate during the last quarter of 1973. Since most domestic crude oil contracts were year-long contracts which did not terminate until after December 31, 1973, maintaining supplier/purchaser relationships as of December 1, 1973 preserved and stabilized most of the nation's crude oil distribution system during a period when the potential for disorder was at its peak.

The second major reason for the December 1 rule was that it established a supply floor upon which the buy-sell list supply estimates could be furnished. The initial buy-sell list for February through April 1974 depended upon each refiner being able to estimate its own crude oil availability for a three-month period. In order to make these estimates meaningful, it was necessary to stabilize as much of the existing crude flow as possible so that refiners would have a definite point of reference from which to measure the extent of their shortage. Without maintaining existing supplier/purchaser relationships, it would have been virtually impossible to make the estimates upon which the "buy-sell" allocation program depended. Moreover, the December 1 rule enabled FEA to minimize the amount of crude oil that had to be allocated through mandatory sales under the buy-sell list by preventing crude supply imbalances among refiners from worsening during the critical start-up of the allocation program. As described below, the December 1 rule is an important factor in the current buy/sell list program, since each refiner-buyer's allocation amount is generally calculated by utilization of the February through April 1974 crude runs as the fixed supply level.

The third principal reason for adoption of the December 1 rule was that it preserved access by small and independent refiners to price-controlled domestic crude oil. Without this rule, many small and independent refiners could have been supplanted or cut off by major integrated refiners.

Finally, the December 1 rule has an important function when considered in conjunction with FEA's price controls on old oil at the producer level. With old oil supply arrangements being frozen, producers do not have the ability to freely shift purchasers, and the present purchaser has no incentive to offer a price for old oil production in excess of the lawful ceiling price.

However, to the extent the supply needs of refineries have changed since December 1, 1973, the rule's inflexibility creates problems. This is particularly the case with new refineries and with refineries that are dependent on domestic oil the December 1, 1973 supply levels for which are decreasing or have been terminated.

b. Buy/Sell List Program.

Under the buy/sell program as currently in effect under 10 CFR §211.65, each small refiner and independent refiner (as those terms are defined in the Allocation Act) is entitled to purchase in each three-month allocation quarter an amount of crude oil equal to the difference between (1) one-quarter of the crude oil it refined (i.e., its "runs to stills" or "crude runs") during the year 1972 and (2) the volume of its runs to stills during the period February through April 1974 (without regard to buy/sell purchases or sales by the refiner during that period), subject to processing agreement adjustments and increased allocation amounts to take into account post-1972 capacity. Small refiners are refiners with a total refining capacity not in excess of 175,000 barrels per day and independent refiners are refiners (regardless of size) that basically possess less than 30% coverage for their refining capacity in controlled crude oil production. Purchases by small and independent refiners, called "refiner-buyers," are made from the 15 U.S. refiners which are neither "small" nor "independent" within the meaning of the Allocation Act. This group, called "refiner-sellers," includes the 15 largest integrated oil companies in the United States, except for several firms classified as independent refiners by reason of their relatively small amount of controlled crude production. Each refiner-seller's share of the total sales obligation under the buy/sell list is fixed; it is the ratio of that refiner-seller's refinery capacity to the total refinery capacity of all 15 refiner-sellers as of January 1, 1973.

The current buy/sell list program has been in effect since June 1, 1974. The program in effect for February through May 1974 was based on each refiner's supply estimates (with no distinctions between majors and independent and small refiners). Each refiner with supplies less than the national average (as calculated by FEA) was permitted to purchase supplies up to the national average from refiners with supplies in excess of the national average. The intent was to permit all refiners in this period of extreme shortages to operate at the same supply to capacity ratio.

FEA's special pricing rules governing allocation sales of crude oil under the buy/sell program (10 CFR §212.94) provide that a refiner-seller may charge the weighted average price of all crude oil delivered to it in the area of the country where the sale is made in the month in which the sale is made. The seller may also add to the price a "handling fee" of 30 cents per barrel and may adjust the price to take into account the fact that the crude oil sold may be of a higher or lower grade than the seller's average grade. Further adjustments may be made, if necessary, to shift to the buyer additional transportation costs associated with the sale. The program also allows a refiner-seller to pass through on a dollar-for-dollar basis in its prices for refined petroleum products any increased costs related to replacing allocated crude with higher-priced, foreign crude oil (10 CFR §212.83(c)).

Due to surplus crude oil supplies in the world market and FEA's adoption of the entitlements program (which provides crude cost equalization benefits formerly provided to a certain extent by buy/sell list purchases), of the approximate total purchase opportunity of 100,000,000 barrels on the list, between 60% and 70% was purchased in the allocation quarter commencing March 1, 1975. This contrasts with a utilization of between 85% and 90% in prior allocation quarters.

c. Old Oil Allocation Program.

The FEA adopted the final regulations for its old oil allocation program (the entitlements program) in November 1974. The program is designed to equalize substantially costs of crude oil for domestic refiners and to enable independent refiners and marketers who depend heavily upon high cost crude to remain competitive with those having lower crude costs. FEA's rationale underlying its adoption of the program was that some refiners--including the major old companies, as a class--enjoyed far greater access to price controlled old oil than certain other refiners--including small and independent refiners, as a class.

The entitlements program allocates low-priced old oil proportionately among all refiners based on their levels of crude runs in a particular month, thus significantly reducing cost disparities which were extant between refiners with access to old oil and those dependent on higher cost domestic (new, released and stripper) and foreign crude oils.

Under the program, cost differentials are reduced through the issuance of "entitlements" to refiners which grant them access to price-controlled old oil. Old oil represents about 40% of the total national supply, and the average price ceiling for old oil is approximately $5.25, compared with over $11 for domestic and imported oil not subject to price controls.

Each month, FEA establishes a national average ratio of old oil supplies to crude runs. By a notice published in the Federal Register, all refiners are issued entitlements equal to the national average ratio, with additional entitlements being issuable to small refiners. Refiners with less than the national average supplies of old oil will then sell their excess entitlements, and refiners with a higher level of old oil supplies than the national average will have to buy entitlements for these excess old oil supplies.

The issuance of entitlements is based on a refiner's actual crude runs, rather than refinery capacity, so that refiners' product outputs are more effectively cost equalized.

If, for example, 70% of a refiner's runs for a month were old oil, and the national old oil supply ratio was 40%, the refiner will have to buy entitlements equivalent to 30% of its total refinery runs for the month from refiners who had old oil supplies below the national average and who therefore had excess entitlements.

Every month, FEA determines the national old oil supply ratio and publishes 40 days after the close of the month a listing showing the number of entitlements issued to each refiner for that month. Entitlement transactions for a particular month are required to be completed by the close of the second month following that month.

Thus, refiners with less than their share of low priced old oil sell entitlements to refiners with more than the national average supplies of old oil. Refiners which sell entitlements use the proceeds to offset the cost of their high priced imported or domestic crude oil, a benefit which is generally required to be passed through to their customers under FEA's price regulations. On the other hand, refiners that purchase entitlements may increase their product prices to reflect entitlement costs.

Small refiners were given special consideration under the entitlements program. First, a bias provides for issuance of incremental entitlements to small refiners over and above the national old oil receipts to crude runs ratio for the particular month. The dollar value of these incremental entitlements has been calculated to be equivalent to the maximum subsidy received by small refiners under the oil import program, with an upward adjustment to take the recent rate of inflation into account. In addition, under an emergency rule (Special Rule No. 3), small refiners required to purchase entitlement were phased into the full amount of their purchase obligations, in order to enable them to file any necessary applications for exception and to adjust their business operations and product prices to their increased costs under the program. For small refiners that filed an application for exception by February 21, 1975, the rule's full exemption (as applicable to November and December entitlements required to be purchased for the first 30,000 barrels per day of each small refiner's runs) remained in effect until the initial decision on the application was issued.

Finally, the entitlements program was modified from the form in which it was initially issued to eliminate issuances of entitlements with respect to imports of residual fuel oil and No. 2 home heating oil after February 1, 1975. This amendment was made because the increased import fee structure under the President's energy program provides for a lesser fee for product imports than for crude oil. This difference in applicable fees was calculated to be equivalent to benefits that would have been received by product imports had such imports continued to be eligible for entitlement issuances after February 1, 1975.

3. Allocation Programs for Refined Products.

The refined products allocated under FEA regulations are propane, butane, natural gasoline, motor gasoline, middle distillate fuels, aviation fuels, residual fuel oil, naphthas, gas oils, benzene, toluene, mixed xylenes, hexane, lubricants, greases, special naphthas (solvents), lubricant base stock oils, and process oils.

The basic concepts underlying the product allocation programs include (a) fixed supplier/purchaser relationships which were in existence as of a base period, (b) allocation entitlements based on allocation levels determined by purchasers' current requirements or base period (historical) use of product, and (c) suppliers' allocation fractions.

a. Supplier/purchaser relationships.

The allocation program established fixed supplier/purchaser relationships to assure a continued flow of supplies by providing the maximum number of purchasers with currently identifiable suppliers. Generally, suppliers were directed to supply their 1972 purchasers in order to comply in the most convenient administrative manner with the requirement of the Act that purchasers be supplied at 1972 levels or at a pro rata reduction from such levels in the event of a shortage. In the case of motor gasoline, a purchaser's base period supplier for each month, therefore, is his supplier for the corresponding month of 1972. Thus, in March 1975 the purchaser's supplier would be his supplier in March 1972. Purchasers without 1972 suppliers are assigned base period suppliers. Some fuels, however, are allocated on a quarterly basis, rather than monthly, or on the basis of 1973 rather than 1972, so the base period may be a month or quarter of 1972 or 1973.

Supplier/purchaser relationships are generally established for the duration of the allocation program. However, supplier/purchaser relationships for consumers are somewhat flexible. Large consumers of products ("wholesale purchaser-consumers") and their suppliers may mutually terminate their fixed supplier/purchaser relationships. A new supplier/purchaser relationship between the wholesale purchaser-consumer and another supplier, however, must be assigned by FEA, and is deemed to be a base period relationship. Small end-users and their suppliers may terminate their supplier/purchaser relationships and may form new relationships without FEA approval.

Purchasers of products for resale ("wholesale purchaser-resellers") and their suppliers may not terminate their relationships without FEA approval. Furthermore, wholesale purchaser-resellers (typically, new gasoline retail sales outlets) without base period suppliers cannot form supplier/purchaser relationships without FEA approval.

Supplier/purchaser relationships generally exist for the benefit of purchasers. Base period suppliers must offer to their base period purchasers (including assigned purchasers) during each allocation period the amounts of product required by FEA's regulations. The base period purchaser, however, is not required to purchase his entitlement. In times of relative surplus, a purchaser may purchase his requirements from a non-base period supplier who has surplus product for sale.

b. Allocation entitlements.

(1) Purchasers' allocation entitlements.

Although supplier/purchaser relationships are fixed by reference to the various base period, the amount of product to be allocated to a purchaser depends on whether the purchaser is an ultimate consumer or a marketer of product, and in the case of consumers, the use to which the product is put. Generally, prior to proportionate reduction of allocation entitlements in times of shortage by application of an allocation fraction, marketers and resellers of products are entitled to receive 100 percent of their base period use while ultimate consumers are entitled to receive amounts determined by usage allocation levels. Consumers of products are classified as either "end-users" (relatively small purchasers) or "wholesale purchaser-consumers" (large purchasers). Allocation levels have been established for certain uses of each product. A consumer has no allocation entitlement unless his use of a product has been accorded an allocation level. Consumers without allocation entitlements because their particular use of a product has no priority may purchase a product only to the extent that a supplier has surplus product for sale.

(2) Allocation levels.

Allocation levels, which are expressed in terms of current requirements or a percent of base period (historical) use, vary according to the priority assigned each use. Agricultural production has the highest allocation level -- one hundred percent of current requirements not subject to a pro rata reduction by application of an allocation fraction. Other users may have an allocation level expressed as one hundred percent of current requirements subject to pro rata reduction by application of an allocation fraction or as a percent of base period use. Thus, for example, the category "emergency services" of residual fuel oil has an allocation level of one hundred percent of current requirements, while "industrial use" of residual fuel oil is accorded an allocation level of one hundred percent of base period use.

c. Allocation fraction.

An ultimate consumer whose allocation level is subject to an allocation fraction and all markters and resellers must accept a pro rata reduction of his basic entitlement if for an allocation period his supplier has insufficient product to meet the needs of his customers whose allocation entitlements are subject to a fraction. A supplier of ultimate consumers must determine and in effect reserve the amount of product to be supplied to purchasers with allocation levels not subject to a fraction before he determines whether he will have sufficient product to supply his customers whose entitlements are subject to a reduction by a fraction.

As previously noted, only consumers have allocation levels which are based upon their use of a product. A consumer whose use of a fuel does not have an allocation level cannot be supplied until the supplier has met his supply obligations to those purchasers with an allocation level and those wholesale purchaser-resellers (marketers) which have a supplier/purchaser relationship with the supplier. Furthermore, with respect to some fuels, not all consumers whose use of the fuel conforms to an allocation level have an allocation entitlement. Thus, the allocation levels for gasoline do not apply to end-users (unless they purchase gasoline in bulk) because of the extreme difficulty in determining the purpose of a purchase at the retail pump level. For example, a taxi fleet operator who purchases in bulk normally is entitled to an allocation of gasoline under the allocation level for "passenger transportation services" of one hundred percent of current requirements subject to an allocation fraction. An individual taxi operator who purchases gasoline at retail for passenger transportation services has no allocation level and, consequently, no allocation entitlement.

Product marketers (wholesale purchaser-resellers) do not have allocation levels based upon the use of fuel. Marketers purchase from their suppliers in order to sell the product to consumers or to other marketers. A marketer's allocation entitlement, generally, is based upon his purchase from his base period supplier during the base period. Thus, a motor gasoline service station which purchased 50,000 gallons of product in January 1972 has a base period use for January 1975 of 50,000 gallons (subject to adjustments). In addition, the marketer would receive product for those amounts he certifies to his supplier for uses not subject to an allocation fraction (such as agriculture production). Other than certified amounts, a marketer's allocation entitlement is subject to his supplier's allocation fraction.

The premise of an allocation program is short supply of product and the resulting need to replace the normal distribution process with allocations. Many, if not most, purchasers will be unable to purchase their actual product requirements. The mandatory allocation program accords an allocation level of one hundred percent of current requirements to agricultural production, Department of Defense use and for some products, certain other priority uses, without imposing a pro rata reduction of their requirements. Thus, all other purchasers with allocation entitlements may be unable to purchase their current requirements or entire base period volumes during a shortage. The allocation fraction is a method by which a supplier assures that his purchasers which must receive less than their requirements will share a shortage on a pro rata basis.

For each allocation period, a supplier determines his total supplies for that period. From total supplies, the supplier subtracts amounts certified for delivery under allocation levels not subject to an allocation fraction and amounts for the state set-aside (which is described below). The remaining supplies (defined as "allocable supply") are available for allocation to the remaining persons and firms which have a supplier/purchaser relationship with the supplier under FEA's regulations.

The supplier then determines his supply obligation for the allocation period. The supply obligation is the allocation requirements of those end-users, wholesale purchaser-consumers and marketers with whom the supplier has a supplier/purchaser relationship and whose requirements are subject to the allocation fraction. The allocable supply for the allocation period is then divided by the supplier's supply obligation and the resulting fraction is the supplier's allocation fraction.

If the supplier's allocation fraction is less than 1.0, say 0.9, then those purchasers subject to the fraction will be offered only nine-tenths of their allocation requirements. If the allocation fraction is greater than 1.0, then the supplier will have surplus product for distribution under FEA's surplus product regulation.

If a supplier's allocation fraction exceeds 1.0, the supplier distributes product as if his fraction were 1.0. Special rules apply to the disposition of the surplus product which remains. Upon determining that his allocation fraction will exceed 1.0, large suppliers ("prime suppliers") are required to report their surplus to FEA. Within 10 days of receipt of the notice, FEA can direct the supplier to distribute his surplus to certain purchasers, retain the surplus in inventory or take other appropriate action. Thus, FEA might divert a supplier's surplus to another supplier who has a very low allocation fraction to provide relief to that supplier's customers.

If FEA does not direct the disposition of the supplier's reported surplus, he is then required to offer a portion of his surplus to his branded and non-branded independent marketer customers. These marketers must be offered in the aggregate the same proportion of the supplier's surplus product as their 1972 purchases bear to the supplier's supply obligation. Upon compliance with this rule, the supplier may distribute his remaining surplus at his discretion. Suppliers which are not required to report their surplus to FEA are nevertheless required to distribute their surplus in the same fashion.

d. Adjustments to Base Period Use.

Because the base period year in many cases is 1972, FEA has provided adjustments to base period volumes to reflect changed conditions since 1972. An "unusual growth" adjustment was provided to adjust for actual growth in 1973 in excess of 1972 purchases less certain amounts. Further, until August, 1974, the regulations provided a "changed circumstances" adjustment to reflect other growth. At the present time, base period volumes cannot be adjusted except upon a showing of serious hardship or gross inequity. The regulations, however, provide a basis to reflect increased current requirements for those consumers which have an allocation level expressed in terms of current requirements. These adjustments are more or less automatic unless a purchaser or his supplier disputes the amount of the increased current requirements. In cases of disputes, application must be made to FEA to resolve the issue.

e. State Set-Aside.

Provision for emergencies is made under the regulations through the State set-aside program. Currently, a percentage of products subject to the State set-aside, such as gasoline and distillate fuels, which would be otherwise available in a state must be "set aside" from the working stocks of the suppliers who serve the state to meet hardship and emergency requirements of consumers. The State, typically through the Governor's office, administers the distribution of the fuels in the State set-aside.

The State set-aside for an allocation period cannot be accumulated or deferred. The State offices normally release the unused portions of their set-aside for distribution within the State before the end of the allocation period.

f. Miscellaneous Features.

FEA's regulations attempt to provide a basis to allocate refined products in an equitable manner without undue delay or interference. Thus, the regulations fix supplier/purchaser relationships and use historic volumes for convenient reference. However, the mandatory allocation program recognizes that supply imbalances can occur between regions of the country. Consequently, provision is made whereby FEA can adjust reported allocation fractions and redirect product to areas where it is needed.

In many cases, suppliers changed their distribution patterns between 1972 and 1974, often withdrawing from market areas. Accordingly, the regulations, while imposing the obligation to supply 1972 customers, provide for substitute suppliers to assist base period suppliers in meeting their obligations with a minimum of disruption.

Special provisions exist to assist the construction industry since many of its members are no longer working on projects in the same areas where their 1972 suppliers are located. Thus, in 1972 a contractor may have used a local supplier in Denver for a project but in 1975 his work has shifted to a site in Alabama. Obviously, his base period supplier in Denver is unable to supply him in Alabama. The regulations provide a means for the contractor to be supplied by an assigned supplier at the new location.

(1) Curtailments of Alternate Sources of Energy.

Because of increasing curtailments of energy sources other than refined petroleum products, such as natural gas, FEA is required under the Act to give consideration to applications for assignment of suppliers and base period volumes to those persons who can use refined petroleum products and who have been curtailed under a federal or state order or plan from their primary fuels. FEA's regulations provide a detailed basis for consideration of these applications without creating undue problems for traditional users of refined products who must now share their fuels with new users with significant energy demands.

(2) Special Provisions Applicable to Particular Products.

As noted above, the general provisions provide a framework for allocation of all products. However, special conditions unique to certain products require distinct rules for allocating those products. The particular rules for each product are grouped under a separate subpart in the regulations. The nature and extent of these special rules can be indicated by providing a few specific examples.

(A) Aviation fuels.

Aviation fuels unlike gasoline, are allocated on a quarterly rather than monthly basis. Furthermore, the unique problems faced by international air carriers have required special rules to provide those carriers with domestic product without creating undue hardships for domestic air carriers.

Prior to the embargo, international air carriers purchased their fuel requirements from bonded stocks which are outside the allocation program. During the embargo the price of bonded aviation fuels increased sharply causing severe financial problems for these carriers. Further, many bonded fuel suppliers went out of business. Thus, international air carriers sought access to domestic supplies. Most, however, did not have base period suppliers or adequate base period volumes in those cases where they had purchased domestic fuels in the base period.

Domestic carriers were concerned that international air carriers if granted access to domestic fuels would purchase large quantities of domestic fuel and deprive them of already reduced supplies. Furthermore, it was anticipated that international carriers would purchase domestic fuel subject to allocation fractions and continue to purchase available bonded fuels to replace the quantities of domestic fuel not allocated to them because of low allocation fractions. This would have been inequitable to domestic carriers. As a result, a rather complicated rule has been devised to provide for domestic allocations to international carriers which fluctuate as international carriers purchase bonded fuels. Internationals are thereby treated on an equitable basis with domestic carriers.

(B) Propane.

Because propane is in short supply with increasing demand because of natural gas curtailments, several unique features have been developed for its allocation in addition to the general rules. Thus, a purchaser of other fuels may purchase his current requirements in excess of his allocation level if he can locate surplus products. However, many users of propane are limited by regulation in their use of propane, including their inventories, to prevent undue diversion of available propane stocks. Special rules have also been devised to regulate the use of propane by synthetic natural gas manufacturers.

Propane has also proven to be different because, unlike other fuels, the effective level for application of the usual allocation rules is not the first distribution level but the second. Thus, special rules have been devised to account for the first level of production and to adjust for the need to apply the general allocation rules at the second (producer-supplier) level of distribution.

(C) Space heating fuels.

In order to assure adequate supplies of fuel for heating, space heating requirements are accorded an allocation level which specifies a minimum allocation fraction a supplier may use to reduce the purchaser's allocation entitlement when the supplier experiences a shortage. For middle distillate fuels and residual fuel oil, the allocation level for space heating requirements is one hundred ten percent of the amount the purchaser used during the base period. In the event a supplier determines that his allocation fraction for period will be less than 0.8, the allocation level for space heating becomes eighty-eight percent of base period use, not subject to the allocation fraction. This is the equivalent of one hundred ten percent times 0.8, and in effect requires the supplier to apply a fraction no lower then 0.8 to the allocation entitlements of his space heating customers. In the case of propane, the allocation level is ninety-five percent of base period use, and the minimum allocation fraction is 0.9. Although these special rules for space-heating which combine aspects of the two priority allocation levels are complex and require suppliers to make an extra set of allocation calculations, they have been proven necessary by FEA's experience with its original allocation levels for space heating.

(D) Utility allocation.

In order to assist utilities which use residual fuel oil, a special utilities allocation program exists to allocate specified quantities of this fuel on a monthly basis to utilities. These quantities are determined each month by FEA and published in the Federal Register. Obviously, this allocation method can only be used in situations where there is a limited number of purchasers who report to FEA in order that their needs can be quickly assessed and suppliers advised on a monthly basis.

(E) Motor gasoline.

Motor gasoline retail sales outlets, with very few exceptions involving independent marketers, are treated in FEA's regulations as separate entities even when a number of such outlets are owned and operated by the same person or firm. Therefore allocation entitlements of retail outlets are calculated on an individual station basis rather than for an entire chain of outlets. In order to provide marketers who own and operate two or more outlets a certain amount of flexibility in marketing gasoline while generally preserving historical distribution patterns, FEA gasoline regulations permit a marketer to shift a portion of any outlet's entitlement to another outlet to respond to changing demand patterns. This shift is limited to an increase or decrease of thirty percent in any outlet's entitlement.

These special rules, among others, have proven useful for motor gasoline to meet the needs of independent marketers while providing for equitable distribution of gasoline on a geographic basis.

g. <u>Protection of Independent Marketers</u>.

Section 4(c)(1) of the Act requires that the mandatory allocation program provide for allocation of residual fuel oil and refined petroleum products to each branded and non-branded independent marketer and each small and independent refiner in an amount sold or otherwise supplied to them during corresponding periods of 1972, as reduced pro rata if supplies are below 1972 levels. FEA regulations provide basic allocations based on 1972 volumes, or for some products, 1973 volumes, to fulfill this requirement. In addition, FEA regulations contain other provisions specifically designed to perserve the competitive viability of branded and non-branded independent marketers and also of small and independent refiners engaged in marketing of product, an objective of the program specified in section 4(b) of the Act.

Suppliers whose allocation fractions exceed 1.0, for example, and who therefore have surplus product, are required by FEA regulations to offer their surplus to their branded and non-branded independent marketer purchasers in at least the same proportion as those class of marketers purchased of the suppliers' total supplies during the base period. This requirement prevents suppliers from favoring their owned and operated resale outlets in distributing surplus product.

A major area of concern with respect to independent marketers and small independent refiners is the retailing of motor gasoline. FEA regulations provide special rules with respect to independent marketers' and small and independent refiners' gasoline retail activities.

With respect to independent marketers and small and independent refiners who operate more than one retail sales outlet and who closed outlets after January 1, 1973, FEA regulations granted an adjustment to base period volumes of outlets which remain open by an amount up to the total base period volumes of the stations closed during the period January 1, 1973 through June 1, 1974. The regulation also provides that marketers may file for an adjustment to base period volumes for the remaining outlets to compensate for outlets closed after June 1, 1974.

Generally, FEA regulations treat each retail sales outlet as a single firm. This prevents firms which operate multiple outlets from shifting supplies from one outlet to another in excess of thirty percent. The regulations also provide, however, that independent marketers and small and independent refiners may apply to FEA for treatment of some or all of their retail sales outlets as a single firm. Granting a petition for treatment as a single firm does not necessarily give an independent complete freedom to move gasoline among outlets or open and close outlets at will, but does provide a flexibility not otherwise available to other marketers.

Most importantly, the entitlements program for refiners (described above) was adopted in part to provide relief to those independent marketers whose competitive viability was threatened because they were dependent for supplies upon refiners without low cost old crude oil. These marketers, as product supplies increased following the end of the embargo, were threatened because of their inability to purchase products on a basis competitive with those marketers who were supplied by refiners with large quantities of low priced old crude oil.

III. Problems Inherent in the Emergency Petroleum Allocation Act and their solution through the Phase-out of Old Oil.

As noted above, the EPAA was conceived and enacted in the face of the 1973 Arab oil embargo principally to ensure the maintenance of essential activities and equitable distribution of limited petroleum supplies, while preserving an economically sound and competitive petroleum industry. Faced with projected shortfalls in excess of fifteen percent for the first quarter of 1974, the Congress concluded that government intervention in the marketplace was necessary on a short-term basis to avoid severe individual hardship and economic dislocation.

The Act was not, however, drafted with a view toward long-term controls. Moreover, as noted, the supply situation today is much different from what it was in the fall of 1973. Therefore, over the past several months problems which are inherent in the EPAA have become increasingly apparent to FEA as its regulatory program has emerged from the short-term crisis that precipitated it. Listed below, in no particular order, are some of the serious problems that are now surfacing and would in our opinion be perpetuated by a further extension of the EPAA as now written. Following the description of the problems created by the Act is a discussion of FEA's current proposal to phase-out price controls on old oil and thereby eliminate the two-tier price system which is the principal cause of many of these problems.

A. Problems Inherent in the Emergency Petroleum Allocation Act

1. The EPAA is in Certain Major Respects Inconsistent with the National Goal of Achieving Long-Term Energy Independence

Although the original objective of the EPAA was to distribute equitably a limited supply of petroleum and to control prices so that the industry did not unnecessarily profit from the shortage at the expense of the public, the situation has changed completely since November 1973, when the EPAA was enacted. The EPAA was principally designed to enhance and fairly allocate restricted petroleum supplies on a short-term basis. Now, a worldwide surplus of petroleum exists, and everyone agrees that our major task is to reduce our undue dependence on imported petroleum, which currently meets about 39 percent of our domestic needs.

The most efficient way to reduce demand (and thereby to reduce imports) is, of course, through the pricing mechanism. While we recognize that there is considerable controversy over the timing and the extent to which prices should be raised to reduce demand, we believe that FEA should be given greater flexibility than the EPAA now affords it to permit market mechanisms to play at least a partial role in reducing our dependence on foreign oil.

The EPAA also creates such inflexibility in FEA's price control program that considerable disincentives to increased <u>domestic</u> production are created. For example, the requirements of Section 4(g) of the Act unnecessarily limit the President in decontrolling the price of all domestic crude oil, or even granting more limited exemptions to certain segments of the industry or types of production, in order to provide appropriate incentives to increased domestic production and refinery capacity. The agency's flexibility will be even more severely restricted if the interpretation of the Act given it by a three-judge panel of the Temporary Emergency Court of Appeals on February 18, 1975, in Consumers Union v. Sawhill, No. DC-26, is upheld on review by the full court.

Moreover, certain FEA allocation programs which are directly or indirectly mandated by the EPAA tend to frustrate the goal of reducing our dependence on foreign oil. For example, the crude oil entitlements and the buy-sell programs, which are largely designed to give small and independent refiners necessary access to the cost advantages of price-controlled domestic crude oil, must to some degree have the undesirable effect of encouraging imports, since the burden of their higher cost is not borne solely by the importer, but shared with his competitors.

2. The EPAA Denies Consumers the Full Benefits of Competition

The EPAA and the FEA regulations which implement it have the effect of preventing the free operation of market forces in the petroleum industry. Such drastic restrictions on competition are no longer warranted by the current supply situation. We believe that the EPAA's broad-brush approach -- necessary as it was in an embargo situation -- has had the ironic effect in the current marketplace of maintaining some prices at artifically high levels, to the detriment of the ultimate consumer.

For example, the mandatory allocation requirements have necessitated the continuation of the supplier/purchaser relationships that existed during a certain base period, which for most products is 1972. Although necessary to ensure the flow of supplies during a shortage, fixed supplier/purchaser relationships have significantly reduced competition in the present surplus period. Thus, for example, they prevent the federal, State and local governments from procuring fuel at the lowest prices based upon competitive bids, causing continuing higher costs to taxpayers for fuel used by governments. Private consumers, unable to select their suppliers, may also thereby incur higher fuel costs.

Moreover, price controls, while overtly holding down prices, also are operating to support higher prices than might be possible in a free market. The two-tier price system, for example, creates cost disparities which in certain cases allow recovery of higher margins by competitors blessed with lower current costs than would be possible under free market conditions. The dollar-for-dollar pass through rule in

Section 4(b)(2) of the EPAA, which in effect allows the continuation of historical profit margin levels, tends to provide government endorsement of and justification for such profit margins, even though those margins were in some cases unnecessarily high during the base period, and the logic of market conditions might dictate lower margins today.

FEA's mandatory allocation programs also restrict ease of entry into certain sectors of the industry, thus further preventing the public from realizing the full benefits of free competition. For example, under the EPAA, FEA is <u>required</u> to control the movement of all domestic crude oil. An important aspect in the planning of any new refinery construction, therefore, is negotiation with FEA to ensure that adequate volumes of crude will be allocated under the buy-sell list, and that the new refinery will be eligible to participate in FEA's entitlements program. A similar degree of government involvement can characterize other types of capital investment, down to and including the construction of new retail outlets. Such significant FEA intervention tends to make construction of new refineries or marketing outlets a matter of political clairvoyancy as well as economic calculation, thereby injecting uncertainties which undoubtedly are causing efficient projects that are in the public interest to be delayed or cancelled altogether.

3. The EPAA Prolongs Unwarranted Economic Distortions and Inefficiencies

An unavoidable effect of an extended allocation program is to maintain within the petroleum industry those inefficiencies and distortions that existed during an arbitrarily-chosen base period. Continuation of historic distribution patterns may result not only in prolonging such inefficiencies, but also may have adverse effects upon industrial expansion and population movement.

With respect to domestic crude oil, for example, FEA met the EPAA allocation requirements by freezing supplier/purchaser relationships as of December 1, 1973. As domestic production continues to decline at differing rates in different parts of the country, necessary adjustments in crude oil distribution channels cannot be resolved through the operation of normal market mechanisms, and can only be accomplished by ad hoc action by FEA, which is ill-equipped to deal with such matters.

Distortion must also result from continued regulation of only petroleum products without comparable regulation of such substitute sources of energy as coal, electricity and natural gas. Such disparate treatment disrupts the functioning of normal market forces, and prevents a coordinated response to the nation's energy problems.

4. The EPAA Makes it Very Difficult for the Petroleum Industry to Reach Rational Business Decisions

The constant need for regulatory changes to respond to ever-changing market conditions (such as the establishment of the cost equalization program to solve problems created by the two-tier price system) seriously inhibits the industry's ability to engage in long-term business planning. That planning that can be done must also be skewed to reflect the distortions built into the marketplace as a result of the rigid requirements of the EPAA. This problem will only be exacerbated by further piecemeal extensions of the EPAA, rather than enactment of a new regulatory program which deals with the realities of today's marketplace and our long-term needs.

A prime example of the uncertainty created by FEA regulations results from the supplier/purchaser relationship rules, noted above. These rules have created an administrative house of cards held together only by historical, and in many cases impractical, supplier/purchaser relationships that are mandated by the Act. The more time that passes, the more fragile these relationships will become and the greater the disruption that will result when the program is terminated. In this atmosphere, the industry is understandably reluctant to make the investment decisions which must be made soon if the country's long-term energy goals are to be met. It is therefore incumbent on the Congress to concentrate its attention to the longer-term solutions which will bring some normalcy to the industry.

B. Proposal to Phase-Out Old Oil

As can be seen from the above discussion of the problems inherent in the Emergency Petroleum Allocation Act, the solution to many of these lies in the elimination of the two-tier pricing system for crude oil. The two-tier pricing system inevitably causes cost disparities among refiners and marketers of petroleum products which in turn create economic distortions. Although these cost disparities have been substantially reduced by the crude oil entitlements program, they can never be entirely eliminated while the two-tier pricing system exists. Such cost disparities significantly hinder FEA's ability to assure that the competitive viability of the independent sector of the petroleum industry is maintained.

Moreover, the existing complicated structure of price controls at all levels of distribution, which is necessitated due to the existence of the cost disparities resulting from the two-tier price system, tends to be self-defeating over the long run by reducing normal incentives toward increased production and cost control and by eliminating the ability of the industry to engage in long range business planning. As the effectiveness of price controls lags over time, regulations of greater complexity and reach become necessary to maintain the controlled-price structure. Tightening of controls tends to further stifle initiative and to contribute to greater economic distortion.

In his State of the Union Message on January 15, 1975, President Ford called for a massive energy conservation program in which consumption of energy resources would be reduced and domestic production of fuels would be increased, in order to reduce this country's dependence on imported crude oil. Among specific complementary measures proposed to curtail domestic energy consumption, the President listed decontrol of the price of domestic crude oil.

Decontrol would permit domestic crude oil prices to rise to the prevailing world price levels so that the demand-dampening effects which have been felt worldwide would be felt to the full extent in the United States. Under the two-tier price system now in effect, the price of most domestic oil is held at a level approximately half that of world price levels, so that the impact which the escalation of free market prices has had on demand overseas has been considerably cushioned in the United States. The removal of price controls on domestic crude oil is a necessary and integral part of the program to reduce energy consumption and thereby curtail dependence on imported crude oil and lessen our balance of payment deficit.

In addition to reducing dependence on imported oil by reducing demand, decontrol of domestic crude oil prices would stimulate domestic production, or at least slow the rate of decline in domestic production, displacing some supplies of crude oil that would otherwise have to be imported.

It is now generally agreed that measures to insure maximum domestic production of crude oil are essential in order to assure adequate and dependable energy resources for the United States, until alternative domestic energy resources can be developed over the long term. Furthermore, the FEA has found that the production incentives afforded since the fall of 1973 by the rules permitting "new" and "released" domestic crude oil to be sold at free market prices are of decreasing impact or effectiveness.

The existing incentives are only effective for limited periods of time since the inevitable slackening of output will eventually bring production below base levels to the point where existing incentives are no longer adequate to encourage investment in secondary/tertiary recovery and other costly programs designed to increase total output of crude oil. While it is true that the additional incentive afforded by the decontrol of old oil would also eventually diminish in effect due to the inevitable decline or exhaustion of worked-over reservoirs, the purpose of FEA is not to devise a permanent solution to limited domestic production capabilities but to propose incentives of sufficient effectiveness and duration as will yield maximum levels of domestic production until such time as supplementary energy resources can be developed and exploited. Although existing incentives are believed to have contributed substantially to the current improvement in the rate of decline in domestic production, the FEA believes that existing incentives clearly cannot work to maintain domestic production at levels now thought necessary to avoid an unacceptable degree of reliance on imported fuels over the next few years.

Other parts of the President's program call for legislative action. In particular, the enactment of a windfall profits tax and of legislation to alleviate the impact of higher energy costs on consumers have been proposed. In light of the fact that the Congress has made little progress in either developing a comprehensive energy program or providing the President with the authority he needs to implement his comprehensive energy program, and in order to avoid any adverse impact on our national economic recovery, FEA has proposed a gradual two-year phase-out rather than abrupt decontrol of old oil. This gradual phase-out will allow the Congress sufficient time in which to enact an effective windfall profit tax, while at the same time gradually eliminating the economic disincentives and distortions resulting from the present two-tier price system. By spreading the relatively small, 5-6 ¢ per gallon, price increase over a 25-month period, furthermore, its impact upon the consumer would not be unduly burdensome, when compared to its benefits.

Although the FEA has not yet completed its analysis of all the comments received with respect to its proposal to phase-out old oil and is still considering possible modifications in view of those comments, we remain convinced that the

Nation cannot afford to wait indefinitely for the Congress to enact a decontrol plan of its own. Action is presently needed to develop domestic supplies, to reduce our vulnerability to import disruptions by reducing demand, and to allow FEA to eliminate many complex regulatory programs whose continued existence is solely due to the distortions caused by the two-tier price system. Therefore, FEA is working rapidly to perfect its proposal to phase-out price controls on old oil, so that the amendment may be submitted to the Congress in accordance with the provisions of Section 4(g) of the Emergency Petroleum Allocation Act at an early date.

IV. Conclusion

I have tried to present a detailed explanation of our implementation of the Act by operation of our mandatory allocation and price control programs along with a discussion of some of the problems associated with indefinite continuation of those programs. One purpose of this presentation has been to impress upon you the complexity and totally pervasive nature of the regulatory program necessary to carry out the requirements of the Emergency Petroleum Allocation Act.

It is apparent that these regulatory programs, which were originally designed to deal on a temporary basis with a period of severe shortage of supply, are now operating in a totally different, surplus-supply environment. If the government is forced into the long-term posture of regulating this complex industry and influencing, if not dictating, its business decisions, we believe that the Nation will be poorly served. Accordingly, the Administration opposes any extension mandating this degree of regulatory involvement.

Let me emphasize that we are not oblivious to certain real problems which may require some continuing regulatory role with respect to the petroleum industry after August 31 of this year. For example, FEA forecasts that shortages of certain natural gas liquids such as propane and butane may continue to exist in the coming years. Some authority to allocate these products, if in critically short supply, may still be necessary to prevent large industrial users or synthetic natural gas plants from diverting excessive portions of the available supplies. The continued competitive viability of independent marketers and small refiners, which was one of the principal reasons for the enactment of the EPAA in 1973, also remains as valid a concern today. This area, too, would require continuing regulatory authority of a standby or limited nature, at least until the phased decontrol of old oil was completed.

The essential point, however, is that the form and extent of any necessary continuing federal regulation of the petroelum industry cannot conceivably be determined until the Congress has completed action on the President's short-term energy conservation proposals, some of which are discussed above. The primary need for any continued allocation and price control authority would depend on the effects of those proposals, and would be appropriate to complement the near-term conservation measures to achieve the goals of the President's program.

This being the case, we urge that the Committe defer consideration of amendments to or extension of the Allocation Act until we understand with greater certainty the nature and characteristics of the national energy policy ultimately developed by the Congress and the President. Instead, the Administration urges the Congress to continue its thorough and constructive review of the President's program, with a view to prompt action on its substance.

I am confident that the Congress and the Administration will use well the time available to us before the expiration of the Act and resolve many of our national energy policy issues. Then we may turn anew to examine carefully but promptly the type of continuing allocation authority which may be necessary to carry out our national energy program. And we will not hesitate to submit to the Congress such legislation as this examination suggests may be necessary.

Thank you.

STATEMENT OF

FRANK G. ZARB

ADMINISTRATOR

FEDERAL ENERGY ADMINISTRATION

Before the

COMMITTEE ON INTERIOR AND INSULAR AFFAIRS

UNITED STATES SENATE

May 19, 1975

aviation fuel, have risen far more quickly during the past several years than have gasoline prices. FEA believes that in the future gasoline, therefore, ought to bear a greater share of increased costs.

In response to comments concerning the hardship to electric utilities and their customers caused by disproportionately large increases in residual fuel oil prices, further direct restraints have also been proposed on the passthrough of increased costs to residual fuel oil.

(e) Natural Gas Liquids

Propane is produced both from crude oil and from natural gas, with approximately 30 percent of the domestically produced propane derived from crude oil and 70 percent from natural gas. About 10 percent of the propane used in the United States is imported. Other liquid products produced from natural gas and subject to FEA regulations are butane and natural gasoline.

The Cost of Living Council's Phase IV petroleum price controls, which were effective in August, 1973, and form the basis for FEA's current price regulations, did not distinguish between propane derived from crude oil and propane derived from natural gas. By virtue of the fact that "refiner" was defined broadly in the regulations to include gas processors as well as crude oil refiners, all propane, including that derived from natural gas, was subject to the same price rules. These price regulations were designed with crude oil refiners in mind, however, and were not well suited to regulate natural gas processors.

Propane prices became a controversial issue in the closing months of 1973 and the first months of 1974, at a time when prices rose dramatically from historic levels. During that time, propane was treated under the refiner price rules as one of the many products to which refiners could allocate increased product costs in any amounts they wished to determine maximum lawful selling prices. This treatment was intentionally adopted to allow propane prices to rise and thereby to provide an incentive to increase supplies of propane, which were seriously short at that time. This price rule, together with a tight supply situation for propane, permitted a disproportionate "loading" of increased crude oil costs on to propane prices. Propane prices rose rapidly during the fall of 1973, creating strong pressures to revise the original CLC rule. Because FEO determined that prices had risen higher than necessary to encourage sufficient supply, FEO issued a Special Propane Rule in January, 1974, which restricted the amount of increased product costs that could be assigned to propane prices to that proportion of the total increased product costs incurred by a refiner in any twelve-month period, which that refiner's sales of propane bore to its total sales of all covered products in the same period.

The Special Propane Rule brought propane prices down somewhat, and seemed to have stabilized them. However, beginning in June and July of 1974, propane prices began to increase once again. In response to the likelihood of further increases with the approach of the heating season, the FEA issued in August an Emergency Amendment to the Special Propane Rule that expressly dealt with the fact that some propane is derived from natural gas while other propane is derived from crude oil. The Emergency Amendment to the Special Propane Rule further restricted the amount of increased product costs that could be assigned to propane produced from crude oil, so that the amount of increased costs of crude oil that could be used to justify higher propane prices was limited to that proportion of a refiner's increased cost of crude oil equal to the percentage that the sales volume of propane <u>derived from crude oil</u> was to the total sales volume of all covered products derived from crude oil. The Emergency Rule further provided that, with respect to natural gas liquids, only the increased costs of natural gas liquids purchased from unaffiliated entities could be used to justify increased prices of propane. This was done because, under FEA price regulations, there should not have been significant increased costs since May 1973, as to natural gas liquids obtained from affilitated entities.

When the Emergency Amendment was issued, the FEA acknowledged that its price rules did not address the production of natural gas liquid products, including propane, from natural gas in an appropriately specific manner, and the FEA therefore indicated that it would propose more specific rules in the near future on this subject. On September 10, 1974, proposed rules specifically designed to cover prices of natural gas liquids and natural gas liquid products were published. Following receipt of written comments and hearings on this proposal, a final rule was issued.

The basic determination with respect to the new price rules for natural gas liquids and natural gas liquid products (propane, butane, and natural gasoline) was that, consistent with the FEA price regulations generally and with the requirement of Section 5(b)(11) of the Federal Energy Administration Act of 1974, the new regulations would continue to limit propane prices to historic levels, while providing a means of allocating the actual increased costs of producing propane from natural gas to the lawful prices that could be charged for the product.

The principal features of the revised cost-based system now in effect with respect to the pricing of natural gas liquids are:

(1) the continuation of May 15, 1973 as the reference point from which increased costs and lawful prices are to be

determined, but with a permitted adjustment of May 15, 1973 selling prices of natural gas liquid products at the first sale level to at least 8.5 cents per gallon for propane, 9 cents per gallon for butane, and 10 cents per gallon for natural gasoline;

(2) provision for the addition of up to .5 cent per gallon to May 15, 1973 selling prices to reflect increased non-product costs incurred in processing natural gas liquids;

(3) provision for the addition of an increment to May 15, 1973 selling prices to account for actual increased cost of natural gas shrinkage attributable to the production of natural gas liquids since that date;

(4) provision for the increased costs attributable to propane to be applied selectively (with appropriate safeguards for independent marketers) among classes of purchaser to increase propane prices for sales to different classes of purchaser;

(5) a requirement that refiners who process natural gas liquids exclude revenues that represent recovery of increased costs of crude oil from the revenues received in the sale of natural gas liquid products, for the purpose of determining net-back payments to royalty owners or producers; and

(6) a price rule for natural gas liquids extracted in gas processing facilities constructed after the effective

date of the new regulations, which provides an incentive for the construction of such facilities by permitting somewhat higher prices to be charged for products produced in new plants.

4. RESELLERS AND RETAILERS.

a. Dollar-for-Dollar Pass Through of Increased Product Costs

(1) Product costs

Resellers (wholesalers) and retailers are restricted in the prices they may charge for petroleum products to an amount that reflects their May 15, 1973 prices, plus an amount that reflects, on a dollar-for-dollar basis, increases in their cost of the product since May 1973. Increased costs are computed on the basis of the difference between the current weighted average unit cost of the product in inventory and the weighted average unit cost of the product in inventory in May 1973, and must be passed through on a product-by-product basis. In other words, increased product costs may not be reallocated among products by resellers or retailers.

(2) Non-product costs

In addition, in recognition of increased non-product costs, the regulations permit specified per gallon increases in prices charged for certain products by resellers and retailers, to cover non-product cost increases. The