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UNITED STATES
GENERAL ACCOUNTING OFFICE

Federal Energy Administration's Efforts To Audit Domestic Crude Oil Producers

FEA's audits of independent producers have

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

B-178205

The Honorable Abraham A. Ribicoff
Chairman, Committee on Government
Operations
United States Senate

Dear Mr. Chairman:

This report summarizes our review of the Federal Energy Administration's (FEA's) compliance and enforcement efforts devoted to domestic crude oil producers.

In our March 31, 1975, letter to you, we provided you with information on FEA's progress in redirecting the compliance and enforcement program along with preliminary information on the results of the initial crude oil producer audits. In subsequent discussions with your staff, we agreed to elaborate on the producer audit efforts.

In developing this report, we visited FEA headquarters and three of its regional offices, Dallas, Denver, and Kansas City; examined audit reports and supporting documents; and held discussions with auditors and program officials.

Regulating prices of domestic crude oil production is a difficult task. There are over 19,000 domestic crude oil producers, ranging from one-family, backyard operations with a single well producing a few barrels of oil a day to major oil companies with control of thousands of wells. Ownership patterns are often complicated by assigning production rights to other parties and by combining the production of several oil-producing properties in the same area into a single producing unit to achieve maximum production at a minimum cost.

To date, FEA has concentrated its compliance and enforcement efforts on independent producers of crude oil. Independent producers account for about 30 percent of domestic crude oil production. As of August 22, 1975, FEA audits of independent producers' operations resulted in

--consent agreements with 36 producers under which the producers agreed to refund a total of $3.2 million to customers and to pay penalties of about $115,000.

--notices of probable violation issued or being prepared for 52 other producers involving about $11 million in potential violations.

--investigations of 163 producers completed without any violation being detected.

Since FEA regions did not follow a uniform policy for compromising civil penalties, producers that were determined to be in violation of price regulations were treated inequitably.

In contrast to its work on independent producers, FEA had not completed enough work on crude oil production activities of major oil companies to establish whether those companies had complied with petroleum pricing regulations. Twenty major oil companies control about 70 percent of the domestic crude oil production.

FEA needs to intensify its audit coverage of the crude oil production operations of major oil companies. In addition, it needs to implement:

--A more systematic method for selecting independent producers for audit so that audit efforts can be concentrated on those producers most likely to be in violation of pricing regulations.

--A uniform policy for arriving at civil penalties so as to insure equitable treatment of producers in violation of pricing regulations. Some regions had assessed no penalties, whereas other regions attempted to collect some penalty from each violator.

Our findings are discussed below, followed by conclusions to the Administrator, FEA, and comments of FEA officials on a draft of this report.

BACKGROUND

Twenty large oil companies control the production (through leases, long-term supply contracts, etc.) of about 70 percent of domestic crude oil. Most of the companies are fully integrated in that they are involved in all facets of industry operations--exploration, production, transportation, refining, and marketing. The 30 largest oil companies refine about 85 percent of the petroleum products sold in the Nation.

For years, crude oil prices remained relatively low and supply was plentiful. In 1972, domestic crude oil sold for about $3.39 a barrel and imported crude oil sold for about $3.32 a barrel. However, domestic crude oil production continued to decline and the oil industry became more dependent on imported crude oil. In October 1973, when imports accounted for more than 35 percent of domestic consumption, the Arab nations cut off oil to the United States and other countries.

The Emergency Petroleum Allocation Act of 1973 (87 Stat. 627) was to help minimize the adverse impacts of short-term petroleum shortages by placing equitable restrictions on supply, cost, and profit. The act, which was the basic legislative authorization for control of petroleum product prices, expired August 31, 1975; however, the President signed legislation on September 29, 1975, reinstating the price controls until November 15, 1975.

The Federal Energy Administration Act of 1974 (88 Stat. 96), provided for a reorganization of governmental functions, on an interim basis, to deal with energy shortages. FEA carries out the petroleum pricing provisions of the Emergency Petroleum Allocation Act.

To bring about the legislated energy goals, FEA established a series of regulations governing the allocation and pricing of crude petroleum and refined products. The regulations governing the pricing of domestic crude oil are a carryover of regulations which were originally developed by the Cost of Living Council under authority contained in the Economic Stabilization Act of 1970.

Basically, the regulations established a two-tier system which provides for controlled and free market prices on the first sale of domestic crude production through four basic rules.

--Montnly production up to levels produced during the corresponding month in 1972 is termed "old oil" and is limited to a ceiling price of $1.35 higher than prices on May 15, 1973. This averages to about $5.25 a barrel.

--Production exceeding 1972 levels (less adjustments for any production below 1972 levels in previous months) can be sold as "new oil" at uncontrolled prices--about $12.75 a barrel.

--For each barrel of new oil produced in a month, a matching amount of old oil production is "released" from price controls. Released oil quantities cannot exceed the production level in the corresponding month of 1972.

--"Stripper well oil," production from properties averaging 10 or fewer barrels a day for each well, is also eligible for sale at uncontrolled prices.

FEA regulations define the average daily production of crude oil from a property as the oualified maximum total production divided by the product of the number of days in the year times the number of wells that produced during the year. To qualify for maximum total production, a well must have been maintained at the maximum feasible rate of production, in accordance with recognized conservation practices, and not

significantly curtailed by mechanical failure or other disruption in production. If unusual curtailments in operations occur, operators may make adjustments in the computation of a well's average daily production. Computing an oil well's average daily production is important because that figure determines whether an oil well is a stripper or a nonstripper and the amount of new or released oil which is produced by a well. Once a property qualifies as a stripper well under FEA regulations, all sales are eligible for uncontrolled prices even if production rises above 10 barrels a day in subsequent years.

In 1974 about 2 billion barrels, or 64 percent, of the total domestic crude oil produced were sold as old oil subject to ceiling prices. The remaining 36 percent, or 1.2 billion barrels, were sold at uncontrolled prices, as follows:

Type of crude oil	Percent of 1974 production	Number of barrels (millions)
New	15	480
Stripper	12	384
Released	9	288
Total	36	1,152

In a previous report to you on the problems in FEA's compliance and enforcement effort (B-178205, Dec. 6, 1974), we pointed out that there was almost no direct audit of crude oil producer operations which provide the basis for the cost of crude oil processed in refineries. We pointed out that audits of producer operations were important because it was the point of production that the type--new, old, stripper, or released--and consequent price of crude oil used in refineries were determined. Since the cost differences between old and other types of crude oil are substantial, we believe an adequate program of verification at that level is needed to insure that crude oil purchasers, and ultimately, consumers, are not overcharged. In response to that report, FEA said it was redirecting its compliance and enforcement effort to include audits of crude oil production.

Currently, producers can be audited through one of two FEA programs. Independent producers' operations are audited through a program called Project Producer.[1] Producers that are also refiners are audited through the Refinery Audit and Review Program.

[1]The program was initially called Project Manipulator.

When FEA believes a provision of the price regulations has been violated, it first attempts to obtain a voluntary price rollback and/or a refund of overcharges by the producer. If the producer agrees to take the voluntary action, FEA formalizes the action in a written consent order. Under recent regulation changes, a consent order has the same binding effect as an administrative order.

If voluntary compliance cannot be achieved, FEA may issue a Notice of Probable Violation (NOPV) which notifies the producer that FEA has reason to believe it has violated the pricing rules. The producer has 10 days in which to respond to the notice, and it may also have an informal conference with FEA. If the producer fails to rebut the charges, FEA may issue a Remedial Order which can require the producer to refund overcharges to its customers. FEA allows 10 days for appeal of a Remedial Order. If FEA denies the appeal, the firm can appeal further through the judicial system.

In addition, the regulations provide for civil or criminal penalties when FEA determines that a violation has occurred. Civil penalties may be assessed to a maximum of $2,500 a day for each violation. FEA can compromise, settle and collect civil penalties; however, it does not have the authority to prosecute to collect these penalties. This is done by the Department of Justice. Criminal penalties of $5,000 a day for each violation may be imposed whenever FEA determines that a violation of its regulations is willful. FEA is to refer cases involving significant evidence of willful violation to the Department of Justice for criminal prosecution.

PROJECT PRODUCER

In November 1974 FEA initiated Project Producer to audit independent crude oil producers' production operations. FEA's national Office of Compliance and Enforcement selected from monthly reports, which producers were required to submit on crude oil production, the 125 producers that reported the greatest volume increases in new oil produced from September 1973 to October 1974. The 125 producers accounted for about 4 percent of the total production of new uncontrolled oil reported to FEA during the period.

Because the potential for violations is greater among those producers reporting the greatest volume of increases in new oil, FEA officials believed and we agree that efforts should be directed at such producers. In February 1975 FEA headquarters officials told us that they were reviewing the monthly production reports submitted by producers to target for audit an additional 1,000 independent producers that had reported large volume increases in new oil production. However, as of July 31, 1975, FEA headquarters had not selected and notified field auditors of additional independent producers that should be audited under Project Producer. As a result, regional offices have selected their own lists of producers for audit under the project.

The methods by which regional offices selected the additional producers and the effectiveness of such methods are somewhat questionable. In some cases, regional offices selected producers on refinery auditors' recommendations; however, in most cases, regional offices identified and selected producers by reviewing community telephone directories or industry publications. In some cases, the regional offices made the selection without knowing either the total production of the producer or the percentage of uncontrolled oil included in its production. We believe that, with limited manpower available to audit the 19,000 crude oil producers, FEA should have a more systematic basis for selecting potential violators of the pricing regulations. We believe FEA headquarters should expedite its efforts to identify and select for audit additional producers that reported large volume increases in uncontrolled oil.

As of August 22, 1975, FEA reported that 93 field auditors were assigned to Project Producer. One hundred ninety-nine producer investigations had been completed, and no violations were found in 163 of these cases. FEA negotiated consent agreements with 36 producers that were violating pricing regulations which involved refunds of about $3.2 million. Penalties totaling about $115,000 were collected from 18 of the 36 producers that signed consent agreements, and FEA is negotiating the amount of the penalty with 5 other producers that signed consent agreements. In addition, 21 NOPVs with potential violations of about $4.9 million have been issued to producers and 31 NOPVs with potential violations of about $6.2 million were in various stages of preparation.

Violations detected included the erroneous classification of old oil as new, released, or stripper well oil. For example, the following excerpt from a memorandum dated December 23, 1974, prepared by an FEA investigator illustrates violations detected.

> "1. I have finished my investigation of [the company]. Out of about 170 leases, I found discrepancies in 16 leases. The total overcharges collected were $185,778.76.
>
> "2. Two of the leases had claimed moderate amounts of production as new and released oil when it was not. The violation on these two leases was only $3,210.88.
>
> "3. The remaining 14 leases had been classified as strippers. Their production had been drastically cut in the last 4-5 months of 1973. Their production was then divided by 365 days. When the production is divided by the days of production or when the historical and current production patterns are studied, it becomes apparent that these are not stripper leases. The firm

has maneuvered their production to try to fall within the stripper category. If they get away with it, they produce half the normal amount of oil and still get the full amount of money for it.

"4. I have presented my findings to the firm. They declined to make any comment until receiving written notice. I recommend that FEA issue an NOPV to the firm as soon as possible."

On July 3, 1975, the Regional Administrator issued an NOPV to the producer charging it with violations in the amount of $185,778. After being granted several extensions, the producer formally responded to the NOPV on August 5, 1975. The producer questioned the manner in which FEA had computed the amount of the violation and requested a conference with FEA. As of September 5, 1975, FEA and the producer had not met to discuss the NOPV.

Resolving the above case and many other cases involving potential violations of the pricing regulations was delayed until regulatory questions were clarified by FEA's regional counsel and/or FEA's headquarters Office of General Counsel. For example, FEA field auditors used different formulas in computing the average daily production of oil wells because of uncertainties concerning the manner in which the computation should be made. Under one formula auditors used the number of calendar days in the year, whereas under another formula auditors used the actual production days. For one of the producers FEA investigated, application of the first formula would have identified the average daily production as 7.7 barrels while application of the second formula would have identified the production as 11.7 barrels a day. In March 1975 FEA regional offices expressed uncertainties to the national office about the proper method of computing average daily production. On June 10, 1975, FEA's Office of General Counsel notified regional offices that actual production days should be used in computing average daily production.

In addition, because FEA headquarters did not provide formal guidance to FEA regions regarding the circumstances under which penalties should be sought from producers that were in violation of pricing regulations, regional offices we visited used different criteria for assessing civil penalties under Project Producer. The following table shows, for the three regions we visited, the reported number of consent agreements reached, the dollar value of the violations, and the amount of penalties that had been collected from violators as of July 25, 1975.

Regional office	Number of consent agreements	Amount of refunds and rollbacks	Amount of penalties collected
Dallas	5	$ 446,827	0
Kansas City	10	652,466	$50,035
Denver	4	188,191	0
Total	19	$1,287,484	$50,035

Kansas City regional office officials told us that they sought a penalty for every violation they detected and that their goal was to collect a penalty which approximated 10 percent of the amount of the violation. According to them, the 10 percent approximates interest the producer would have paid to borrow money equivalent to the overcharge amounts. In contrast, the Dallas and Denver regional offices had collected no penalties under Project Pacesetter, and regional officials told us they intended to assess penalties only when they determined that overcharges emanated from negligence or intentional disregard of the regulations.

Under these different approaches, a producer in the Kansas City region that FEA determined had knowingly violated pricing regulations would have been required to refund overcharges and to pay a penalty, whereas a similar violator in the Dallas or Denver regions would have only refunded the overcharges.

We believe that FEA needs consistent criteria for determining when penalties should be assessed against violators of the pricing regulations so that violators are treated equitably, regardless of their geographic location.

CRUDE OIL PRODUCTION OF MAJOR OIL COMPANIES

FEA has not sufficiently audited major oil companies' domestic crude oil production to establish whether these companies are in substantial compliance with crude oil pricing regulations.

FEA has audit teams assigned to the 30 largest refining companies, which account for about 85 percent of domestic refining capacity. Before February 1975 the audits were conducted on a cyclical approach. Under this approach the auditors reviewed refiner transactions applicable to specific periods.

	Transaction during period		Scheduled completion date
	From	To	
Cycle I	May 1, 1973	Jan. 31, 1974	May 31, 1974
Cycle II	Feb. 1, 1974	June 30, 1974	Sept. 30, 1974
Cycle III	July 1, 1974	Sept. 30, 1974	Jan. 31, 1975

Ordinarily two auditors were assigned to each refiner and were responsible for completing a comprehensive, 13-segment audit program covering the major facets of the refiners' operations. One of the 13 segments called for the auditors to determine the validity and accuracy of quantity and cost of domestic crude purchases, including purchases made by a refiner from its own crude oil producing affiliates, shown on monthly reports which the firms submitted to FEA. Verification was to encompass the base month of May 1973 and subsequent months, and representative quantity and cost data were to be traced to supply and payment documents.

In our previously mentioned December 1974 report to you, we pointed out that FEA had not completed the audit work, including the work on domestic crude oil, on the first two cycles, primarily because of the limited manpower assigned to each refiner. We also reviewed the third cycle audit reports on the 30 major refiners to determine the coverage afforded to domestic crude oil transactions.

We found that the audit teams did no audit work at 16 of the 30 refiners. At 13 refiners the audit work done was not sufficient to permit auditors to make an overall assessment of refiners' compliance with crude oil pricing regulations. At the remaining refiner, compliance actions had been initiated on two violations the auditors found. One violation, which involved the erroneous classification of injection wells as producing wells, thus allowing certain leases to be classified as stripper well leases, resulted in overcharges of about $4 million for the period July to November 1973. FEA and the company are negotiating the method by which the company will repay the overcharges. The other violation involved the erroneous calculation of the monthly production of wells during the 1972 base year. FEA has directed the company to recompute the base year production so that the dollar amount of overcharges can be determined.

In February 1975, FEA changed its method of auditing refiners from the cyclical approach to a module approach. Under the module approach, FEA identified 20 distinct aspects of a refiner's operations which could be audited by the audit teams. (See enc. I.) Each of the 30 audit teams was assigned certain modules which were to be given priority attention. The teams were not given deadlines for completing the assigned modules but were to submit reports after work on each module was completed.

Under the domestic crude module, FEA auditors were to verify costs associated with company-owned production (equity crude) as well as purchases from nonaffiliated sources. Cost associated with equity crude can be traced to the ultimate source documents, such as company production records and reports; however, the individual producers maintain the source documents associated with nonaffiliated crude purchases. FEA auditors were not directed to verify source documents in the case of nonaffiliated crude purchases, but they were to insure that invoice costs were accurately recorded by the company.

In June 1975 FEA officials told us that from one to four auditors had been assigned to each refiner. According to FEA officials, 12 of the 30 audit teams were not assigned the domestic crude production module and the remaining 18 teams were assigned the domestic crude oil production module as one of the priority areas. However, as of July 8, 1975, only one audit of domestic crude oil production had been completed under the module approach. The audit covered 1 month of a major refiner's operations, and the auditors concluded that the company was properly handling costs attributable to domestic crude oil purchases. Regional officials told us that the auditors assigned to the 18 companies whose domestic crude production were to be audited were responsible for reviewing from 1 to 10 additional audit modules. With only from one to four auditors available at each major refiner to work on a number of audit modules in addition to the domestic crude production module, it is highly unlikely that any of the modules can receive adequate attention.

CONCLUSIONS

Although crude oil price controls initially expired on August 31, 1975, FEA officials have publicly stated that FEA is committed to completing its audits of the petroleum industry for transactions occurring during the period price controls were in effect. Furthermore, the President signed legislation on September 29, 1975, reinstating the price controls until November 15, 1975. We believe FEA must strengthen and improve its audits of crude oil producers in order to provide adequate assurance that producers are in substantial compliance with crude pricing regulations.

We proposed that FEA:

--Intensify the coverage afforded production operations of major oil companies.

--Expedite efforts to identify and disseminate to the regional offices the names of independent producers that are, according to reports submitted to FEA, most likely to be in violation of pricing regulations.

--Insure implementation of a uniform policy regarding penalties which should be sought and collected from producers that are determined to be in violation of FEA pricing regulations.

FEA COMMENTS

On September 2 we met with officials of FEA's Office of General Counsel and Office of Regulatory Programs to discuss our report and to obtain their comments. FEA officials agreed with our report and its findings and said that they had initiated changes which should improve the program for auditing domestic crude oil producers.

The officials pointed out that on August 12, 1975, FEA's General Counsel and Assistant Administrator for Regulatory Programs issued a joint memorandum to all Regional Administrators setting forth FEA's policy on civil penalties. The memorandum pointed out that willful violations are subject to criminal action. It stated that a civil penalty should be sought in all cases where the violation appears to have been more than the product of an honest mistake, but not a willful action. The memorandum sets forth the following examples of instances in which a civil penalty is warranted:

1. Violation of a simple, clear regulation.

2. Violation of a complex but nevertheless well-known provision of the regulations with respect to which FEA has provided the industry with such guidance.

3. Repeating, even if inadvertently, a practice which the party was previously notified by FEA constitutes a violation.

4. Failure to prepare adequate records and otherwise failing to take reasonable precautions that would prevent inadvertent violations.

5. A violation believed to have been willful but with respect to which there is insufficient evidence to support a criminal prosecution.

The officials believe the policy statement will result in a more consistent assessment of penalties against violators of crude pricing regulations.

The number of auditors assigned to the largest refiners was increased, so that generally from two to eight auditors will be assigned to each of the refiners. The additional manpower will permit

more effort to be placed on the domestic crude oil module. In addition, on September 10, 1975, the Acting Associate Assistant Administrator for Compliance, Regulatory Programs approved a revised staffing plan under which about 30 of the 93 auditors currently assigned to Project Producer will be transferred to the Refinery Audit and Review Program to assist in completing the crude oil production module at large refiners. FEA intends--through the use of stratified sampling techniques--to complete its audits of the domestic crude production module by December 31, 1975. These audits will include verification of costs associated with equity production. Verification of nonaffiliated crude production will be made under Project Producer.

Also, the Office of General Counsel issued two rulings dated August 29, 1975, which should clarify certain regulatory questions which have impeded completion of several producer investications. One ruling clarified the manner in which the average daily production of a well should be calculated when crude production has been curtailed and the other ruling clarified how a property is defined for purposes of computing base-period monthly production.

On August 29, 1975, FEA also issued an amendment to the crude pricing regulations which states that lease condensates (or certain liquids produced from oil and gas wells) are included in the definition of crude oil and that liquid condensates produced from gas wells are not eligible for the stripper oil exemption.

FEA is still in the process of selecting additional independent producers for audit under Project Producer. According to FEA officials, they have experienced many delays in receiving copies of the monthly reports because other FEA organizational elements have been entering the data on the monthly reports into a computer system. FEA has now received a major portion of the monthly reports and plans to select additional incependent producers for audit by late September 1975.

Sincerely yours,

for Phillip S. Hughes
Assistant Comptroller General
of the United States

REFINERY AUDIT AND REVIEW PROGRAM

1. Desk Review of Company Monthly Reports Supporting Schedules
2. Review of Company Procedures
3. Domestic Crude
4. Imported Crude/Transfer Pricing
5. Transportation/Marine and Pipeline
6. Purchased Products
7. Cost Recovery
8. Refinery Balance Incentive
9. Class of Purchaser/Discounts
10. Octane Ratings
11. Residual Fuel--Public Utilities
12. Profits
13. Non-Product Costs
14. Pricing
15. Entitlements
16. Complaints
17. Allocation Sales Calculations
18. Customary Business Practices (Credit Cards, Lease Cancellations, etc.)
19. Reseller Crude Sales Calculations
20. Special Projects