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The Honorable Edward M. Kennedy  
Chairman, Subcommittee on Administrative  
Practice and Procedure  
Committee on the Judiciary  
United States Senate

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Dear Mr. Chairman:

Your letter of May 17, 1975, requested that we indicate the major problems in developing, implementing, and enforcing the Federal Energy Administration's (FEA's) regulation of the price of natural gas liquids (NGLs), such as propane, butane, and natural gasoline. We examined program documents and industry comments on proposed regulatory changes, and we interviewed officials at FEA Headquarters in Washington, D.C., and the FEA regional office in Dallas, Texas.

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The natural gas liquid industry is a large, extremely complex portion of the energy industry. Propane alone is produced in over 750 gas processing plants and 250 refineries across the country. Various processes are used to produce NGLs, and the processing plants operate under differing contractual arrangements involving producers, transporters, and plant owners. The agreements concerning the ownership and operation of NGL plants are complex and sometimes involve numerous participants.

The Emergency Petroleum Allocation Act of 1973 (Public Law 93-159) and the Federal Energy Administration Act of 1974 (Public Law 93-275) direct FEA to regulate and control industry pricing of at least two NGLs--butane and propane. However, the legislation was not specific and FEA price regulations were poorly-suited for application to NGL plants. As a result, there was considerable confusion within the industry. FEA did not implement a meaningful compliance and enforcement program; however, they indicated that many processors were either unaware that the price regulations applied to their sales activities or unsure as to the effect of the regulations on the prices which could legally be charged for their products.

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In January 1975 FEA implemented regulations tailored specifically to NGL plants and in August 1975 FEA took action to apply the same regulations retrospectively. Because of the numerous requests and inquiries about the appropriate interpretation and application of these regulations, FEA proposed amendments to include provisions inadvertently omitted and to adapt them more specifically to gas plant operations. Also, FEA has recently started some limited compliance audits of gas processors. FEA officials acknowledged that, although the pricing of NGLs was one of the most difficult regulatory questions FEA faced, the solution took longer than necessary.

#### BACKGROUND

NGLs primarily encompass propane, butane, and natural gasoline or mixtures of these and other hydrocarbon liquids. NGLs are byproducts of two different types of manufacturing plants--the gas processing plant and the crude oil refinery. The gas processing plants account for about 70 to 75 percent of domestic NGL production.

Gas processing plants process wet or rich streams of natural gas. A wet or rich gas stream is usually one which is potentially economical to process for its liquid content. The natural gas remaining after processing is termed residue gas. Gas processing plants extract liquids from the wet gas and, by further processing, separate the liquids into the various NGL products.

By extracting the liquids from the raw gas stream, the volume and British thermal unit (Btu) content of the natural gas is reduced. This reduction is referred to as shrinkage.

The other manufacturing plant which produces NGLs as a byproduct is the crude oil refinery. The NGL output of a refinery constitutes a small percentage of total refinery products.

The different types of NGLs serve various markets. The largest market for butane is its use as a refinery blending stock for gasoline. Butane also is used as a fuel for residential and commercial application and as a refinery feedstock. Propane is used as a fuel for residential and commercial applications and also to a lesser degree, for a refinery feedstock. Natural gasoline, with some further processing, is used as gasoline.

#### FEA STATUTORY RESPONSIBILITIES OVER NGLs

Both the Federal Energy Administration Act of 1974 and the Emergency Petroleum Allocation Act of 1973 charge FEA with the responsibility for

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regulating and controlling refined petroleum products which were defined in the latter act to include propane and butane.

FEA has contended, for regulatory purposes, that all types of natural gas processors are refiners and are, therefore, within the scope of the petroleum price control program. In November 1973 the Cost of Living Council<sup>1</sup> first determined that NGLs extracted from natural gas were subject to the phase IV petroleum regulations. Phase IV price controls were continued in essentially their initial form and were in effect when the Congress on November 27, 1973, enacted the Emergency Petroleum Allocation Act of 1973 under which FEA now administers the price control regulations. 765

Section 4(b)(1)(A) and (C) of the Emergency Petroleum Allocation Act of 1973 states that allocation regulations shall provide for the protection of public health, safety, and welfare (including maintenance of residential heating, such as homes and apartments); the national defense; and maintenance of agricultural operations. Section 4(b)(2)(A) and (B) of the same act provides:

"In specifying prices\*\*\*such regulations shall provide for--(A) a dollar-for-dollar passthrough of net increases in the cost of crude oil, residual fuel oil, and refined petroleum products [which include butane and propane] to all marketers or distributors at the retail level; and (B) the use of the same date in the computation of markup, margin, and posted price for all marketers or distributors of crude oil, residual fuel oil and refined petroleum products at all levels of marketing and distribution."

The Federal Energy Administration Act of 1974 specifically directed the Administrator of FEA to provide, by rule, for equitable allocation of all component costs of producing propane gas. Section 5(b)(11) of the act states in part that,

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<sup>1</sup>Responsibility for the administration of the petroleum pricing regulations was first placed with the Cost of Living Council (CLC) until transferred to the Federal Energy Office on December 26, 1973. On April 30, 1974, the CLC statutory authority expired, but the agency was extended by Executive order to June 30, 1974. On June 27, 1974, legislation establishing the FEA--FEO's successor agency--became effective.

"Such rules may require that (a) only those costs directly related to the production of propane may be allocated by any producer to such gas for purposes of establishing any price for propane, and (b) prices for propane shall be based on the prices for propane in effect on May 15, 1973."

The wording of the above acts apparently resulted in FEA experiencing difficulties in interpreting the intent of the acts. More specifically, the use of "shall" in the former and "may" in the latter excerpt resulted in interpretive problems. The following excerpt from a November 20, 1974, FEA study on the pricing of NGLs illustrates the difficulty encountered by FEA in attempting to cope with the law:

"Although a price control mechanism based on price increases determined by a mechanism other than cost would not follow the suggestions of the second sentence of Section 5(b)(11), FEA is not required by law to adopt these suggestions since the language of the Act is permissive ('Such rules may require ...'). However, a somewhat greater problem is posed by the first sentence of Section 5(b)(11). The Administrator 'Shall ... in administering any pricing authority, provide by rule for equitable allocation of all component costs of producing propane gas.' (emphasis added) Although it may be argued that this language requires FEA to structure its price control mechanism on the basis of cost, the meaning of the above underlined phrase is far from clear. Neither the Act itself nor the conference report offers any enlightenment on the matter.

"It is a general rule of statutory construction that a specific provision takes precedence over the general provision. The reference to propane in Section 5(b)(11) is specific, and the mandates to promote price stability and minimize economic dislocation are quite general.

"However, the meaning of Section 5(b)(11) is very unclear."

Thus, FEA encountered basic difficulties in attempting to regulate NGLs.

DEVELOPMENT OF SPECIFIC GAS  
PLANT REGULATIONS

FEA has contended that natural gas processors have been subject to the rules which apply to crude oil refineries. It was never made clear, however, how the price rules, which did not specifically address the activities of such producers and processors, should be construed so as to apply to them. At the same time, FEA officials admit that the refiner price rules were not suited for regulating the price of NGLs produced from natural gas by gas processors. See appendix I for a chronology of dates and FEA actions.

Refiner price rules

The refiner price rules permit crude oil refineries to pass through their increased crude oil product costs by increasing their product prices above May 15, 1973, base prices. Under these rules, natural gas processors did not have an increased cost of crude oil to pass through since they refine natural gas and not crude oil. The application of the refiner price rules to gas plants would have limited the processors to essentially their May 15, 1973, prices.

In May 1974 the Director of FEO's Refinery Audit Review Program (RARP) proposed that separate regulations for gas plants be adopted. An analysis further supporting the need for separate regulations was completed in July 1974.

New regulations proposed

In September 1974 FEA issued a Notice of Proposed Regulations designed specifically to regulate gas plant operations and the pricing of NGLs. FEA held public hearings and received written comments regarding the proposed regulations.

In the proposed regulations FEA stated that the refiner price rules were not suited for regulating NGLs and that application of the rules would limit lawful NGL prices to their May 15, 1973, levels. The thrust of the proposed regulations was to provide for methods of increasing NGL prices above the May 15, 1973, level.

Among the concerns expressed by FEA in the proposed regulations were the following:

- A short supply could develop from prices that are too low because it would no longer be economical to extract the liquids from natural gas.
- If prices from propane are too low in relation to other fuels derived exclusively from crude oil, excessive demand for propane would very likely result, especially from segments of the market which have not previously been using propane.
- The current rules limit maximum lawful prices for propane produced from natural gas to essentially their May 15, 1973, prices, but permit propane produced from crude oil to be priced at higher levels which reflect the increased cost of crude oil. As a result, there are sharp differences in maximum lawful prices for propane.

A prime example of price disparity was evident in the sale of propane. According to an FEA official, prices charged for this product ranged from 5 to 28 cents a gallon.

#### Industry comments

FEA received over 150 responses to the proposed regulations. Many industry responses to the proposed regulations stated that NGL price increases were especially necessary for propane--an essential fuel. The basic thrust of the industry's comments was that NGL price increases were necessary to avoid shortages of these products. Some responses indicated that if prices were fixed too low the processors would limit the extraction operations and leave the propane and liquids in the natural gas stream, thereby reducing supply needed by the domestic, agricultural, industrial, and commercial sectors.

#### New regulations implemented

As a result of the above process and of the industry's comments on the need for increased prices, subpart K of 10 C.F.R. Part 212, governing gas processors and NGLs, was adopted.

The basic elements of the new regulations included

- establishing adjusted base prices for propane, butane, and natural gasoline to be applied in determining allowable price and cost increases;

- providing for allowable nonproduct cost increases limited to a maximum of one-half a cent a gallon; and
- providing for an allowable increased product cost composed of the increase in the price of the residue gas above the May 1973 price, proportionately assigned to the liquids removed from the gas stream (shrinkage).

The cost of shrinkage<sup>1</sup>, according to FEA, is the reduction in sales revenue received from the natural gas because of the reduced volume and B.t.u. content of the gas after processing.

The new regulations became effective January 1, 1975. The time from inception of the petroleum price regulations, August 1973, through December 31, 1974, was ignored. FEA's limited audit work showed that during this period, the gas plant operators under audit significantly increased NGL prices.

After internal deliberation, FEA issued Ruling 1975-6 on May 29, 1975, to explain how the period before January 1, 1975, would be handled. Specifically, the ruling stated that increased costs of natural gas shrinkage could be passed through as increased product costs pursuant to the refiner price rules. In addition, the ruling more clearly described the application of the refiner price rules in determining NGL prices before the January 1, 1975, effective date of the new regulations.

In his statement before the Subcommittee on Administrative Practice and Procedure, Committee on the Judiciary, United States Senate, on June 19, 1975, the Administrator of FEA acknowledged that it had taken too long to deal with the NGL problem, but said that the press of other matters unduly delayed FEA response. The Administrator added that:

"The principal reason for taking this action was to put NGL processors on an equal footing with their refiner competitors. Rigid application of the refiners' rules would have meant that NGL processors would be held to May 15, 1973, selling prices, which in some cases were as low as three or four cents per gallon, while their refiner competitors were allowed to increase their prices to reflect the increased cost of crude oil."

<sup>1</sup>On December 5, 1975, FEA issued a ruling regarding the computation of natural gas shrinkage.

On August 29, 1975, FEA granted exception relief to all firms, other than resellers and retailers, who sold NGLs or NGL products from August 19, 1973, through December 31, 1974, to the extent that these products were produced in gas processing plants. The exception permitted the regulations effective January 1, 1975, to be applied retroactively. Specifically, to determine their maximum selling prices for these products, firms were permitted to

- use the adjusted May 15, 1973, selling price specified in the January 1, 1975, regulations;
- recover nonproduct cost increases which the members of the class actually experienced in 1974 up to \$.0025 a gallon; and
- disregard certain regulatory provisions otherwise applicable to members of the class.

#### Proposed amendments

Since the promulgation of the January 1, 1975, NGL regulations, FEA received numerous requests and inquiries as to the appropriate interpretation and method of application of the regulations. The inquiries made apparent the need for certain changes in the NGL regulations to include provisions which were inadvertently omitted and to adopt the existing provisions more specifically to gas plant operators. With this in mind, on October 21, 1975, FEA proposed several specific amendments to the January 1, 1975, NGL regulations. As of February 2, 1976, proposals were still under consideration, but if adopted will affect the same price policy reflected in the original regulations and will be effective as of January 1, 1975.

#### POTENTIAL PRICE VIOLATIONS

Gas processors did not comply with the refiner price rules even though FEA maintained that they were subject to the refiner price regulations. FEA did not enforce the regulations because they did not address the gas processing industries' method of operation. According to FEA, enforcement of the refiner price rules would have placed a financial hardship on the industry because virtually all gas processors were in violation beginning with the latter half of 1973 and continuing throughout 1974. Although FEA does not have estimates of total potential violations at the gas processor level through application of the refiner price rules, the magnitude would have been substantial.

The enactment of the January 1, 1975, regulations and the decision to apply them retroactively decreased the dollar amount of the potential violations. According to an FEA official, however, potential violations are still substantial and could total \$100 to \$300 million. FEA recently issued an audit plan for NGL producers and initiated investigations of 21 small producers. According to an FEA official, these producers under investigation account for about 4 percent of the domestic NGL production. None of these audits has been completed.

Since the enactment of specific gas plant regulations, two major petroleum companies and one other refining company have challenged FEA's authority to regulate NGLs. The companies have separately filed suits against FEA and, in brief, contend that FEA does not have legislative authority to regulate NGLs. The companies seek declaratory and injunctive relief against FEA's enforcement of its regulations to NGLs.

We hope that the foregoing information will be helpful to you.

Sincerely yours,

Phillip S. Hughes  
Assistant Comptroller General

## APPENDIX I

CHRONOLOGY OF FEA'S REGULATION OF NGLs

<u>Time frame</u>	<u>FEA action</u>
August 1973	Refiner price rules applicable to gas processing plants.
Early 1974 (Jan. to Apr.)	Aware of inadequacy of refiner price rules as related to gas processors and NGLs.
May 1974	Director of RARP proposed development of separate regulations for gas processors.
September 1974	Proposed regulations published for hearings and written comment.
January 1975	New regulations (subpart K of 10 C.F.R. Part 212) adopted applicable to gas processors and NGLs.
May 1975	Ruling 1975-6 issued regarding treatment of gas processors and NGLs prior to January, 1975.
August 1975	Granted exception to firms selling NGLs between August 19, 1973, and December 31, 1974; January 1975 regulations were applied retroactively.
September 1975	Initiation of compliance audits of gas processors based on January 1975 regulations, ruling 1975-6, and class exception.
October 1975	Amendments proposed to regulations dealing with first sale price, base price, and increased product costs.
December 1975	Ruling 1975-18 issued regarding computation of natural gas shrinkage.

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