



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

110794

ENERGY AND MINERALS
DIVISION

NOVEMBER 6, 1979

B-178205

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



110794

AGD 1452

Dear Mr. Curtis:

Subject: [Review of FERC's control over interstate
gas supplies] (EMD-80-5)

AGC
002

Although the Natural Gas Policy Act of 1978 (NGPA) was recently passed, natural gas in interstate commerce prior to November 8, 1978, remains, for the most part, subject to regulation under the Natural Gas Act of 1938 (NGA). While the new act makes major changes in the regulation of natural gas supplies, that gas which was flowing in interstate commerce prior to the new act's passage generally remains dedicated to the interstate market unless an abandonment authorization is approved by the Commission. Accordingly, the Federal Energy Regulatory Commission (FERC) (formerly the Federal Power Commission) 1/ has a continuing responsibility for ensuring that these supplies are sold in interstate commerce. This responsibility includes the approval or disapproval of producer requests to abandon interstate natural gas sales.

Because of the possible unauthorized diversion of these dedicated supplies to more profitable markets, we reviewed the Commission's control over interstate natural gas supplies. The review showed that (1) natural gas has been diverted from interstate commerce to more profitable intrastate markets, (2) interstate sources of natural gas have been abandoned without Federal Power Commission (FPC) or FERC approval, (3) procedures for detecting abandonments and diversions, which were non-existent under FPC, have only recently been addressed by FERC and need strengthening, and (4) authority to assess civil penalties against violators is needed.

1/The Federal Energy Regulatory Commission replaced the Federal Power Commission in September 1977, upon passage of the Department of Energy Organization Act, which created the Department of Energy.

007716

(308400)

The extent to which natural gas supplies have been diverted is extremely difficult to ascertain; however, potential and actual diversions brought to the attention of the Commission by purchasers and producers during the past 5 years totals an estimated 663 billion cubic feet. Of this estimate, 218 billion cubic feet has been, or is being, repaid. The other 445 billion cubic feet is either yet to be ruled upon by the Commission, or the initial determination is being appealed.

The practical effects of such diversions may well be found in recent instances of natural gas supply shortages. For example, a shortfall of natural gas during the 1976/1977 winter--one of the Nation's most severe--of 43.6 billion cubic feet was attributable to supply problems in the interstate market. Such shortfalls have resulted in school closings, industrial shutdowns, and various socio-economic hardships. Although diversions were not the only factor, they likely played a contributing role.

SCOPE OF REVIEW

We conducted our review at FERC Headquarters in Washington, D.C., and two companies involved in the production and sale of natural gas in Oklahoma--Phillips Petroleum Company, Bartlesville, Oklahoma, and Kerr-McGee Corporation, Oklahoma City, Oklahoma. We examined sales contracts between producers and purchasers and compared the current status of dedicated natural gas sources with records of filings with the Commission. We discussed the availability and use of existing procedures for detecting unauthorized abandonments and diversions with Commission officials. In addition, we examined numerous rate schedules and Commission decisions concerning disposition of past Natural Gas Act violations.

We discussed our findings with FERC Headquarters officials whose comments have been recognized in this report. We also discussed the results of our work at the two companies with responsible company officials.

NEED FOR A RELIABLE MONITORING SYSTEM

Although the Commission (FPC and later FERC) has for years had the legislative responsibility for overseeing interstate supplies, it has not effectively policed the movement of interstate natural gas. Rather than having

its own policing activity, the Commission has essentially relied on the interstate natural gas pipeline companies to assure that interstate supplies are actually marketed in interstate commerce. The rationale for relying upon the pipelines is that diverted gas reduces the supply available to the interstate pipelines, thereby impairing their marketing capability. Accordingly, it was assumed that the pipeline companies would report violators to the Commission. While this reliance has resulted in the identification of some violations, a policy of relying on industry to police itself, is in our opinion, ineffective and unreliable because

--the pipeline companies themselves may divert supplies,

--the pipeline companies may elect not to report violations by producers since they are dependent upon the producers for supplying their product and the reporting of violations may impair their ability to obtain future supplies, and

--some producers may be affiliates of the pipeline companies or vice versa.

While FPC efforts to monitor interstate supplies were generally non-existent, FERC has attempted to improve its monitoring by creating an Office of Enforcement. The efforts of this office however, are severely hampered by a lack of information on the location of natural gas supplies committed to interstate commerce. Although the identity of interstate sources of natural gas is, for the most part, provided to the Commission, the Commission does not have a cumulative updated listing which identifies those sources currently dedicated to interstate commerce. It is therefore difficult to identify that gas which is dedicated to interstate markets versus that gas which can be legally sold elsewhere.

For example, a natural gas field will generally have numerous wells which are owned by several different producers. Those producers electing to market their gas in interstate commerce were required to file with the Commission for approval. Each filing received a Docket Number which became the official record of filing. Over a period of years numerous filings were made as additional wells are drilled

by the various producers. Composite listings of each producers' dedications, however, were never maintained. As a result, it is now necessary to research every filing by a producer to determine what is dedicated or what may have been removed from dedication through abandonment. This practice is time consuming, costly, and impractical.

The lack of an effective system for identifying dedicated sources of interstate gas is further complicated by the fact that required producer filings are frequently not made and often go undetected. The fact that timely abandonment filings are sometimes not made was clearly demonstrated at the Kerr-McGee Corporation. Although required to obtain Commission authorization prior to abandonment, the company had abandoned several wells without FERC's knowledge because abandonment filings had not been made. In fact, eight wells had been abandoned for 5 years or more, but requests for abandonment authority were yet to be filed.

In our opinion, FERC cannot accomplish its mission of controlling interstate supplies until dedicated sources of interstate gas are readily identifiable and effective procedures are in place for assuring that appropriate and timely filings are made. Accordingly, we believe that the Commission needs to develop audit procedures for investigating compliance with the act. We believe the audits would not only help in detecting diversions, but would also act as an incentive for producers to make appropriate and timely filings.

When questioned about the possibility of producer audits, FERC officials stated that producer audits would involve an enormous undertaking in manpower and other resources and that the practicality of such a program is highly questionable. We agree that audits of every producer on a continuing basis are not feasible. However, we believe that it is quite practical to audit a sampling of companies, especially those companies which may have past records of non-compliance. In this regard, FERC officials told us that one of the functions of FERC's Division of NGPA Compliance is to routinely conduct field audits to review rates being collected for both interstate and intrastate sales and to verify contractual entitlement to the rates being collected. They suggested that perhaps such audits of interstate sales could include a review of company compliance with NGA requirements, including dedicated acreage. We

believe this suggestion has merit and should be given strong consideration in FERC's overall audit responsibility.

NEED TO IMPROVE
ENFORCEMENT EFFORTS

We found that FPC had historically not sought criminal penalties against violators as provided by the act but rather had implemented a policy requiring the repayment of diverted supplies. FERC has been more aggressive in its enforcement efforts and has recently referred two gas diversion cases to the Justice Department which have resulted in criminal convictions. We believe these recent actions represent a significant improvement in enforcement activities, but further improvements are needed.

We also found that the Natural Gas Act of 1938 does not contain authority for assessing civil penalties, such as monetary fines, for violations of the act. Such authority is needed so that FERC has greater latitude in carrying out its enforcement responsibilities. FERC has recognized the need for such authority. In responding to a question posed by its congressional oversight house subcommittee concerning the adequacy of FERC's remedial powers, the Chairman, FERC, in a letter dated March 31, 1978, said that it would be helpful if more substantial civil penalties could be imposed under the Natural Gas Act. However, such authority was never formally requested.

Past Enforcement Efforts
Were Inadequate

The fact that FPC did not penalize violators is illustrated by a 1976 case in which 78 violations of the act were identified. Although many of the violations were technical in nature, other very serious violations were identified including the diversion of natural gas from interstate to intrastate markets, the abandonment of interstate sales without Commission approval, and the marketing of gas in interstate commerce without Commission authorization. Although identified as having a historical record of violations, the FPC did not seek criminal penalties against the producer. The producers involved in these violations were other than the companies we visited.

Rather than seeking criminal penalties, the FPC felt that the public interest is better served by the adoption

and implementation of a settlement that resulted in the repayment of diverted supplies. Such action, the Commission asserted, constituted an effective set of sanctions. We disagreed. The repayment of equal volumes merely represents a restoration of that which rightfully belonged to the interstate users all along. Repayment does not serve as a sanction, nor does it provide a deterrent to future violations. Violators who divert gas receive the benefit of higher prices and increased profits with little, if any, risk of facing the full consequences of these violations, even if detected.

Recent Enforcement
Activities Have Improved

Upon completion of our evaluation, FERC advised us that the Office of Enforcement had recently referred two natural gas diversion cases to the Department of Justice which have since resulted in convictions. Although these diversions were not discovered by FERC, but rather came to light in the course of certificate proceedings, we believe the seeking of criminal penalties to be a vast improvement over past Commission actions. Also, we were told that the Office of Enforcement is increasing its activity in the gas diversion area and that other cases involving diversion issues are under investigation. However, our discussions with the enforcement staff indicated that their efforts continue to be spent on reviewing past regulatory cases and that audits of companies to detect diversions are not being made.

We also believe that FERC should formally seek authority to assess civil penalties under the NGA to provide it with the latitude it needs to assess penalties that are more commensurate with the violations.

CONCLUSIONS AND RECOMMENDATIONS

Although FERC has made some improvements, further improvement is necessary if the Commission is to have suitable oversight for assuring the integrity of interstate supplies. Producer dedications cannot readily be determined, audits of producer operations under the NGA are not made, and violations of the act appear to go undetected unless voluntarily reported.

We believe that the Commission should take a more active role to ensure compliance with the Commission's regulations

and legislative responsibilities. Accordingly, we recommend that the Commission:

- Prepare a listing of selected producer filings which identify natural gas dedicated to the interstate market. The producers selected could be coordinated with plans for conducting NGPA field audits.
- Develop audit procedures for the purpose of detecting unauthorized abandonments and diversions.
- Establish and implement an audit program to ensure that dedicated supplies are delivered as prescribed and that appropriate and timely filings are made.
- Continue the recent use of available criminal penalties as appropriate.
- Formally seek enabling legislation from the Congress for assessing civil penalties which will increase the Commission's latitude in carrying out their enforcement responsibilities under the Natural Gas Act.

— — — —

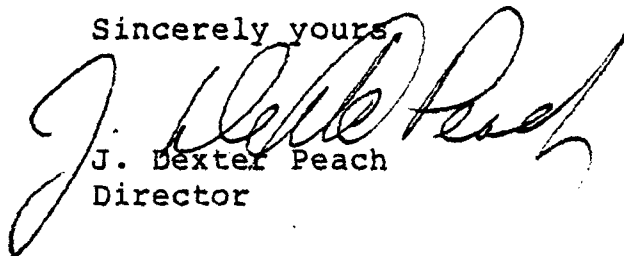
As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations no later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

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

B-178205

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

Sincerely yours,

A handwritten signature in cursive script, appearing to read "J. Dexter Peach". The signature is written in black ink and is positioned above the typed name and title.

J. Dexter Peach
Director