DOCUMENT RESUME

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[Potential Savings through Purchase of Royalty Oil for Strategic Petroleum Reserve]. EMD-79-1; B-178205. October 6, 1978. 6 pp.

Report to Secretary, Department of Energy; by J. Dexter Peach, Director, Energy and Minerals Div.

Issue Area: Energy: Role of Fossil Fuels in Meeting Future Needs (1609).
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Authority: Energy Policy and Conservation Act of 1975 (P.L. 94-163).

A 1977 report to the Congress stated that oil produced from Outer Continental Shelf and onshore Federal leases--on which royalties are paid--could be purchased for the strategic petroleum reserve at substantial savings to the Government. Department of Interior officials calculated that, based on May 1978 crude oil prices, royalty oil would be $3.01 a barrel less than the national average composite price. Total savings that could result from buying royalty oil for the reserve could be significant, especially if current price differences and price controls remain. The Office of Strategic Petroleum Reserve cited three potential problems associated with purchasing royalty oil: an additional administrative burden to the Federal Government, unsuitability for reserve storage, and passing on some of the cost to oil users rather than taxpayers. To minimize the cost to the Federal Government of the strategic petroleum reserve, the Secretary of Energy should purchase all suitable royalty oil for storage in the reserve. (RRS)

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

ENERGY AND MINERALS
DIVISION

B-178205

OCT 6 1978

The Honorable
The Secretary of Energy

Dear Mr. Secretary:

Our Office has studied and reported on various aspects of the oil purchase policy being followed for the strategic petroleum reserve (reserve). In February 1977 we issued a report 1/ to the Congress which stated that oil produced from Outer Continental Shelf and onshore Federal leases--on which royalties are paid--could be purchased for the reserve at substantial savings to the Government. The Federal Energy Administration, which was responsible at that time for developing the reserve, considered buying royalty oil for storage but concluded that it would adversely impact financially on small refiners that relied on royalty oil.

In a July 6, 1978, letter to the head of your Office of Strategic Petroleum Reserve, we asked for comments on the potential savings available if the Government purchased the royalty oil that is not sold to small refiners. The response of July 24, 1978, was that the difficulties of purchasing royalty oil for the reserve outweighed the potential savings. We would like, in this letter, to elaborate on this issue because we believe that the savings are very significant even in view of the difficulties that they may entail.

BACKGROUND

To diminish U.S. vulnerability to the effects of a severe interruption in energy supplies, the Energy Policy and Conservation Act (Public Law 94-163) required the creation of a strategic petroleum reserve. In December 1976 the Federal Energy

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1/"Issues Needing Attention In Developing The Strategic Petroleum Reserve," EMD-77-20, February 16, 1977.

EMD-79-1
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Administration submitted to the Congress a plan which stated that the reserve would contain 500 million barrels of oil by December 1982. The Department of Energy accelerated the reserve schedule by 2 years and undertook to store 500 million barrels of oil by the end of 1980. The Department now plans to store 1 billion barrels by the end of 1985. While the Department has not yet estimated the cost to store 1 billion barrels, it has estimated the cost to store 750 million barrels at $14.4 billion.

Oil for the reserve will be stored in salt caverns and in mines. Thus far, the Department has acquired four storage sites in Texas and Louisiana near the Gulf Coast.

The Department is required by the Energy Policy and Conservation Act to acquire crude oil for the reserve in a way which minimizes cost. The act also authorizes purchase of royalty oil for the reserve. But the Department's plan is to acquire, through its entitlements program 1/, all crude oil needed for the reserve on the open market at a price near the national average composite price.

THE POTENTIAL SAVINGS

The Department of the Interior collects royalties, in money and in kind, i.e., as oil and natural gas, from oil produced on leased Federal onshore lands and from the Outer Continental Shelf. Interior has been selling all of the royalty oil taken in kind to small refiners. According to Interior, in calendar year 1977 royalty oil production was 69.2 million barrels of which 40.4 million barrels or 58.4 percent was taken by the Federal Government and sold to small refiners. The Federal Government received cash for the remaining 28.8 million barrels or 41.6 percent. Interior expects very little change in these relative percentages in the near future.

Department officials calculated that based on May 1978 crude oil prices, royalty oil would be $3.01 a barrel less than the national average composite price. Total savings that could result from buying royalty oil for the reserve

1/Entitlements permit refiners to share the benefits associated with access to price controlled crude oil. The Department issues each refiner enough entitlements to permit it to process the national average ratio of price controlled oil to total crude oil purchased. In purchasing crude oil for the reserve, the Department considers itself a refiner.

could be very significant, especially if current price differences and price controls remain. For example, in our July 1978 letter, we calculated that 24 million barrels of royalty oil would not be sold to small refiners in the August 1978-July 1979 time frame. This amount could be acquired for the reserve at a $72 million savings to the Federal Government. Because DOE plans to purchase oil for the reserve through 1985, additional savings of over $400 million 1/ could be possible.

THE PERCEIVED PROBLEMS

In its July 24 letter to us, the Office of Strategic Petroleum Reserve listed the following three problems associated with purchasing royalty oil.

--Purchasing royalty oil would result in additional administrative burden to the Federal Government.

--Some royalty oil is not suitable for reserve storage.

--Purchasing royalty oil would result in the Department having to pass on some of the cost of the reserve to oil users rather than taxpayers.

Additional administrative burden

The Office of Strategic Petroleum Reserve letter states that additional administrative burden would result from handling numerous leases and transportation arrangements, and from arranging agreements whereby the royalty oil that is not suitable for storage would be exchanged for suitable oil. A Department official, however, told us that no attempt to quantify the additional burden had been made. This official stated that royalty oil production involved over 13,500 leases, which suggests to the Department a large quantity of administrative work.

We then asked Interior officials who administer the royalty oil program if they could estimate the additional administrative burden which would result if the royalty oil not sold to small refiners were acquired for the reserve. They

1/This figure is based on the assumption that there will be approximate annual savings of $72 million during the 1980 -1985 time frame.

estimated the administrative cost to be $700,000 a year --$240,000 a year for offshore leases and $460,000 a year for onshore leases. The estimated annual administrative burden of $700,000 is less than one percent of the estimated potential annual savings resulting from acquiring royalty oil for the reserve.

Suitability of royalty oil

The Office of Strategic Petroleum Reserve letter states simply--without elaboration--that some royalty oil is not suitable for reserve storage. We agree that some royalty oil may not be desirable or suitable for the reserve because of such factors as its quality or geographical location; however, based on other information we have obtained, it appears a large majority of the oil would be suitable. According to a September 1977 report prepared by the Federal Energy Administration, about one-third of royalty oil production not taken in kind comes from the Louisiana offshore, 90 percent of which is low sulfur, light or intermediate gravity which is the type the Department plans to store in the reserve. In addition, we were informed by an Interior official that a major percentage of the remaining royalty oil not taken in kind would also be suitable for reserve storage.

Passing some of the cost of the reserve on to oil users

The Office of Strategic Petroleum Reserve letter states that if royalty oil is purchased for the reserve, the refiners that had been relying on royalty oil would have to buy higher cost, imported oil. Consequently, payment of some reserve costs would be transferred from taxpayers to oil users. We would like to point out that because the Department is now using the entitlements program to purchase oil for the reserve, some of the cost of the reserve is already being passed on to oil users. Although an additional increase in this passed-on cost would result from the Department acquiring royalty oil for the reserve, it would be very minimal, as the following calculations show.

In May 1978 the crude oil entitlement was $1.63 a barrel which represented the difference between the average imported cost and composite refiner acquisition cost of crude oil for May 1978--$14.49 and $12.86 a barrel, respectively. The Department estimates that between August 1978 and July 1979, about 228 million barrels of oil will be placed in the reserve. All of this oil will be the higher priced imported oil;

consequently, during this period, the Department, through use of the entitlements program will pay about $372 million less for this oil. This amount will result in increasing the price of oil by about $0.06 a barrel. 1/ If the Department purchased 24 million barrels of royalty oil for the reserve rather than selling it to small refiners, this amount of lower priced oil would not be used in calculating the entitlements figure. Consequently, the resulting savings to the Federal Government of $72 million would increase the crude oil cost by only $0.01 a barrel. 2/

CONCLUSIONS

The Energy Policy and Conservation Act requires that the cost to the Federal Government of acquiring oil for the strategic petroleum reserve should be minimized. We believe that if the Department purchased royalty oil not sold to refiners for the strategic petroleum reserve, substantial cost savings would result.

While we agree with the Department that acquisition of royalty oil will result in additional administrative burden, this burden, based on estimates by the Department of the Interior, is less than one percent of the estimated potential annual savings resulting from acquiring royalty oil for the reserve. Additionally, although some royalty oil may not be suitable for reserve storage, it appears a large majority of the oil would be suitable. Finally, although it is true that acquisition of royalty oil will transfer some of the reserve cost--$0.01 a barrel--from taxpayers to oil users, $0.06 a barrel is already being transferred to users through use of the entitlements program. Therefore, we believe, the potential savings far outweigh the problems the Department has identified in connection with purchasing royalty oil.

RECOMMENDATION

To minimize the cost to the Federal Government of the strategic petroleum reserve, we recommend that you purchase

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1/This figure was arrived at by dividing $372 million by the total amount of crude oil subject to the entitlements program in 1977--6.570 billion barrels.

2/This figure was arrived at by dividing $72 million by 6.570 billion.

all suitable royalty oil for storage in the strategic petroleum reserve.

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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 not 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 Director, Office of Management and Budget; the Chairmen, House Committees on Appropriations and Government Operations and Senate Committees on Appropriations and Governmental Affairs; and oversight committees for the Department.

Sincerely yours,

J. Dexter Peach
Director