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Fact Sheet for the Chairman, Subcommittee on Fossil and Synthetic Fuels, Committee on Energy and Commerce, House of Representatives

January 1987

NAVAL PETROLEUM RESERVES

Oil Sales Procedures and Prices at Elk Hills, April Through December 1986

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GAO/RCED-87-75FS

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Resources, Community, and
Economic Development Division

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January 29, 1987

The Honorable Philip R. Sharp
Chairman, Subcommittee on Fossil
and Synthetic Fuels
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

At your office's request, we updated the information in our earlier fact sheet, Naval Petroleum Reserves: Sales Procedures and Prices Received for Elk Hills Oil (GAO/RCED-86-163FS, May 9, 1986). Specifically, this fact sheet provides information on oil sales procedures and prices received by the Department of Energy (DOE) for oil sold from the Elk Hills Naval Petroleum Reserve (NPR-1) for the period April through December 1986. The procedures in effect for oil sold between April 1 and September 30, 1986, resulted in oil being sold for as low as $3.91 per barrel.

In light of the information on oil sales prices provided in our previous report, you urged DOE, in a May 12, 1986, letter, to review its sales procedures. On May 15, 1986, you also proposed legislation, ultimately enacted on August 29, 1986 (Public Law 99-413), that limited DOE's authority to sell NPR-1 oil unless certain sales price criteria were met. DOE subsequently revised its procedures in time for the October to December 31, 1986, oil sales period. As a result, DOE received average prices of $13.42, $13.70, and $13.58 per barrel for NPR-1 oil delivered in October, November, and December 1986, respectively, which compared favorably with California oil market prices.

We obtained information on NPR-1 oil sales prices and procedures from DOE documents and discussions with officials at DOE headquarters in Washington, D.C., and the NPR-1 office near Bakersfield, California. We provided DOE program officials with a draft of this fact sheet and discussed its factual accuracy with them. Their comments have been incorporated where appropriate. In accordance with your request, we did not obtain official agency comments.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this fact sheet until 3 days after the date of this letter. At that time, we will provide copies to the Secretary of Energy and other interested parties and will make copies available to others upon request.

If you have any further questions, please contact me on (202) 275-7756. Major contributors to this fact sheet are listed in appendix I.

Sincerely yours,

James Duffus III
Associate Director

BACKGROUND

The Elk Hills Naval Petroleum Reserve (NPR-1), located near Bakersfield, California, ranks seventh among domestic producing oil fields. NPR-1 also produces large quantities of natural gas and natural gas liquids. The U.S. government owns approximately 78 percent of NPR-1, and Chevron, U.S.A., Inc., owns approximately 22 percent. The Department of Energy (DOE) operates the field, but Chevron and the government share production, revenues, and expenses in proportion to their ownership shares.

Between fiscal years 1985 and 1986, DOE reported a decline in revenues generated from the sale of the government's share of crude oil, natural gas, and natural gas liquids as a result of lower petroleum prices and production. In fiscal year 1985, the average daily production rate was over 130,600 barrels of oil; in fiscal year 1986, the rate was about 112,400. Revenues from sales in fiscal year 1985 totaled $1.3 billion and production costs were about $111 million. In fiscal year 1986, revenues from sales totaled about $763 million, while production costs were about $131 million.

Basis for selling NPR-1 oil

NPR-1 was originally established in 1912 to provide a source of liquid fuels for the armed forces during national emergencies. Crude oil production from the field started in 1919 and continued at various levels, reaching a peak of 65,000 barrels per day in 1945. After World War II, NPR-1 production was slowed to the minimum level necessary to prevent damage to the field. Following the Arab oil embargo in 1973-74, the Naval Petroleum Reserves Production Act of 1976 (Public Law 94-258, April 5, 1976) was enacted. This act authorized and directed that NPR-1 be produced at the maximum efficient rate for 6 years.[1] The act further specified that after 6 years the president could extend production in intervals of up to 3 years after certifying that continued production is in the national interest.

In accordance with the act, the president informed the Congress on October 5, 1984, of his certification that it is in the national interest to continue production of NPR-1 at the maximum efficient rate through a second 3-year period ending on April 5, 1988. The act provides that such petroleum shall be used, stored, or sold. When sold, the government's share of petroleum shall be sold at public sale to the highest qualified bidder without regard to federal, state, or local regulations controlling sales of petroleum products.

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[1]The maximum sustainable daily rate that permits economic development and depletion of the reservoir without detriment to ultimate recovery.

NPR-1 crude oil was sold in accordance with DOE procedures in effect for sales made through September 30, 1986. New procedures were developed for sales made after October 1, 1986.

Procedures for selling NPR-1 oil under contracts running through September 30, 1986

The government's share of NPR-1 crude oil production is sold on the open market by competitive bidding as provided for by the Naval Petroleum Reserves Production Act. Under procedures for sales through September 30, 1986, DOE solicited bids from interested parties through an invitation for bid and awarded contracts to the highest responsible bidders until all available oil was sold. On the basis of their perceptions of supply and demand conditions in the oil market during the contract period, prospective buyers submitted bids showing the quantity of oil they would purchase and a per barrel bonus or discount that DOE would apply to an established base price in effect on the date of delivery.

To establish the base price, DOE periodically obtained "Crude Oil Price Schedules" from the major oil companies operating in the central California area. These schedules reflected the "posted" prices the oil companies were willing to pay for oil of a specific type and quality. DOE then computed an average price on the basis of the three highest postings for oil of like quality to oil produced from NPR-1 and nearby fields. This average price, with appropriate adjustments for NPR-1 oil quality, became DOE's crude oil base price for the period covered by the price schedules. DOE's base price, and consequently, the prices paid by the purchasers, fluctuated as the relevant posted prices changed during the contract period.

RESULTS OF NPR-1 OIL SALES FROM APRIL 1, 1986 TO SEPTEMBER 30, 1986

On February 28, 1986, DOE awarded contracts to 16 companies for the sale of about 82,000 barrels per day of NPR-1 crude oil between April 1 and September 30, 1986.[2] These companies bid a record high average discount of $4.49 from DOE's base price. The discounts ranged from $0.87 to $6.98 per barrel. These contracts resulted in DOE selling Elk Hills oil as low as $3.91 per barrel. The range of prices DOE received for NPR-1 oil is shown in table 1.

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[2] One company later defaulted, and the number was reduced to 15.

Table 1

Prices Received for NPR-1 Oil

Month	Range of prices received High	Low
April	$11.27	$6.25
May	10.68	6.23
June	10.60	5.98
July	10.43	4.59
August	9.69	3.91
September	10.47	5.57

Source: DOE Revenue Accounting Office, NPR-1.

The NPR-1 oil prices were largely influenced by the situation that existed in the California oil market. Oil prices in the spot market, for example, began to decline in late November 1985, but the posted prices in California lagged behind this decline until early February 1986. From October 1985 through the first week in February 1986, posted prices had remained fairly stable, ranging from $24.88 to $24.95 per barrel. Bids for the April 1 to September 30, 1986, contract period submitted to DOE in late January 1986 were made on the basis of January posted prices with the discounts offered reflecting the disparity between posted prices and spot market prices.

DOE and industry officials stated that the unprecedented discounts were offered in an attempt to minimize or eliminate the differential between the postings and spot prices and reflected the buyers' perceptions of the uncertainties in future oil prices. However, the subsequent decline in posted prices resulted in DOE's base price for NPR-1 oil dropping from $23.51 on February 10, 1986, to $14.47 on April 3, 1986. Since then, DOE's base price has gone as low as $10.41; at the end of September, it had gone back up to $13.05.

RESULTS OF BONUS/DISCOUNT BIDDING PROCEDURE

DOE's bonus/discount bidding procedure to sell NPR-1 oil resulted in net bonuses to the government of about $272 million. Between July 1, 1976, and September 30, 1986, DOE received about $349 million in bonuses over the prices posted in the NPR-1 area during 10 of DOE's oil sale contract periods. For four contract periods, DOE sold oil at discounts from the posted prices that amounted to about $77 million. The 6-month contract period ending September 30, 1986, accounted for about $57 million of the $77 million in discounts.

CHANGES TO PROCEDURES FOR SELLING NPR-1 OIL AFTER OCTOBER 1, 1986

On May 12, 1986, the Chairman, Subcommittee on Fossil and Synthetic Fuels, House Committee on Energy and Commerce, sent our May 1986 report to the Secretary of Energy, urging him to assess how DOE's bidding procedures for selling NPR-1 oil could be changed in light of the rapidly changing oil market.[3] In addition, on May 15, 1986, the Chairman, along with nine other members, introduced legislation that prohibited the sale of NPR petroleum at a price less than the higher of 90 percent of the current sales price of comparable petroleum in the same area or the price of petroleum being purchased for the Strategic Petroleum Reserve (SPR) minus the cost of transportation from NPR-1 to the SPR.[4]

On May 22, 1986, the Secretary of Energy stated that the process for selling oil from NPR-1 had gotten out of step with today's marketplace and, as a result, the taxpayer was not receiving a fair return on the sale of the crude oil. He ordered a comprehensive review of the bidding process for selling oil to be undertaken immediately.

DOE subsequently revised its sales procedures and on July 29, 1986, requested bids from potential purchasers for the October 1 to December 31, 1986, contract period. The new procedures require bidders to submit a specific price for the oil rather than a bonus or discount to a base price. The highest bidders will then pay that price adjusted monthly on the basis of changes in spot market quotes for two crudes sold on

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[3]Naval Petroleum Reserves: Sales Procedures and Prices Received for Elk Hills Oil (GAO/RCED-86-163FS, May 9, 1986).

[4]Legislation containing these provisions was enacted on August 29, 1986 (Public Law 99-413).

the California spot market.[5] The new procedures also reduce the contract period from 6 months to 3 months; shorten the time period between the invitation for bids, contract award, and oil delivery; and strengthen the government's right to reject bids deemed unfavorable to the taxpayer. DOE plans to continually monitor and evaluate its experience under the new procedures and make changes as necessary.

Under its new procedures, DOE awarded contracts to 7 companies on September 10, 1986, for the sale of 53,000 barrels of oil per day for the October 1 to December 31, 1986, contract period. Before awarding these contracts, DOE conducted an analysis that concluded that the bids submitted by the proposed awardees complied with the minimum price criteria set forth in Public Law 99-413. Since the act does not prescribe a precise methodology or formula for ensuring compliance, DOE had flexibility in choosing, among other things, current sales prices, comparable petroleum, and the time period to use. The monthly adjustments to the bid prices, based on changes in spot market quotes for the two crudes sold on the California market, resulted in DOE receiving average prices of $13.42, $13.70, and $13.58 per barrel for NPR-1 oil delivered in October, November, and December 1986, respectively. These prices exceeded DOE's averages of the October, November, and December spot market quotes of $12.84, $12.72, and $13.39 respectively, for the two crudes sold on the California market.

OTHER DOE EFFORTS RELATED TO NPR-1 OIL SALES

DOE also initiated other efforts designed to avoid future NPR-1 oil sales at less than fair market value. These include testing the sale and shipment of NPR-1 oil to the SPR and preparing unused storage tanks at NPR-1 for possible storage of oil.

During October 1986, DOE shipped about 267,000 barrels of oil, about 8,600 barrels per day, to the SPR via interstate oil pipelines. According to DOE, the purpose of the shipments was to test the logistics of transporting oil from California to the SPR in Texas and Louisiana. This oil is expected to reach the SPR in February 1987. The NPR office billed the SPR office at prices ranging from $13.32 to $13.41 per barrel, based on oil quality, for the NPR oil. These prices were based on DOE's revised procedures for pricing oil sold to its commercial customers. In addition, DOE will pay pipeline tariff charges of $2.67 per barrel for shipment of the oil to the SPR.

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[5]The two crudes are (1) blended oil transported through the Four Corners Pipeline Company's line 63 from the San Joaquin Valley (the area where NPR-1 is located) to the Four Corners' Hynes Station near Los Angeles and (2) Alaska North Slope oil delivered at Los Angeles.

According to DOE, it owns five storage tanks at NPR-1, but they were not in usable condition during most of the last sales contract period. DOE informed us that it put one of these tanks in a usable condition during late summer of 1986 and that this tank, which can hold about 220,000 barrels, has been used to store about 70,000 barrels of NPR-1 oil produced in September 1986.

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