United States General Accounting Office

GAO

Testimony

For Release
on Delivery
Expected at
9:30 a.m. EDT
Thursday
May 4, 1989

The Strategic Petroleum Reserve Amendments of 1989

Statement of Keith O. Fultz
Director, Energy Issues
Resources, Community, and Economic
Development Division

Before the
Committee on Energy and Natural Resources
United States Senate

045343 / 138580

GAO/T-RCED-89-38

GAO Form 160 (12/87)

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to discuss your bill, the Strategic Petroleum Reserve Amendments of 1989 (S. 694). I will also present our analysis of alternative, nontraditional methods of financing the Strategic Petroleum Reserve (SPR). My testimony today reflects our continuing work on the SPR, including our report, Strategic Petroleum Reserves: Analysis of Alternative Financing Methods (GAO/RCED-89-103, Mar. 16, 1989).

Your bill extends the SPR's authorizing legislation and requires DOE to both continue to fill it at the highest practicable rate and plan for its expansion to 1 billion barrels. The bill also gives the President authority to distribute SPR oil while it is in transit. We agree in concept with the bill's provisions. They are consistent with our view that the SPR will remain critical to the United States' energy security into the next century.

We reviewed approximately 40 alternative methods for financing the SPR. While most of them have some advantages, all of them have economic or other disadvantages that may outweigh their benefits. Accordingly, we cannot recommend any as being superior to annual appropriations that are recorded in the budget. Further, we are concerned about the growing number of proposals to establish off-budget entities to carry out governmental functions.

BACKGROUND ON THE SPR

The SPR, authorized by the Energy Policy and Conservation Act (Public Law 94-163, Dec. 22, 1975), as amended, is the nation's first line of defense in an oil supply disruption. By law it may not be drawn down and the oil distributed unless the President determines that a severe energy supply interruption has occurred or that drawdown is necessary to fulfill U.S. obligations under the international energy program.

As of April 1989, over 565 million barrels were stored in the SPR, and over $19 billion in appropriations have gone toward its development. In fiscal year 1988, DOE disbursed $338 million from the SPR petroleum account for the acquisition and transportation of 20.8 million barrels of oil. On the basis of the amounts appropriated and the market price of oil, DOE currently expects a fill rate of 60,000 to 65,000 barrels per day during fiscal year 1989.

Future expenditures of between $5 billion and $6 billion may be required to bring the SPR's inventory to 750 million barrels of crude oil, enhance drawdown capability, and improve distribution capacity. DOE has also recently estimated that an additional $6 billion may be needed if the SPR is expanded to 1 billion barrels. Particularly during this period of budget austerity, these expenditures are significant.

FUTURE ROLE OF THE SPR

Current trends point to increased importance of the SPR over the next decade. In our report, Energy Security: An Overview of Changes in the World Oil Market (GAO/RCED-88-170, Aug. 31, 1988), we said that although the United States, like other major oil-importing countries, is less vulnerable to an oil crisis today than it was a decade ago, certain developments may over time increase its vulnerability. For example, U.S. domestic production is decreasing, and imports are increasing. In the 1990s the world oil market may again become tight and production may become increasingly concentrated in the Middle East.

Because of the increase in U.S. oil imports, the import protection provided by the SPR has begun to decline. According to DOE, the amount of oil in the SPR from 1983 to 1987 exceeded 90 days of imports, but it has now fallen to 89 days. The Energy Information Administration has estimated that over the next decade, net oil imports will further increase from about 6.3 million barrels per day in 1988 to about 9.3 million barrels per day in 1995 and 10.2 billion barrels per day in the year 2000. If these estimates are accurate, the SPR, even when filled to its currently planned 750-million-barrel capacity, would not provide 90 days of import protection.

THE STRATEGIC PETROLEUM RESERVE AMENDMENTS OF 1989

The Strategic Petroleum Reserve Amendments of 1989 would address this situation by, among other things, (1) extending the SPR's legislative authority for 5 years, (2) extending the requirement that the President carry out petroleum acquisition, transportation, and injection activities at the highest practicable fill rate achievable, subject to the availability of appropriated funds, and (3) requiring the Secretary of Energy to amend the existing SPR reserve plan to provide his plans for a 1-billion-barrel SPR. The legislation would also require that the SPR be filled at no less than 75,000 barrels per day until 1 billion barrels are in storage.

While we have not taken a formal position on the appropriate fill rate or the ultimate size of the SPR, we agree in concept with the Strategic Petroleum Reserve Amendments of 1989. In our report on the world oil market, we said that the United States should continue to develop the SPR as quickly as is fiscally responsible. Further, according to DOE, if the SPR is expanded to 1 billion barrels, construction and fill would take over 10 years. Therefore, if the SPR is to meet future U.S. energy security needs, planning for its expansion should be initiated as soon as possible.

The bill also proposes that in assessing alternatives in the development of a 1-billion-barrel SPR, the Secretary of Energy consider leasing privately owned storage facilities. In our alternative financing report, we noted that regional storage reserves may have certain advantages. For example, such storage facilities could be geographically dispersed in patterns similar to the demand for oil and could facilitate distribution. However, leasing regional storage facilities may be more expensive in the long run than storing crude in the SPR salt domes. It appears appropriate for DOE and the Congress to consider these trade-offs in planning for an expanded SPR.

Current law may be interpreted as requiring that oil in transit first be placed in the SPR before it can be sold at drawdown. The bill would change this by giving the President the authority to distribute such oil when he finds that a severe energy supply interruption is imminent and that the price of world oil has increased substantially. Such a provision would appear to enhance the SPR's ability to respond rapidly to an energy emergency.

ALTERNATIVE FUNDING PROPOSALS

The SPR is currently funded through annual appropriations by the Congress. The sources of these funds are general government revenues from, for example, taxes, duties, or borrowing. Most government expenditures are funded in this way, and SPR expenditures, for most of the SPR's history, were included in the annual budget. The Omnibus Budget Reconciliation Act of 1981 established the SPR Petroleum Account, the account that pays for SPR oil acquisition and transportation, as an off-budget account. However, in 1985, as part of the effort to control government expenditures, the Gramm-Rudman-Hollings Act brought this account back on the budget.

In our recent report, we examined approximately 40 alternative financing proposals for the SPR and compared them with the current financing procedure. Our comparison covered (1) short- and long-term acquisition and financing costs to the government, (2) the effect on the budget and national debt, and (3) other key considerations, such as who would control the SPR oil. We did not, however, quantify the costs or benefits of specific proposals. Instead, we focused on the likely impact of the proposals from a broader perspective--for example, whether a proposal would tend to increase or decrease annual expenditures or the national debt. We also did not attempt to analyze all possible combinations of the proposals.

For clarity, we grouped our analysis of the proposals into three broad categories:

-- first, proposals that increase government revenues by selling financial instruments such as bonds, increasing taxes or user fees, selling government assets or using receipts from revenue-producing assets, or selling futures or option contracts and dedicating these revenues to the acquisition of oil for the SPR;[1]

-- second, proposals that acquire oil by means other than outright purchase, such as renting or leasing, mandating that firms contribute oil to the SPR, or providing inducements to encourage private SPR contributions; and

-- third, proposals that set up a separate SPR entity to handle financing or acquire oil and manage the SPR.

Revenue-Raising Alternatives

Revenue-raising alternatives include special bonds and taxes, asset sales and receipts, and futures and options contracts. These proposals generally address the means by which the government could raise money for funding the SPR, but they do not directly affect the purchase price of oil or other SPR costs. In practice, revenue raised in these ways could be used to finance any government

[1]GAO is currently reviewing dedicated funding and will be issuing a report on this subject in the near future.

expenditure--not just to purchase SPR oil. However, these proposals dedicate the revenues to funding the SPR.

The proceeds obtained from issuing special bonds to purchase SPR oil would substitute for conventional debt (i.e., the issuance of Treasury securities), which is normally used, when necessary, to finance government expenditures. If these bonds can be sold at a lower interest rate than comparable Treasury offerings by, for example, indexing the face value of the bonds to the price of oil, the government's interest cost might be reduced. However, if the price of oil rises, the government will have to repay a greater amount when the bonds come due. This additional amount may or may not be more than the interest saved over the life of the bond on a discounted present value basis.[2]

Additional revenues received from new or increased taxes or asset sales, such as the sale of government land, would lower the current budget deficit to the extent that they result in additional income and budget expenditures are not increased. However, new taxes, such as a dedicated gasoline tax or a tax on petroleum products, would increase the price consumers pay for these

---

[2]The discounted present value, also known as the net present value, is a concept that allows meaningful comparison of dollar flows, either money received or money spent, that occur at different times. In general, revenues to be received in the future are worth less than equal revenues on hand today because money on hand can be invested to yield a higher amount in the future or, in the case of the federal government, it can reduce the amount borrowed. The farther into the future the expected revenues or costs are, the less value they have in today's dollars.

products. Furthermore, the sale of a revenue-producing asset, such as the Naval Petroleum Reserve, would result in the loss of future revenue. The sale price of a revenue-producing asset would need to reflect the discounted present value of future revenues for the government to avoid a loss. In our view, asset sales should be evaluated on their own merits. We have consistently recommended against asset sales and other proposals that would reduce outlays and the deficit in the short term, but lead to higher deficits in the long run. Furthermore, the proceeds of most asset sales are excluded from the calculation of the budget deficit for purposes of the Gramm-Rudman-Hollings procedure.

The sale of options contracts on currently stored SPR oil would also raise some revenue for the purchase of additional oil for the reserve. An options contract would give the purchaser the right (but not the obligation) to buy SPR oil at an agreed-to price on an agreed-to date. Such contracts might be attractive to firms that wish to ensure that they have access to oil should a disruption occur. To retain control of SPR oil until a disruption occurs, DOE could sell options contracts at a price that reflects the expected price of oil during a disruption. However, the per-barrel selling price of such an options contract is likely to be low, reflecting that under current market conditions the risk of a disruption is also low. Therefore, this proposal is not likely to raise enough revenue for the government to purchase meaningful quantities of oil for the SPR. Selling options contracts at a disruption price, however, may be desirable as an energy policy alternative to facilitate early distribution of SPR oil.

Alternative Ways of Acquiring Oil

Alternative ways of acquiring oil (other than the current method of government purchases) include renting and leasing, and compulsory or induced private contributions. The government could rent or lease oil at an initial cost less than outright purchase; but over several years, this alternative is likely to prove more costly since the "rent" is likely to reflect both the private sector's higher cost to borrow money and its desired profit. In addition, lease proposals might complicate drawdown unless the question of whose oil (the government's or the lessor's) is withdrawn first in an emergency is settled during negotiation of the lease.

The government, under existing provisions of SPR legislation, could require the private sector to store oil, to which the private sector retained title, in the SPR. On the other hand, the private sector might be induced to store oil in the SPR in return for some form of compensation, such as the receipt of government-owned SPR oil at less than disruption prices at drawdown. Such an agreement would allow the government to reduce its current costs in exchange for reduced expected future profit resulting from the sale of SPR oil. Like leasing proposals, these alternatives might complicate drawdown.

Establishing a Separate SPR Entity

Some proposals suggest establishing a separate SPR entity--a government corporation, such as the Tennessee Valley Authority, or a trust.[3] Separate government entities have sometimes been established for business-type activities that generate receipts from selling products or services and finance their costs primarily by such receipts. However, the SPR, an integral part of DOE, normally generates no revenues.

A separate SPR entity could obtain oil by using some of the alternatives I have just discussed. For example, it could use funds from the sale of assets or debt to buy oil, or be the beneficiary of dedicated revenue. If the entity is off budget, its expenditures would not be reported in the budget. However, if the government provides funding to the entity, that funding would count against the deficit.

We are concerned about the growing number of proposals to establish off-budget entities to carry out governmental functions.

---

[3]A trust, as used here, means an entity with the power to undertake financial transactions on behalf of another person or institution, in this case, the SPR. The Treasury also maintains separate receipt and expenditure accounts, usually called Trust Fund Accounts; these are not referred to here.

Such entities avoid the discipline required by constrained budget resources. They are a serious threat to the integrity of the government's budget and financial management systems. If the proliferation of such entities continues, it will raise grave doubts about the credibility of the government's reports on its financial operations and condition. This will make it even more difficult for decisionmakers and the public to understand and deal meaningfully with the overriding problem of the budget deficit.

CONCLUSION

In conclusion, Mr. Chairman, we believe that the SPR will continue to be critical to U.S. energy security into the next century. Your bill will help ensure that the SPR meets its objectives by requiring DOE to fill it at the highest practicable rate and to plan for expanding its ultimate size.

Most of the alternative financing proposals we examined have some advantages. However, all of them also have disadvantages that must be carefully weighed. On the basis of our analyses, we are not prepared to recommend any as superior to the current process of financing SPR oil purchases through annual appropriations. Further, we are concerned about the growing number of proposals to establish off-budget entities to carry out governmental functions.

As the Comptroller General has pointed out, the budget deficit is among the most urgent issues facing the administration and the Congress. Unless this problem is solved, it will hamstring the nation's ability to achieve vital policy goals, such as filling the SPR.

We would be pleased to answer any questions that you or members of the Committee may have.