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

PROCUREMENT, LOGISTICS, AND READINESS DIVISION

JULY 29, 1982

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The Honorable Gordon J. Humphrey
Chairman, Subcommittee on Preparedness
Committee on Armed Services
United States Senate

Dear Mr. Chairman:

Subject: Defense Fuel Supply Center's Procedures for Exchanging Naval Petroleum Reserve Crude Oil for Fuel Products (GAO/PLRD-82-103)

On January 6, 1982, you asked us to review the Defense Fuel Supply Center's (DFSC's) procedures for administering exchange contracts. These contracts, which deviate from normal procurements, require contractors to purchase a predetermined amount of Naval Petroleum Reserve (NPR) crude oil for every barrel of petroleum product they sell to the Department of Defense (DOD). You expressed concern about whether the Federal Government is receiving the optimum return for the sale of its crude oil through these exchange contracts, which are new to DFSC.

We found no problems with DFSC's contracting procedures. Moreover, our review of 22 oil companies indicated that the Federal Government is currently receiving a fair return for its crude oil.

We discussed our observations with your Office on May 21, 1982, and this report summarizes the results of our review.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objectives were to determine (1) if DFSC has been using suitable procedures in its exchange contracts and (2) if the Federal Government has been receiving optimum value for the NPR crude oil.

We made our review primarily at DOD's DFSC in Cameron Station, Alexandria, Virginia. We interviewed officials at DFSC, DOD, the Department of Energy, and NPR in Elk Hills, California, and consulted with officials from the oil industry--the Independent Refiners Association of California, the American Petroleum Institute, and publishers of an oil publication.

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We contacted officials in 24 companies that were competing for exchange contracts. This included 21 companies awarded the third contract and successful and unsuccessful bidders of other contracts. We obtained the companies' views on the exchange contracts, the current market need for crude oil, their use of the crude oil, supply assurance, and other related issues.

In addition, we reviewed legislation, studies, industry publications, solicitations, contracts, and related documents. We analyzed the three solicitations issued for exchange contracts to identify the quantity and type of petroleum to be provided, the contract period, and the geographic coverage. We analyzed seven exchange contracts for contract value, the market and price analysis, the amount of competition, and the exchange ratio of crude oil to petroleum products. We also compared exchange and nonexchange contracts to evaluate differences in competition and petroleum product price. We found too many variables to compare the petroleum product price of exchange and nonexchange contracts. Some of the variables include the method of transportation, the market, and the escalation clauses.

We made our conclusions on the basis of current conditions. Therefore, because of crude oil market fluctuations, we cannot make projections on the future value of the crude oil. Also, we did not attempt to identify alternative ways of pricing NPR crude oil, obtaining an assured supply of petroleum products, or obtaining an optimum return for NPR crude oil. We made this review in accordance with our current "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions."

BACKGROUND

The need for supply assurance of petroleum products became evident in 1973 and 1979, when DOD experienced difficulties in obtaining adequate petroleum supplies. In 1973 the NPR in Elk Hills, California, was closed and could not be made operational for 9 months. In 1979 military readiness inventories of jet fuel were seriously reduced because DOD had to compete with civilian customers desiring gasoline for motor vehicles.

The Energy Security Act, dated June 30, 1980, made provisions for DOD to use, exchange, or sell the NPR crude oil to meet its petroleum product requirements. The act, however, prohibited DOD from using NPR crude oil while it was being used for the Strategic Petroleum Reserve. Beginning October 1981, the Strategic Petroleum Reserve requirements were to be purchased on the open market, which gave DOD the opportunity to use the NPR crude oil for supply assurance.

Although DOD officials admit that in today's market such supply assurance is not as imperative as it was during the 1979 shortage, they recognized the need to minimize disruptions in the marketplace during supply shortages. Therefore, DOD began to consider different options for providing an assured supply of petroleum products once the crude became available. After much deliberation, DOD decided to use the exchange agreement option.

DOD believes that there are two reasons the exchange contract offers supply assurance. First, it provides crude oil to refiners who convert the oil into the petroleum products DOD uses. Second, the NPR crude oil can be used as a leverage by the refiner to obtain fuel from other sources. Another reason DOD favors the exchange agreement is that it gives DFSC experience in handling crude oil procurements and sales.

DFSC has awarded contracts for three solicitations as part of the exchange agreement. The first two exchange solicitations were used to meet DOD's inland and west coast requirements for JP-4 jet fuel. These solicitations required the offerors to buy one barrel of NPR crude oil for every barrel of petroleum product sold to DOD.

Two companies were awarded contracts for the first solicitation in June 1981 for 5 months. These contracts used about 4,500 barrels of NPR crude oil a day from production facilities in Teapot Dome, Wyoming. The second solicitation was awarded to six companies in October 1981 for 5 years and uses about 34,000 barrels of NPR crude oil a day from Elk Hills, California.

The third solicitation was used to meet DOD's requirements on the gulf and east coast. It fulfilled DOD's needs for three types of petroleum products instead of one; JP-4, JP-5, and military diesel fuel. Twenty-one companies were awarded contracts for this solicitation in March 1982 for 6 months. It uses about 100,000 barrels of NPR crude oil a day from Elk Hills.

DFSC officials informed us that a solicitation to fulfill all of DOD's requirements for JP-4 and military diesel fuel will be issued soon.

CONTRACTING PROCEDURES

Traditionally, DFSC has procured petroleum products through nonexchange contracts, but in an effort to obtain supply assurance, DFSC now procures petroleum products through exchange contracts. These contracts require contractors to purchase a predetermined amount of NPR crude oil for every barrel of petroleum product they sell to DOD. This type of procurement is new to DFSC and has brought about changes that have reduced competition. However, DFSC contracting procedures have compensated for this reduction.

DFSC officials measure competition in terms of coverage. They believe competition under the exchange solicitations was better than under the nonexchange solicitation. Coverage is a comparison between the quantity of petroleum product requested in the solicitation and the quantity offered in the responses. On the first and third exchange solicitations, the amount of JP-4 petroleum offered by the contractors was 531 and 431 percent of what was requested, while offers under the nonexchange solicitations for the same geographical areas were only 165 and 123 percent of the amount requested. The second contract, which had an extremely low coverage rate, was for a 5-year term. The amount of petroluem offered by the contractors was only 128 percent of what was requested. DFSC has no plans to issue another solicitation for that length of time, according to a DFSC official.

We believe competition may have been reduced because the response rate for the exchange contracts is lower than nonexchange contracts. For example, the response rate of two exchange contracts were only 4 and 3 percent of the solicitations issued, while a nonexchange contract covering the same geographical area had a response rate of 23 percent. One reason for this reduction may be that companies do not need the crude oil provided by these contracts because of the abundant supply in today's market.

DFSC expected competition to be reduced since it required offerors to purchase a certain quantity of crude oil for every barrel of petroleum it sold to DOD. To compensate for this, DFSC negotiated with all offerors on appropriate terms and conditions.

The market analysis also minimizes concerns over reduced competition because it provides control over the petroleum product price. This analysis, conducted by the Market Research Group in DFSC, establishes the price ranges to assure that the petroleum product price is fair and reasonable. These ranges are based on sales data obtained from oil industry publications, the contractors, and other agencies, such as the Civil Aeronautics Board. In the analysis the price for DOD's products are compared to industry standards and comparable commercial products.

Another factor that minimized concerns over the product price was the evaluations made on each contract. Even though each evaluation was different, the contract awards were made to the lowest bidder. The third contract, which was the largest in terms of responses and awards, was awarded using a computer analysis. This analysis considered not only the offeror with the lowest petroleum product price but also the one with the least cost, including transportation. This analysis also matched low bids of small businesses with areas set aside for small business.

VALUE OF THE CRUDE OIL

To assess the value of the crude oil, we analyzed both the petroleum product and NPR crude oil price. The NPR crude oil price is based on a Petroleum Transfer Agreement between DOD and the Department of Energy, which was signed in June 1981. In this agreement DOD is to pay the Department of Energy a fair market value for the petroleum received. This price is equal to the average of the three highest prices per barrel posted or published by purchasers of crude oil of like quality and gravity in specified geographical areas.

In its exchange contracts, DOD is charging this same price to the companies. Our survey of 20 companies awarded the latest contract showed that 12 are reselling the crude oil. Ten of these are selling it for the same price or less than they paid DOD. This is an indication that DOD probably could not have received more for its oil in the open market.

CONCLUSION

We found that under the exchange contracts, DOD is receiving a fair price for the NPR crude oil. We also found that DFSC contracting procedures provide sufficient control over the procurements.

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Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of the report. At that time, we will send copies to interested parties and make copies available to others upon request.

Sincerely yours,

for Donald J. Horan
Director