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Report to the Chairman, Committee on Appropriations, House of Representative[s]

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NAVAL PETROLEUM RESERVE NO. 1

Efforts to Sell the Reserve

GAO

United States
General Accounting Office
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Resources, Community, and
Economic Development Division

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July 28, 1988

The Honorable Jamie L. Whitten, Chairman
Committee on Appropriations
House of Representatives

Dear Mr. Chairman:

This report responds to the first portion of your May 24, 1988, request that we review (1) proposed sales of the Elk Hills, California, Naval Petroleum Reserve (NPR-1) and (2) other asset sales proposals by the fec eral government. That portion of your request relating to other asset sales proposals will be covered in a separate report.

This report (1) discusses the legal authority for proposed sales of any o the four Naval Petroleum Reserves (NPR) and (2) describes the chronology of events leading to and following each proposed sale, including th rationale for each sale and the result of each proposal, with concentration on NPR-1. In addition, the report includes a discussion of proposals t produce and sell NPR-1's oil and gas production for nonmilitary use. We are also providing information on our analysis of the administration's 1987 divestiture report, which details its most recent rationale and pro posal for selling NPR-1.

In summary,

- The Congress must authorize the sale of the NPRS, and it has not delegated that authority.
- Since 1912, four proposals to sell the NPRS have been made; none of these proposals were approved by the Congress.
- Prior to 1976, when full NPR-1 production was authorized, a number of proposals were made to utilize NPR-1 for purposes other than as a military defense reserve. These included a proposal to return NPR lands to the public domain for leasing and several proposals to produce NPR oil/ gas reserves and use the sales receipts for nonmilitary purposes.
- Our analysis of the Department of Energy's (DOE) 1987 divestiture report indicates that DOE has not adequately justified the sale of NPR-1. More information is needed, including information on the amount of oil reserves and on NPR-1's value to the government through continued ow ership and operation.

Background

Four naval petroleum reserves—NPR-1, -2, -3, and -4—have been esta lished. The reserves were originally under the Department of the N management. On October 1, 1977, responsibility for managing the reserves was transferred from the Department of the Navy to DOE.

The most productive of the reserves, NPR-1, is a large (about 48,000 acres) operating oil field located in Kern County, California. The fie jointly owned: the federal government owns 78 percent, and Chevr U.S.A. (formerly Standard Oil Company of California) owns 22 per Oil production at NPR-1 peaked in 1981 at 181,000 barrels per day, a is now considered to be a mature oil field with declining production About 109,000 barrels of oil per day were produced in fiscal year 1 DOE estimates that as of September 30, 1987, about 630 million barr recoverable reserves remained. The administration's fiscal year 19 budget proposal shows $3.5 billion in expected sales receipts if NPR were sold at the end of fiscal year 1989.

Constitution Grants the Congress Power to Dispose of Federal Property

The Constitution gives the Congress the sole authority to "... dispo and make all needful Rules and Regulations respecting the Territor other Property belonging to the United States ...." No other autho exists to sell the NPRS. Since 1927, after the NPRS were leased and pr duced without congressional approval, all attempts to sell or to oth wise change the status of the NPRS have been efforts by the executi branch to obtain the legal authorization to do so. (See app. II.)

Chronology of NPR's Use

The NPR's chronology has three general phases: use as a defense res before 1976, production to meet domestic needs since 1976, and a c certed effort to sell the reserve during the last 3 years.

NPR-1 Held Primarily for Defense Use Until 1976

The first phase, from 1912 to 1976, was marked by the congression intent to retain the oil in the ground except when it was needed for national defense or to avoid damage to the field and the irretrievab loss of oil. Except for a period of production during 1921-1927, wh the NPRS were leased without congressional approval by the Depart of the Interior to private industry, this congressional intent was ma tained. Despite this stated purpose, available documentation indica the existence of a number of proposals for divestiture or other cha in the reserves' status after they were returned to Navy control in However, only five proposals were sufficiently documented to sup an analysis. Further, only one of these proposals, made in 1959 by Pres dent Eisenhower in his Annual Budget Message to the Congress for Fiscal Year 1960, was specifically aimed at selling the reserves. His rationale was twofold: to relieve the Navy of an "inappropriate responsibility" and to provide additional federal revenues. As determined by our review of the available documentation, no action was taken on the proposal.

The other four proposals were attempts to change the status of the NPR: rather than to sell them outright. The first such proposal, made in 1942 was to allow Standard Oil Company of California to operate NPR-1 and take all of the oil for a period of 5 years. The second proposal, made in 1948, was to transfer the responsibility for the NPRS from the Navy to the Department of the Interior, which could then have leased the lands to oil companies for production. The rationale for the proposal was tha the Navy saw no benefit in overseeing reserves because it believed that the NPRS would not be opened up by the Congress. The third and fourth proposals made in 1965 and 1970-1973, respectively, were directed toward convincing the Congress that NPR-1 should be opened up for pro duction and that the funds generated should be used for special purposes.

Three of the four above proposals originated with the Department of Defense (DOD); the fourth, with the Department of the Interior. Hearing were held on these proposals, but these attempts to transfer the reserves to Interior or to produce them for anything except military pu poses and prevention of damage to the field were rejected. (See app. II.)

Congress Approves Production for Nonmilitary Use in 1976

The second phase of NPR's history began in 1976. At that time, in response to the energy crisis brought on by the Arab oil embargo, the Congress approved production at NPR-1, with the petroleum product ou put offered for sale to private industry. In 1980, however, the Congres passed legislation clarifying the right of the military to acquire some o all of the oil, as needed, for defense purposes. Following that action, some of the oil production was sold directly to DOD and refined for military use, but most of the production continued to be sold to the private sector. (See app. III.)

Administration's Recent Proposals to Sell NPR-1

Following the unsuccessful sales attempt in 1959, efforts to sell NPR-1 outright were not made again until late 1985-early 1986, the beginning of the third phase. At that time, the administration submitted its proposed fiscal year 1987 budget to the Congress. As part of this budget, the administration proposed selling the government's share of the field because it wanted to reduce the budget deficit and because it wanted the government out of the oil business. In 1986, the administration submitted its fiscal year 1988 budget, which contained a similar proposal. Although the Congress did not authorize either of these proposals, the fiscal year 1987 appropriation act authorized DOE to use up to $500,000 to study an NPR sale. If such studies were undertaken, DOE was required to report on the results of its analysis by June 30, 1987.

On June 30, 1987, DOE submitted the required report, entitled Divestiture of the Naval Petroleum Reserves. Following completion of the report, the administration developed and submitted proposed sales legislation and included the sale of the assets in its fiscal year 1989 budget. The rationale for the sale changed slightly, however, from an emphasis on budget reduction to one of "asset exchange," i.e., taking receipts from the sale of NPR-1 and using them to complete filling the Strategic Petroleum Reserve (SPR) to 750 million barrels of oil and to develop and fill a DOD-dedicated 10-million-barrel Defense Petroleum Inventory. While minimizing the emphasis on budget reduction, this proposal would accomplish the administration's objective of transferring NPR-1 into the hands of a private sector operator, thereby removing the government from the business of operating the oil field. The specifics on how the asset exchange proposal would work, however, have not been developed by DOE, and no congressional action has been taken on the proposed sales legislation.

DOE's 1987 Divestiture Report Does Not Justify Sale of NPR-1

At the request of the Chairman, Subcommittee on Energy and Power, House Committee on Energy and Commerce, we critiqued the administration's June 30, 1987, divestiture report, which proposed the sale of NPR-1 as well as NPR-3.[1] We concluded that DOE's divestiture report does not provide enough information to the Congress to justify a sale of NPR-1. Key among its problems are the following:

[1]Because DOE considers NPR-3 to be financially insignificant, we did not perform a sales analysis of it.

- Its conclusions rely heavily on inaccurate data concerning NPR-1's recoverable reserves. Accurate reserve data are essential for estimating the reserve's value.
- It estimates the NPR-1's value from industry's perspective rather than that of the government. The report should have valued the reserve using the government's own production schedules, price forecasts, and discount rate and then tested the sensitivity of that value to differing industry assumptions about these factors.
- It did not consider the potential for leasing NPR-1 as an alternative to either selling or holding the asset. Leasing could offer another way to protect the government's interest in view of uncertainties about future oil prices.

Scope and Methodology

In conducting our work, we interviewed DOE, DOD, and Office of Management and Budget (OMB) officials in Washington, D.C. To the extent that documentation was available, we obtained and reviewed records of hearings, agency correspondence, and other documentation relating to past events affecting the NPRs. We conducted our study in June and July 1988, except where we drew on completed and ongoing studies for the Chairman, Subcommittee on Energy and Power, House Committee on Energy and Commerce. The results of our analysis are presented chronologically in appendixes II through V. (See app. I for our detailed scope and methodology.)

We did not obtain official agency comments on a draft of this report in order to meet the requested report date. However, we discussed the information in this report with cognizant officials of OMB, DOE, and DOD and made changes in the report as appropriate.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will provide copies to the Secretary of Energy and other interested parties and make copies available to others upon request. This report was prepared under the direction of

Keith O. Fultz, Senior Associate Director. Other major contributors are listed in appendix VI.

Sincerely yours,

J. Dexter Peach
Assistant Comptroller General

Contents

Abbreviations

B/D	barrels of oil per day
DOD	Department of Defense
DOE	Department of Energy
GAO	General Accounting Office
NPR	Naval Petroleum Reserve
NPR-1	Naval Petroleum Reserve No. 1
OMB	Office of Management and Budget
RCED	Resources, Community, and Economic Development
SPR	Strategic Petroleum Reserve

Background, Scope, and Methodology

Background

Naval Petroleum Reserve No. 1 (NPR-1) covers about 48,000 acres in Kern County, California, and is the eighth largest producing oil field in the country. It consists of four known, commercially productive, geologic zones in which petroleum has been trapped. These zones have been designated by DOE as the Shallow Oil, Stevens, Dry Gas, and Carneros Zones. Jointly owned and operated by the U.S. government (about 78 percent) and Chevron, U.S.A.[1] (about 22 percent), NPR-1 has generated over $12 billion in sales receipts to the government through its production of crude oil, natural gas, and natural gas liquids. Although NPR-1 has had limited production since the early 1920s, most of this amount has been generated since full production was authorized in 1976.

The total amount of recoverable reserves at NPR-1 has been estimated at about 1.5 billion barrels by DOE and Chevron engineers. From 1912, when NPR-1 was first set aside as an oil reserve, until 1976, only about 298 million barrels of oil were produced; most of this came from the Shallow Oil Zone. From 1976 to September 30, 1987, an additional 558 million barrels were produced, primarily from the Stevens Zone, leaving an estimated 630 million barrels of remaining recoverable reserves. During the 1976-1987 period large amounts of natural gas and natural gas liquids were also produced. In fiscal year 1987, for example, 125 billion cubic feet of natural gas and 230 million gallons of natural gas liquids came from NPR-1 wells and gas-processing facilities. Not all of the natural gas produced was sold. Approximately 62 percent of the government's share of the natural gas production was either injected back into the well to maintain reservoir pressures or used in field operations.

Oil production at NPR-1 peaked in 1981 at 181,000 barrels of oil per day (B/D), and it is now considered a mature oil field with declining annual production. In fiscal year 1987, NPR-1 produced at an average daily rate of about 109,000 B/D. DOE currently has several studies and one demonstration project underway to better assess the actual production potential of NPR-1. No results have been released to date.

The administration is currently proposing to sell its ownership interest in NPR-1 and remove the government from its overall responsibility for managing the field. The administration believes that (1) NPR-1 is no longer needed as an emergency source of oil for national defense purposes, as better sources are available, and (2) the private sector can operate the field more economically and efficiently.

[1] Standard Oil Company of California is the predecessor of Chevron, U.S.A.

Objectives, Scope, and Methodology

Our objectives were to (1) review the proposed sales of NPR-1; (2) discuss the legal authority relevant to those proposed sales; (3) describe the chronology, rationale, and result of each proposal; and (4) analyze the administration's recent efforts to determine the value of NPR-1. For the purposes of our review, we considered not only proposals to sell the assets of NPR-1, but also proposals to sell the products of NPR-1—crude oil, natural gas, and natural gas liquids—as sales proposals. Although attempts to sell or produce the NPR occurred more frequently beginning in 1942, we also reported on the initial attempt to produce NPR-1 because it more clearly focused the Congress' intent for the NPR.

We reviewed available correspondence, studies, legislative proposals, hearing records, budget documents, and historical summaries of the Naval Petroleum Reserves from DOE, DOD, and OMB. We interviewed officials at these three agencies to reconstruct past events for which little or no documentation existed. We also drew on our earlier and ongoing work for the Chairman, Subcommittee on Energy and Power, House Committee on Energy and Commerce. This work addressed industry and agency comments on the current proposed sale,[2] DOE's efforts to improve NPR-1 operations,[3] and DOE's divestiture report to the Congress; the last of which is the subject of a draft report.

The documentation relevant to the disposition of NPR assets or their oil and gas production since the early 1920s was not always clear as to whether the proposals were specific to NPR-1 or included all four NPRS. (See app. II.) As a consequence, unless the documentation allowed us to specifically identify NPR-1 as the object of a divestiture proposal, we frequently refer to the NPRS as a group. Further, although the divestiture proposals since 1985 included both NPR-1 and NPR-3, we generally limited our analysis to events surrounding disposition of NPR-1 because NPR-3 has been of much less significance as it is nearly depleted. Our work was performed in June and July 1988 and was done in accordance with generally accepted government audit standards. The results of our analysis are presented chronologically in appendixes II through V.

[2] Naval Petroleum Reserve No.1: Government and Industry Comments on Selling the Reserve (GAO/RCED-88-43FS, Nov. 23, 1987).

[3] Naval Petroleum Reserve No. 1: Data Corrections Made but More Accurate Reserve Data Needed (GAO/RCED-88-174, June 28, 1988).

Establishment and Development of the NPRs

The NPRS were established beginning in 1912, but little development occurred before 1920. Between 1920 and 1941, the general purpose of the government's NPR oil production was for Navy use or protection of the oil field. However, some illegal leases were let, produced, and then cancelled early in that period. Following an agreement in the early 1940s on how the Navy and Standard Oil Company of California would operate NPR-1, the government adhered to congressional policy of retaining the oil reserves for emergency military use. However, between 1948 and 1973 a number of proposals were submitted to the Congress to change this policy.

Congressional Right of Disposition in the Constitution

Congressional control of the NPRS is based on Article 4, Section 3 of the Constitution, which gives the Congress the power

"... to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States ...."

The Congress, in instructing the executive branch in the administration of NPRS, has not authorized their sale or other disposition. Therefore, neither the Navy nor any other executive branch agency has any authority to dispose of the NPRS.

NPR-1: 1912-1941

By executive order on September 2, 1912, President Taft created NPR-1 by reserving for the benefit of the Navy certain public domain lands.[1] As originally constituted, NPR-1 consisted of about 38,000 acres of oil-bearing land reserved for the "exclusive use or benefit of the United States Navy." About 12,000 acres of NPR-1 were privately owned, primarily by Southern Pacific Railroad and Standard Oil Company of California, with the remaining 26,000 acres owned by the U.S. government. In succeeding years additional acreage was added to the reserve. NPR-1 currently consists of nearly 48,000 acres, with about 37,000 acres belonging to the government and the remainder belonging to Chevron, U.S.A.

The early administration and development of NPR-1 faced numerous problems. When NPR-1 was established, no oil had been discovered.

[1]NPR-2 (Buena Vista), located adjacent to NPR-1 in California; NPR-3 (Teapot Dome), in Wyoming; and NPR-4, in Alaska, were also set aside by executive orders in subsequent years. (NPR-4 was renamed the National Petroleum Reserve-Alaska in 1976 by Public Law 94-258.) NPR-2 has been under lease to private oil companies since the early 1920s and is nearly depleted. NPR-3, included in the current divestiture proposal, is also nearly depleted, with only a few million barrels of currently recoverable reserves remaining. No significant quantities of oil or gas have been found at the National Petroleum Reserve-Alaska.

Although it was set aside for Navy use, the Navy had no authority to explore or develop NPR-1 until the Naval Appropriations Act of June 4, 1920 (41 Stat. 813), placed the NPRS under the authority of the Secretary of the Navy. The first producing well had been drilled by Standard Oil Company of California in 1919 on its property in the central part of NPR-1; and by 1921, 60,000 barrels of oil per day were being produced—none of it on government land.

After the Navy's jurisdiction over the NPRS was established by the Act of June 4, 1920, the Office of Naval Operations developed a "war plan" that provided for the out-leasing, development, and production of the NPRS by industry. The Department of the Interior proposed that the Navy take its royalty in the form of fuel oil, in storage tanks at seaports, as a war reserve stock. However, within the administration it was concluded that the Navy did not have the authority to enter into such lease arrangements. On May 31, 1921, President Harding transferred administration of the NPRS to the Secretary of the Interior by Executive Order No. 3474, thus opening a way for the NPRS to be leased. This action was not submitted to the Congress for confirmation. Portions of NPR-1 were subsequently leased to private oil companies who drilled wells and produced oil and gas from the field until 1927. At that time, most of the leases were cancelled and production stopped because of a lack of authority to lease.[2] Some production for protection purposes was allowed on the remaining leases.

In addition, the Supreme Court, in a 1927 decision, found that there was no authority to lease the NPRS. The Court noted that congressional intent was clear that the oil was to remain in the ground as a reserve for the military or unless needed to protect the oil assets.

On March 17, 1927, after about 85 million barrels of oil had been produced, President Coolidge returned NPR jurisdiction to the Navy by executive order. Navy control of NPR-1 leases was reestablished by the Act of February 25, 1928 (45 Stat. 148), and additional authorities to properly manage NPR-1 were granted by the Act of June 30, 1938 (52 Stat. 1252).

Available records indicate that between 1927 and 1938 memories of the Teapot Dome scandals prevailed, and the executive branch complied with the congressional intent noted by the Supreme Court, making it a

[2]The Secretary of the Interior let a number of leases on the reserves. It was subsequently determined that these leases were illegal and that some had been obtained fraudulently by bribing the Secretary. These actions have been referred to as the Teapot Dome scandal.

period of relative tranquility for the NPRs. We found nothing in the history of the NPRs to indicate that this situation changed prior to 1942. Available records noted that at NPR-1 the Navy and Standard Oil Company of California had a "gentlemen's agreement" not to drill wells that would drain each others' reserves.

NPR-1: 1942-1973

During the period between 1942 and 1944, the Navy and Standard Oil Company of California reached an agreement on a unit plan contract, which resulted in an operating strategy for NPR-1. Following this agreement, and on through 1973, the Congress approved production increases at certain times for specific purposes but generally held to its policy of retaining the reserves for emergency military use. Nevertheless, a number of proposals were made through these years to change or amend the congressional policy.

Operating Parameters Defined by a Unit Plan Contract

Shortly after the entrance of the United States into World War II, it became apparent that additional crude oil production would be required on the West Coast. Standard Oil Company of California informed the Navy that the "gentlemen's agreement" was no longer binding and that it would drill and produce oil from its lands within NPR-1. The Secretary of the Navy communicated the situation to the President on February 23, 1942. On March 21, 1942, the President stated that if satisfactory arrangements could not be promptly concluded with Standard Oil Company of California, the Secretary of the Navy was authorized to start condemnation proceedings through the Department of Justice to acquire the property.

Faced with this threat, Standard Oil Company of California officials met with Navy officials; and on November 20, 1942, the parties entered into a contract to operate NPR-1 as a unit. The basic thrust of the agreement was to authorize Standard Oil Company of California to operate the field and take all of the oil production for a period of 5 years. This production was estimated to total about 27.5 million barrels and was considered as compensation for giving up possession and control of its lands in NPR-1. Control of the field would revert to the Navy after this 5-year period. However, the equity of the terms of the agreement—specifically the shares of the oil apportioned to Standard Oil Company of California and the government—was brought into serious question by members of the Congress, and the benefit of the contract to the government was questioned by the Department of the Interior. According to a history of Elk

Hills prepared by a Director of the NPRS, the Justice Department determined, after reviewing the contract, that the Navy had insufficient authority to enter into the contract. The contract was later rescinded by mutual agreement of the two parties.

A new unit plan contract and new legislation were subsequently drafted concurrently. The legislation resulted in the Act of June 17, 1944, which authorized the unit plan contract and established the circumstances and conditions for the production of oil at NPR-1. The contract was signed by the Navy and Standard Oil Company of California on June 19, 1944, and was approved by the President on June 28, 1944.

The unit plan contract provided that NPR-1 was to be operated as a single property (a unit) and granted the Navy, subject to the provisions of the contract, absolute control over (1) the time and rate of exploration and development and (2) the quantity and rate of production. According to the contract, Standard Oil Company of California was entitled to receive 15,000 B/D up to the lesser of 25 million barrels or one-third of its share of NPR-1's Shallow Oil Zone reserves. After this, the Standard Oil Company of California was entitled to receive sufficient oil to cover its expenses and taxes related to the unit.

As part of the agreement, Standard Oil Company of California was given a 50-percent vote on NPR-1's two-member Operating Committee and six-member Engineering Committee. The contract also stated that oil production at NPR-1 must be authorized by the Congress. The Navy chose to operate the reserve through a contractor rather than with its own personnel. Standard Oil Company of California bid for the operator's contract in 1944, was awarded the contract, and continued to operate NPR-1 for the next 31 years.

Shortly after the unit plan contract was signed, the Congress, according to DOE, authorized the production of NPR-1 at a level of 65,000 B/D to address fuel shortages on the West Coast and World War II military needs. Following the end of the war, in August 1945, production was cut back to 15,000 B/D and then to 8,500 B/D in May 1946. In 1953, NPR-1 production was increased to 24,000 B/D after engineers determined this level was necessary to stop damage to the reserves and the irretrievable loss of oil. Subsequently, the production level was decreased to 6,500 B/D by 1965. Production was further reduced until it reached a minimum of 2,000 B/D of test production, where it remained until 1976 when NPR-1 was opened for full production.

Proposals to Divest or Produce the Reserves

In the years after World War II, a number of proposals were made with respect to the NPRs. They included (1) disposing of at least two NPRs entirely and (2) producing the NPRs and using the funds from the sale of the oil and gas either to reduce the balance of trade or to compensate private oil industry leaseholders of federal property in the Santa Barbara Channel. Between 1948 and 1973, the House and Senate Committees on Interior and Insular Affairs and the House and Senate Committees on Armed Services held a number of hearings on the propos als. Discussions were held within the administration on whether the change in world and national events warranted the continued maintenance of a naval petroleum reserve solely in support of the national defense. However, all proposals to sell or produce the NPRs failed, and full production of the NPRs was not authorized until 1976.

Proposals to Divest the NPRs

After production was reduced following World War II, the Navy attempted to divest itself of responsibility for the NPRs. According to a Navy official's report on the history of the NPRs, the Navy saw little hope that the Congress would ever allow it to use the NPRs to their full potential. Consequently, in January 1948, the Secretary of Defense recommended to a Special Subcommittee on Petroleum of the House Armed Services Committee that NPR-2 and NPR-3 be returned to the public domain for administration—which could include leasing the reserves—by the Department of the Interior. This recommendation resulted in a bill, H.R. 5316, that was introduced to accomplish this transfer and abol ish the two reserves. Both the Navy and Interior supported DOD's position. However, according to a 1965 history of the NPRs prepared by the NPR Director, the Committee did not support the bill. Also according to that document, Committee members questioned, among other things, th motives behind the introduction of the bill on behalf of certain California interests and the advantage to the government of such change. Com mittee members also feared that this could be the first step in the Navy' loss of control of all NPRs. The NPR Director also noted that following the Committee's rejection of the bill, a number of other bills were introduce in the Congress in the late 1950s to sell certain or all of the NPRs. No committee hearings were ever held on any of these bills.

On January 19, 1959, President Eisenhower, in his Annual Budget Message to the Congress for Fiscal Year 1960, supported a study on the advisability of disposing of the NPRs, in order to relieve the Navy of "an inappropriate responsibility" and to provide additional revenue to the federal government. The President questioned the need for the maintenance of the NPRs as a defense measure, given their relatively small size in relation to the Department of Defense's petroleum needs. As far as we were able to determine, no follow-up action was taken on the President's comments.

Proposed Use of NPR Production for Balance-Of-Payments Relief

In 1965 and 1966, the apparent concern over the nation's problems with balance of payments led to proposals within the administration to increase production at NPR-1, thereby decreasing the amount of oil being imported from foreign countries. Although documentation provided to us by DOD is sketchy and some of it is in draft form, it appears that in 1965 and early 1966, a series of memorandums, staff studies, and draft legislation were prepared and circulated within DOD to request congressional approval for increasing Shallow Oil Zone production at NPR-1 to the full extent of its productive capacity (about 75,000 B/D). The stated purpose for the increased production was to improve the U.S. international balance of payments by over $40 million per year.

In a memorandum dated October 25, 1965, from the Acting Secretary of the Navy to the Assistant Secretary of Defense (Installations and Logistics), the Acting Secretary noted that presidential and congressional approval would be required for any significant production increase. He further noted that work was proceeding on a legislative package but that it would probably be late spring or early summer 1966 before the Congress would consider the proposal. In a draft proposal obtained from DOD, we noted that subsequent to the October 25, 1965, memorandum, the NPR-1 production level was to be increased to 165,000 B/D, for a maximum period of 5 years. This increase in production was expected to reduce U.S. international expenditures by $100 million per year. Although the documentation indicates general concurrence within DOD and by the Secretary of the Interior for a 70,000 to 75,000 B/D production level, we found no indication that the Navy or Interior supported the higher 165,000-B/D level. While we could not determine whether the proposed legislation was ever considered by the Congress, production records indicate that the proposed production levels were never achieved because production never rose above the maintenance levels of only a few thousand barrels per day.

Proposed Use of NPR Production for Leaseholder Reimbursement

Following the Department of the Interior's participation with DOD in the balance-of-payments effort, Interior again became involved in an attempt to use NPR-1 production as a source of funds for a specific nondefense purpose. The Department of the Interior submitted legislation in 1970, 1971, and 1973 that would have placed NPR-1 in production to generate funds for paying off holders of 35 of the 72 federal oil leases in the Santa Barbara Channel. These leases had been suspended by Interior in 1969 following a blowout in one of the oil wells in the channel. The leases, for production by industry of off-shore oil and gas if found, had been issued by Interior in February 1968 under the Outer Continental Shelf Lands Act.

The proposed legislation in 1970, 1971, and 1973 would have allowed compensation to be either in cash or in oil equivalent to the value of the lease. The oil would have come directly from NPR-1, and cash would have been taken from a "Santa Barbara Channel Account" funded by revenues from the sale of NPR-1 oil. Correspondence between the Secretary of Defense and the Chairman, House Armed Services Committee, indicated that Interior's 1970 legislative proposal was supported by the President. We were unable to determine any major differences between the three bills.

Prior to the introduction of Interior's legislative proposals, DOD had shown a willingness to alter the status of the NPRs. According to a summary prepared by DOD, for example, DOD had supported a bill that would have transferred jurisdiction of the NPRs to the Department of the Interior for lease and exploitation in 1967. In that same account, however, DOD opposed the Santa Barbara Channel bill in 1970, identifying several problems with Interior's proposal. According to the Deputy Assistant Secretary of Defense (Installations and Housing), the "most serious pitfall" was the creation of the Santa Barbara Channel Account, a special fund for revenues from the sale of petroleum from the Naval reserves. DOD supported Interior's efforts to buy back the leases but maintained that the use of the reserves for buy-back purposes would set a precedent of providing revenue from the production of the reserves any time the Treasury was short of funds.

According to the DOD summary, the Navy strongly opposed the 1970 Santa Barbara bill. However, the summary also stated that both DOD and the Navy apparently changed their attitudes toward the proposal in 1971. In the summary, DOD was cited as giving "grudging support" to the bill, and the Navy was characterized as "muting its opposition" after the White House called for "team play."

According to the summary, however, by 1973 the Navy had reversed its position and again strongly opposed the provisions of the Santa Barbara legislation. DOD apparently continued its support, according to the summary. None of the records we obtained were complete enough to show the reasons for the Navy's changed position.

Again for reasons that are not clear, Navy's response to OMB's objection to the Department of the Interior's 1973 legislative submission was not coordinated with the Office of the Secretary of Defense and went forward as the official DOD position. As evidence that the Navy's reversal of opinion about the Santa Barbara bill was not shared by DOD, however, in a DOD June 1973 report on a strategic reserve bill, DOD overrode the Navy's objection to the use of NPR-1 for other than national defense.

In his State of the Union Message on September 10, 1973, President Nixon called for the production of oil in NPR-1 to help meet the winter fuel shortage. The President also stated his support both of legislation that would authorize the use of oil from NPR-1 to pay for cancelling the leases in the Santa Barbara Channel and for the use of proceeds from production of NPR-1 to explore NPR-4. During October 17 and 18, 1973, the Investigating Subcommittee, House Armed Services Committee, conducted hearings on the President's statement.

In the hearings, the DOD witness took the position that during the years of uncertain energy supply, the nation's oil supply problems might have little to do with national defense but might pose dangers to the economy and the welfare of the populace, which in their own way are as serious as the dangers of war. While recognizing the intent of the naval petroleum legislation, DOD concluded that the Congress could, with careful control, allow temporary use of the reserve, probably not in excess of 5 percent of the producible oil, for a proven national oil emergency to alleviate hardship. This temporary use could occur without serious jeopardy to the availability of the reserves for military petroleum needs in some future emergency.

The Navy witness, while neither opposing nor supporting the use of NPR-1 for nonmilitary needs, continued to stress the Navy's position that the support of the "national defense" meant that the oil should be reserved for use by the armed services to maintain military readiness or to support military operations in time of domestic or international crises, including war. In its report of November 13, 1973, the Subcommittee concluded that an energy crisis existed but that the reserves should not be produced. As a result, Interior's proposed legislation for the use of NPR-1 was rejected.

Production of the NPRs

The Arab embargo of 1973-1974 made the nation realize that it was vulnerable to oil supply disruptions. Thus, the Congress, in March 1976, authorized full NPR production to address both military and civilian emergency energy needs. NPR-1 has been in constant production to meet such national needs since 1976. The Congress also created the Strategic Petroleum Reserve (SPR) to stockpile oil with which to meet future oil supply disruptions.

The Congress Approves Production of NPR-1 and NPR-3: 1974-1976

After the 1973-1974 energy crisis, the Congress passed a number of national energy security initiatives to help reduce U.S. vulnerability. One of these initiatives in 1974 was to fully explore and develop the NPRS. The NPRS were then opened in 1976 to full production.

As a first step during the Arab oil embargo in opening NPR-1 and NPR-3 to full production, the Congress passed Public Law 93-245 (the Supplemental Appropriation Act of 1974) on January 3, 1974. The act authorized that NPR-1 and NPR-3 be developed to full economic, productive potential. However, full production was not authorized at this time.

In 1975, President Ford sent a bill to the Congress, The Energy Independence Act of 1975, proposing that a national SPR be established and that NPR production be used to fill the SPR. The bill also proposed a broader definition of national defense to include essential civilian and military emergency energy requirements. Full production had previously been allowed only for national defense purposes, meaning military use in time of war.

The Congress held hearings on the idea that proceeds from the sale of NPR-1 oil could pay for strategic oil storage, which would reduce the U.S. vulnerability to oil supply disruptions. After lengthy debate, H.R. 49 was passed by both houses in March 1976. On April 5, 1976, President Ford signed this bill, which is called the Naval Petroleum Reserves Production Act of 1976 (P.L. 94-258). The act was a compromise that transferred NPR-4 in Alaska to the Department of the Interior for administration and directed the Secretary of the Navy to produce the remaining NPRS. The act also allowed the Secretary to use all or any part of the funds from the sale of NPR petroleum or to exchange NPR-produced oil for filling the SPR. Further, the proceeds from the sale of petroleum were to be put into a special account that could pay for (1) operation of the NPRS, (2) procurement of oil for and construction of the SPR, and (3) exploration and study of the NPR-4.[1] This act further required the NPR-1 and NPR-3 to be produced at their maximum efficient rates[2] for 6 years.

NPR-1 Is Produced: 1976 to Present

The Navy began full production at NPR-1 and NPR-3 on July 3, 1976. On October 1, 1977, DOE assumed responsibility for the NPRs and continued the production started by the Navy. All oil/gas production designated for sale was made available to the commercial sector. Contracts for commercial sales have 10-day cancellation clauses that DOD can request the Secretary of Energy to invoke if DOD wants the NPR-1 oil. However, the oil was sold only on the open market using competitive bidding from open-up through fiscal year 1980 when the Congress passed legislation clarifying the right of the military to acquire some or all of the oil, as needed, for defense purposes. Starting in fiscal year 1981, the situation changed and the government's share of NPR oil was disposed of in several ways. The share was (1) transferred to the SPR or exchanged competitively for oil delivered to the SPR, (2) sold to DOD, and (3) sold on the open market when not all of the oil was taken by the SPR or DOD. The government's use of NPR oil ended in November 1986 and since that time all of the government's oil share has been sold on the open market.

DOE, from about 1982 to 1984, made several proposals internally to sell NPR-1 or utilize its receipts to fill the SPR. However, no one outside of DOE proposed the sale of NPR-1 or other usage of NPR-1 revenues until 1985.

[1]The account was called the Naval Petroleum Reserves Special Account. This account was abolished in 1979 by Public Law 96-137, which directed that the revenues from the NPRs be deposited directly into the Treasury as miscellaneous receipts.

[2]"Maximum efficient rate" is defined as "the maximum sustainable daily oil or gas rate from a reservoir which will permit economic development and depletion of the reservoir without detriment to the ultimate recovery."

Proposed Sales of the NPRs

In 1985, OMB proposed to sell the NPRS, among other reasons, to help reduce the deficit. DOE and DOD in 1986 began a detailed analysis of that proposal, including the value that had been placed on NPR-1. At that time, DOE agreed with the proposal and DOD disagreed with it. The Congress did not approve the proposed sale but did authorize funds to analyze it and required any study done to be presented by June 30, 1987. In 1987, the administration again proposed to sell the NPRS, and DOE selected an investment banking firm to develop a marketing plan for the sale.

The sales proposal submitted in 1988 for the fiscal year 1989 budget differed from the previous two. It contained a slight increase in the projected value of NPR-1, and the purpose of the proposed sale changed somewhat to "trading federal assets," reducing the emphasis on budget reduction.

NPR-1 and NPR-3 Sales Proposal Was Developed in 1985

OMB developed the first proposal to sell the government's ownership interest in NPR-1 and NPR-3 in the fall of 1985. This was done after OMB asked all agencies to submit a list of assets that could be sold in order to reduce the government's involvement in private sector functions. DOE's list included NPR-1 and NPR-3.

According to OMB officials, the rationale for the proposed sale of the NPRS was that (1) the NPRS should be operated by the private sector because such operation is a private sector function, (2) economic efficiency gains occur by having the private sector handle this function, and (3) sale receipts would help reduce the deficit.

The Associate Director of OMB raised the issue of selling NPR-1 with the Secretary of Energy. DOD was notified through White House channels at about the same time the Secretary of Energy was apprised of the proposed sale.

OMB staff prepared a net present value[1] analysis of NPR-1 to develop a revenue receipt estimate for inclusion in the fiscal year 1987 budget. Their analysis showed that the minimum price the government would need from a sale to break even was about $3.5 billion to $4 billion.

Detailed Analysis by DOE and DOD Begins in 1986

The President sent to the Congress his fiscal year 1987 budget in early 1986. The budget included $3.6 billion in total sales receipts—$1.2 billion to be received in fiscal year 1987 and another $2.4 billion in fiscal year 1988. The budget expressed the same rationale for selling the NPRS that is cited in the preceding section.

After being informed by OMB in December 1985 that the proposal was in the fiscal year 1987 budget, DOE and DOD initiated studies of the numbers OMB had prepared for the budget and began their own analyses of the value of NPR-1. DOE officials did not challenge the sale since they agreed with OMB that the NPRS should be sold. DOD, however, objected in writing to the President about the sale of the NPRS but lost its appeal, in part because OMB was not convinced at that time that DOD needed a dedicated emergency supply of oil for security purposes.

DOE's Analysis

DOE agreed with OMB's proposed sale of the NPRS but argued that a value should not be included in the budget. It held the view that placing a governmental value on the NPRS in a government document might affect the bids offered. OMB overruled DOE's objection, and as noted in the previous section, estimated sales receipts of $3.6 billion were included in the fiscal year 1987 budget. According to OMB officials, OMB anticipated no adverse effect on potential bids by including the sales revenue figure because (1) it routinely includes estimates for leasing revenues on the Outer Continental Shelf in the budget, (2) the market for oil field properties is competitive, and (3) several billion dollars worth of oil properties are sold every year. In addition, according to those officials, competition

[1] "Net present value" is a technique 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 in the future. The farther into the future the expected revenues or costs are, the less value they have in today's dollars. For example, at a 10-percent discount rate, the net present value of $110 to be received in 1 year is $100. If the $110 were not to be received for 10 years, its current value would be only about $42.41. The net present value technique is particularly useful when comparing the selling or keeping of an investment or asset where long-range revenue and cost streams vary between and among the options.

among bidders for the two NPRs would help protect taxpayers' interests and would ensure that the government receives full value for the NPRS.

At this time, according to DOE staff, OMB's budget numbers had not been developed using a net present value analysis. DOE subsequently prepared its own analysis of the value of NPR-1. (DOE did not compute the sales value of NPR-3 at that time because it is a small portion of the NPR assets and its sales value would be well within the error range for the computed sales value of NPR-1.)

On February 20, 1986, DOE completed its analysis of the numbers that OMB had put into the budget. Some DOE officials believed that the primary purpose for the sale was to reduce the deficit. However, this purpose became questionable, according to DOE officials, when DOE's financial analysis of selling NPR-1 showed that the amount received from the sale could be less than that received under continued ownership.

On June 10, 1986, DOE formalized its net present value analysis, which showed that the value to the government of retaining NPR-1 was $3.1 billion. The analysis also indicated that industry "might be willing to pay only 60 to 70 percent of this amount as the initial sales price." As a consequence, "it was worth only $1.7 billion to $2.3 billion to a private purchaser, depending on [the] financial approach." The reason given for this difference is that an industry buyer would be anticipating what its taxes would be for the productive life of the field and would deduct the estimated tax payments from the total value of the NPR. These results were given to the Chairman, Subcommittee on Energy and Power, House Committee on Energy and Commerce, in June 1986.

On November 13, 1986, DOE staff completed another valuation analysis. This time the analysis was prepared as part of DOE's contracting process in selecting an investment banking firm. The investment banking firm was to assist in developing a strategy to sell the reserves since DOE does not have the in-house expertise to conduct such a sale. This valuation analysis showed that the break-even price to the government was still about $3.5 billion, using mid-range oil price and production assumptions The estimated value to the industry in this analysis was $3 billion. This analysis also showed, however, that the gap between the government's value and industry's could be closed by assuming a 15-percent increase in operating efficiency at the field by private industry or by assuming that the winning bidder would bid 15 percent higher than NPR-1's computed value. Using either assumption, an industry valuation would approximate the estimated value to the government if it retains the

NPRs. With support available for either $3 billion or $3.5 billion, the analysis concluded, "The choice within this range is essentially a policy call on what message the Administration wants to send to prospective purchasers through the budget," i.e., how much money the government would be willing to accept in a sale.

DOD's Analysis

In early 1986, DOD also began to evaluate the OMB analysis. Although no independent value was determined, a DOD question-and-answer paper stated that the budget numbers were flawed because they did not take into consideration all of the elements necessary for a net present value analysis. Further, the document stated that OMB (1) had not considered that the reserves play a role in the energy preparedness plans of DOD, (2) had not conducted the necessary coordination with affected parties, (3) made no provision to compensate DOD for the loss of this national defense asset, and (4) based its estimate of the sales value on faulty assumptions.

Congressional Action

During congressional budget and other special hearings, the Secretary of Energy and DOE officials testified that they supported the sales proposal. The Congress did not approve a sale. The appropriation act authorized the use of no more than $500,000 to study the proposed divestiture and, if such studies were done, required that a report be submitted to the Congress by June 30, 1987.

Analysis Continues and the Proposal Is Altered in 1987

In early 1987, the administration again proposed in the fiscal year 1988 budget to sell the two NPRS. OMB estimated the sale would bring in revenues totaling $3.3 billion for the various portions of the asset—$2.5 billion in fiscal year 1988 and $800 million in fiscal year 1989. The net cash receipts resulting from the sale, however, were shown as only $2.8 billion. This occurred because the $500 million from oil/gas sales expected in fiscal year 1989 would be lost because of the sale and this amount was subtracted from the $800 million sales revenue for a net increase in cash receipts of only $300 million in fiscal year 1989.

In February 1987, DOE selected the Shearson Lehman Brothers investment banking firm to develop a marketing plan for selling the NPRs. Shearson's plan was submitted to DOE in May 1987. In addition to recommending a proposed method for selling the NPRs, Shearson developed an estimated sales value based on current assumptions as to how industry would perceive future production opportunities, costs, oil/gas prices, taxes, and an appropriate discount rate for computing net present values. Assuming a sale at the end of fiscal year 1988, Shearson estimated that the government could expect to receive from a private sector buyer(s) as much as $4.0 billion in immediate sales revenue, exclusive of future federal income tax receipts. Shearson noted, however, that a more aggressive view of the sales parameters could result in a higher value. Because of substantial differences among existing recoverable reserve estimates—and the importance of their estimate to valuing NPR-1—Shearson suggested that a comprehensive recoverable reserve estimate was needed to clarify the valuation estimates.

On June 30, 1987, DOE sent its report, Divestiture of the Naval Petroleum Reserves, to the Congress. DOE used Shearson's industry valuation in developing a comparative analysis of the financial benefits to the government of selling or holding NPR-1. This analysis showed that the government could receive as much as $4.3 billion from an industry sale. This increase in sales receipts beyond Shearson's estimate results from DOE's assumption that bidders will pay a premium for the reserve.

In a September 21, 1987, letter to DOE, the Secretary of Defense stated that DOD viewed its access to NPR-1 oil as a vital part of planning for its emergency fuel supply until an acceptable oil supply of equivalent quantity and availability was provided. Subsequently, a proposal for an alternative oil supply, dedicated to DOD, was jointly agreed to by DOE, DOD, and OMB. The three agencies endorsed use of the sales receipts from the NPRs to establish a DOD-dedicated 10-million-barrel Defense Petroleum Inventory and fill the SPR to its targeted 750-million-barrel level. This use of the sales receipts, according to OMB officials, would be a more effective way of meeting the NPRs' original purpose. The agreement was incorporated in DOE's proposed NPR sales legislation that was sent to the Congress on December 10, 1987, in anticipation that it would be incorporated into the on-going budget reconciliation debate over funding government activities through fiscal year 1988. On December 11, 1987, a letter jointly signed by the agency heads, was sent to the Congress in support of the legislative proposal. However, the proposed sales legislation was not introduced as planned and, therefore, was not included in the congressional budget.

Altered Proposal Put in the Budget in 1988

In early 1988, the administration submitted the fiscal year 1989 budget. The budget continued to press for the sale of NPR-1. However, this budge proposal differs in two ways from the one submitted for fiscal year 1988. First, for budget purposes, a slight increase in value is projected—

$3.5 billion versus $3.3 billion in the fiscal year 1988 budget—and a greater share of expected sales proceeds is programmed for the first year that receipts are projected. The second difference is the proposed purpose of the sale. On the basis of the agreement reached by DOE, DOD, and OMB in December 1987, the fiscal year 1989 budget rationalizes the proposed sale as an "asset exchange," i.e., taking receipts from the sale of NPR-1 and using them to complete filling the SPR to 750 million barrels of oil and to develop and fill a DOD-dedicated 10-million-barrel Defense Petroleum Inventory. This rationale minimizes the emphasis on deficit reduction but would meet the other NPR divestiture objective of transferring NPR-1 into the hands of a private sector operator, thereby removing the government from the business of operating an oil field.

The administration's view on the benefits of transferring NPR-1 to the private sector was reemphasized when, on March 10, 1988, the Secretary of Energy testified before the Subcommittee on Energy and Water Development, House Committee on Appropriations. He stated, "The Government is not competent to run a for-profit business," and he cited problems of staff continuity, congressional continuity, and single-year budgeting. He also stated, "We cannot operate as efficiently as a private sector enterprise can. That field would be more efficient, we would get more oil out of it, it would operate better, if it could be operated by the private sector as opposed to the Federal." However, the Secretary provided no quantitative support to demonstrate the validity of this contention.

No congressional action has yet been taken on selling the NPRS.

GAO's Analysis of DOE's Divestiture Report

At the request of the Chairman, Subcommittee on Energy and Power, House Committee on Energy and Commerce, we analyzed DOE's June 30, 1987, divestiture report. On the basis of our analysis, it appears that DOE has not provided an adequate basis on which to justify a sale of NPR-1 and that other problems with the comparative analysis of selling and retaining NPR-1 leave little basis for congressional decision making on this issue. Key among its problems are the following:

- Its conclusions rely heavily on inaccurate data concerning NPR-1's recoverable reserves. Accurate reserve data are essential for estimating the reserve's value.
- It estimates the NPR-1's value from industry's perspective rather than that of the government. The report should have valued the reserve using the government's own production schedules, price forecasts, and discount rate and then tested the sensitivity of that value to differing industry assumptions about these factors.
- It did not consider the potential for leasing NPR-1 as an alternative to either selling or holding the asset. Leasing could offer another way to protect the government's interest in view of uncertainties about future oil prices.

The report did acknowledge that an independent reserve study was needed and that a new unit plan contract must be negotiated. DOE is currently completing the first phase of its reserve study but had not begun negotiations with Chevron.

We are submitting a report to the Chairman, which summarizes our critique of DOE's divestiture report. Our report contains recommendations to the Secretary of Energy designed to provide better information on whether the proposed sale is in the public interest and on which a divestiture determination by the Congress could be formulated.

Lack of Accurate Data

Complete estimates of remaining recoverable oil and natural gas volumes and a determination of ownership share percentages of gas and oil production for Chevron and the government have not been fully updated since 1957. Without available current reserve data on which to base a value for NPR-1, DOE's and its contractor's estimates may not be representative of the amount of oil and gas available for recovery because the production forecasts are based on noncurrent data. Those forecasts can thus either understate or overstate NPR-1's true value.

DOE's divestiture report did recognize Shearson Lehman's observation that before any sale could take place, an independent reserve study of NPR-1 was needed. In January 1988, DOE contracted for the reserve study with an independent engineering firm. The study is expected to be completed by July 31, 1988. While this study is expected to provide needed data to strengthen the overall management of NPR-1 under continued government ownership, it will also improve the data base for selling purposes.

Inappropriate Methodology

DOE did not independently develop a value of NPR-1 under government retention using its own estimates of production, oil/gas prices, production costs, and discount rate as a benchmark against which alternative proposals could be compared or on which sensitivity analyses could have been performed. Instead, DOE assumed only that the industry expectations for these critical valuation factors developed by Shearson Lehman would apply to government ownership as well and then developed its valuation computations accordingly. This limited comparative analysis was done in spite of DOE's own assessment that the government and private sector bidders would be expected to view these factors differently.

Leasing Not Considered

DOE's divestiture report did not discuss the leasing of NPR-1 as a separate alternative. Department of the Interior officials told us that since NPR-1 is a proven oil field that could continue to yield revenues to the government through royalties, bonuses, and other options, leasing NPR-1 should be studied as an alternative approach for privatization. GAO agrees that leasing should be studied because it may offer another way to protect the government's interest.

DOD's Concerns Subsequently Addressed

DOE's divestiture report did not consider DOD concerns that the loss of NPR-1 would deprive it of an emergency supply of oil that it could control. However, DOE has subsequently recognized the value of an emergency fuel supply to DOD by including a separate 10-million-barrel reserve for DOD in its proposed sales legislation.

Negotiations Not Begun

DOE has not entered into any negotiations with Chevron on a new unit plan contract because, according to DOE officials, it is not needed unless the Congress approves the sale of NPR-1. According to a DOE official, negotiating a fair and equitable settlement of any production/cost disparities is likely to be in an agreement separate from a renegotiated unit plan contract.

We believe that a critical element for DOE in these negotiations is a sound basis for determining its fair and equitable share of NPR-1 reserves. DOE has an option in the reserve study contract that would authorize a more detailed well-by-well geological and engineering analysis that could serve as a basis for redetermining ownership shares in NPR-1 between the two partners. The contract estimates that up to 12 months would be needed to complete this optional work.

We recently reported to the Chairman, Subcommittee on Energy and Power, House Committee on Energy and Commerce, on the need for a complete reserve study, including certain optional work under the existing contract that could assist in any ownership redetermination.[1] We included a recommendation in the report that the Secretary of Energy authorize the exercise of that contract option. We expect DOE's response to this recommendation by the end of August 1988.

[1](GAO/RCED-88-174, June 28, 1988).

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