STRATEGIC PETROLEUM RESERVE

OVERSIGHT HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY
AND MINERAL RESOURCES

OF THE

COMMITTEE ON RESOURCES
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

ON

CLINTON ADMINISTRATION'S PROPOSAL TO UTILIZE TWENTY-EIGHT MILLION BARRELS OF FEDERAL ROYALTY OIL TO PARTIALLY FILL THE STRATEGIC PETROLEUM RESERVE (SPR)

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THURSDAY, APRIL 15, 1999

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES,
COMMITTEE ON RESOURCES,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:03 p.m., in Room 1324, Longworth House Office Building, Hon. Barbara Cubin [chairman of the Subcommittee] presiding.

STATEMENT OF HON. BARBARA CUBIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WYOMING

Mrs. CUBIN. The Subcommittee on Energy and Mineral Resources will come to order.

The Subcommittee is meeting today to hear testimony on the Clinton Administration's proposal to utilize 28 million barrels of Federal royalty oil to partially fill the Strategic Petroleum Reserve.

Under Rule 4(g) of the Committee rules, any oral statements at hearings are limited to the chairman and the Ranking Minority Member. This will allow us to hear from our witnesses sooner and help all these members here keep to their schedules. So, I am not going to go on and read the rest of this script. If all of these members here have any statements, we will put them in the record.

On February 11th of this year, the Energy and Interior Departments jointly announced that the proposal to take 28 million barrels of royalty oil from the outercontinental shelf leases in the Gulf of Mexico to replace a like volume which had been drawn down since the Gulf War. Although the Subcommittee on Energy and Mineral Resources is not the oversight panel per se of the SPR, we are the congressional keepers of the mineral leasing law from which the obligation to pay these royalties arises, and that is how we have jurisdiction.

And this brings us to our two witnesses here today. I would like to establish for the legislative record that the Clinton Administration can and will utilize the option of requiring lessees to surrender a fraction of their production to the government rather than sending the same fraction of value received for the production as dollars to the Treasury. I continue to be interested in this royalty-in-kind methodology as a means to increase efficiency in royalty collections through diminished audit burdens certainly for lessees that they have paid all that they owe when the oil is delivered as well as provide taxpayers with the opportunity to receive added value from downstream marketing or direct utilization by the Government, such as the MMS is now pilot testing with the R-I-K natural gas being burned by the General Services Administration to heat the very building that we are meeting in today.

Now, I realize that the motives of the administration to exercise its R-I-K option for this is SPR non-fill idea may not be so pure as what I have just described. Indeed, the Department of Energy has not had to come begging to the Congress for an appropriation to purchase the 28 million barrels of oil precisely because R-I-K is an option here. At this morning's crude oil price, this represent approximately $460 million that they didn't have to ask the Congress for; not exactly small change, but if were an appropriator rather than an authorizer, I might be upset that my control of the purse strings was being subverted by this plan. But I am a supporter of this plan chiefly because I believe it makes very good sense to take even this small amount of oil out of the supply-demand equation at this time.

When the administration announced the plan, I believe that the oil prices were less than $13 a barrel; now, they are slightly over $16 for May 1999 deliveries of light sweet crude at Cushing, Oklahoma. This recent rise was certainly welcome, but my constituents in this business are still hurting, and they are getting far less than NYMEX prices for their production. Any uptick in prices that will result from the 100,000 barrels of oil per day not flowing into refineries is good for our domestic producers, albeit it is small in comparison to the effect which the recent OPEC quota has appeared to have on global prices.

In conclusion, I do wish to thank DOE and the MMS for sending us their experts to discuss the mechanics of this proposal. I have not asked any oil industry folks to testify at this juncture, because no R-I-K deliveries have been made yet, so there is no track record to examine. But, I reserve the opportunity for follow-up should this Subcommittee become aware of problems with the upstream end of the program managed by the Interior Department.

[The prepared statement of Mrs. Cubin follows:]

STATEMENT OF HON. BARBARA CUBIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IDAHO

The Subcommittee meets today to review the Administration's plans to partially fill the Strategic Petroleum Reserve, or SPR. On February 11th of this year, the Energy and Interior Department's jointly announced that proposal to take 28 million barrels of royalty oil from outer continental shelf leases in the Gulf of Mexico to replace a like volume which had been drawn down since the Gulf War. Although the Subcommittee on Energy & Mineral Resources is not the oversight panel per se of the SPR, we are the Congressional keepers of the mineral leasing law from which the obligation to pay these royalties arises.

And this is what brings our two witnesses here today. I'd like to establish for the legislative record that the Clinton Administration can and will utilize the option of requiring lessees to surrender a fraction of their production to the government rather than sending the same fraction of value received for the production as dollars to the Treasury. I continue to be interested in this royalty-in-kind (R-I-K) methodology as a means to increase efficiencies in royalty collections through diminished audit burdens, certainty for lessees that they have paid all they owe when the oil is delivered, as well as provide taxpayers with the opportunity to receive added value from downstream marketing or direct utilization by the government, such as the Minerals

Management Service is now pilot testing with R-l-K natural gas being burned by the General Services Administration to heat the very building we are meeting in today.

Now, I realize that the motives of the Administration to exercise its R-I-K option for this SPR non-fill idea may not be so pure as what I've just described. Indeed, the Department of Energy has not had to come begging to Congress for an appropriation to purchase 28 million barrels of oil precisely because the R-I-K option is there. At this morning's crude oil price this represents approximately $460 million. Not exactly small change. If I were an appropriator, rather than an authorizer, I might be upset that my control of the purse strings was being subverted by this plan. But, I am a supporter of this plan, chiefly, because I believe it makes very good sense to take even this small amount of oil out of the supply-demand equation at this time.

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Mrs. CUBIN. The chairman now recognizes the Minority Ranking Member for any statement that he might have.

STATEMENT OF HON. ROBERT A. UNDERWOOD, A DELEGATE TO CONGRESS FROM THE TERRITORY OF GUAM

Mr. UNDERWOOD. Thank you, Madam Chairman, and please bear with me while my voice recovers. Thank you.

Legislation considered in this Subcommittee during the last Congress would have required the Federal Government to abandon its traditional practice of taking oil and gas royalties from production on public lands and cash payments and begin taking them "in kind" or as part of the lessees' production in barrels or via pipeline.

Our colleagues, Representatives Mac Thornberry, Kevin Brady, and Barbara Cubin, introduced last year's bill, H.R. 3334. However, the bill would not simply have required oil and gas companies to pay royalties-in-kind instead of cash. It would have also the Federal Government to turn the royalty oil and gas over to a private marketer who would aggregate the oil and gas and sell it on the market, deducting the marketing costs and keeping part of the proceeds.

The administration strongly opposed this legislation, maintaining that the Mineral Leasing Act and the Outer Continental Shelf Lands Act provide adequate authority to take royalties-in-kind when and if needed. The Committee did not complete action on this bill, and a comparable bill has not been reintroduced this Congress.

Royalty-in-kind is nonetheless he subject of administration action and today's hearing. On February 11th, taking advantage of historically low crude oil prices and a glutted oil market, the administration underscored its belief that it has sufficient legal authority by announcing plans to collect royalties-in-kind from companies producing oil on Federal leases in the Gulf of Mexico to partially refill the Strategic Petroleum Reserve.

The administration's proposal to refill the Strategic Petroleum Reserve with crude oil should result in removing some surplus crude oil volumes from the market supply and refilling the volumes drawn down during and after Desert Storm. Since oil that is currently stored in the Reserve was purchased at prices that average about $27 per barrel, adding oil to the Reserve with the current prices of oil near $15 would result in a net decrease in the average price per barrel for oil stored there.

The oil industry and a bipartisan group of congressional House and Senate Members representing oil-rich States have enthusiastically endorsed the plan, because is should help our domestic producers during a period of all-time low prices of crude oil. Their support appears to buttress the administration's position regarding its legal authority. Yet, despite nearly universal support for the administration's plan, there are nevertheless questions about this proposal which should be explored today. For instance, how does the administration intend to actually transfer the petroleum to the SPR? How will the administration deal with the various quality factors, such as sulfur-acid content and viscosity?

Hopefully, today's hearing will provide answers to these and other questions. I look forward to hearing the testimony of our witnesses—Mr. Rick Furiga, from the Department of Energy, and Dr. Walter Cruickshank, from the Minerals Management Service, Department of Interior. Thank you, Madam Chairman.

[The prepared statement of Mr. Underwood follows:]

STATEMENT OF HON. ROBERT UNDERWOOD, A DELEGATE IN CONGRESS FROM THE TERRITORY OF GUAM

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Hopefully, today's hearing will provide answers to these and other questions. I look forward to hearing the testimony of our witnesses, Mr. Rick Furiga, from the Department of Energy, and Dr. Walter Cruickshank, from the Minerals Management Service, U.S. Department of the Interior.

Mrs. CUBIN. Thank you, Mr. Underwood.

Now we will hear from the witnesses. Let me remind the witnesses that, under our Committee rules, they must limit their oral testimony to five minutes, but that your entire statement will appear in the record.

And, with that, I would like to recognize the first witness, Mr. Furiga, Deputy Assistant Secretary for the Strategic Petroleum Reserve, U.S. Department of Energy.

STATEMENT OF RICHARD D. FURIGA, DEPUTY ASSISTANT SECRETARY, STRATEGIC PETROLEUM RESERVE, OFFICE OF FOSSIL ENERGY, U.S. DEPARTMENT OF ENERGY

Mr. FURIGA. Thank you, Madam Chairman. Madam Chairman, Mr. Underwood, it is a pleasure to be here for the first time before this Subcommittee. I won't take time to go into the history of the Strategic Petroleum Reserve or its physical makeup. Just let me say that the Reserve consists of four separate storage sites on the Gulf Coast, two in Texas and two in Louisiana. These four sites have a total storage capacity of 700 million barrels. In that capacity, we currently have 561 million barrels of crude oil.

Let me move right into the Royalty-In-Kind Program which we are very enthused about. That program essentially involves receiving 28 million barrels of royalty oil from the Minerals Management Service to use to add to the Reserve's crude oil. We decided to split the program into two phases. When this program was announced, interest was extremely high on the part of industry. As you have mentioned, we had universal support for implementing this program. We decided to strike while the iron was hot.

Under Phase 1, we chose the largest producers of the royalty oil and sought to obtain up to 50,000 barrels a day for a 3-month period from these large producers to start deliveries as soon as we possibly could. As of right now, we have completed three agreements with Shell, Texaco and BP-Amoco. Tuesday, we finished negotiations with Exxon, and we expect to have an agreement signed by next Tuesday. So, we have four agreements totaling over 43,000 barrels per day for a 3-month period which will be delivered to our Bayou Choctaw site in Louisiana. Until Phase 2—which I will describe in a moment—until Phase 2 of the program is completed, we would prefer not to disclose the exchange ratios that were used in reaching these agreements so as not to jeopardize the participants in Phase 1 offers during Phase 2. We would be pleased to provide those in a closed session if you so desire, but we would just prefer that they not be public at this particular time.

I would like to point out that the Strategic Petroleum Reserve is experienced in buying, selling, and exchanging oil. Recently, we did a very successful exchange of about 11 million barrels of very heavy, sour crude for 8.5 million barrels of high quality, light sour crude. The ratios that we are experiencing under Royalty-In-Kind compare very favorably to what we have experienced in the past.

Phase 2 is where we will seek up to 100,000 barrels per day of royalty oil under a competitive solicitation. This solicitation will be open to all comers. We expect this solicitation to be issued by the end of the month, offers to be received by the end of May, contracts by June 15th. The Phase 2 team is working as I speak to have a solicitation ready so that we can meet that schedule.

In concluding my oral statement, I would like to make a few points. The cooperation between the Minerals Management Service personnel and the Strategic Petroleum Reserve personnel has been very gratifying. They hit the ground running. We formed a Phase 1 team and a Phase 2 team made up of personnel from both offices, and they have worked extremely well together. It is a complex job getting these solicitations together and conducting the negotiations, but they have been performing very well. Industry interest has remained high, and their cooperation and their seriousness in going into these negotiations has been very gratifying.

The first delivery under Phase 1 will start this coming Monday. The oil will be put into the pipeline and will be sent up to our Bayou Choctaw site. Almost 50 percent of the oil being obtained under Phase 1 is domestic crude, which I consider very important.

And, finally, I would like to say that our West Hackberry site, one of our largest sites, is in Congressman John's district, and to the best of my knowledge he is the person who planted the seed of using royalty oil to help fill the SPR last year at a meeting with a member of my staff. That idea worked its way until it became the number one item on the Secretary's list to do to help the oil reserve.

That concludes my oral statement, Madam Chairman.

[The prepared statement of Mr. Furiga may be found at the end of the hearing.]

Mrs. CUBIN. Thank you, Mr. Furiga.

The Chair now calls on Dr. Walter Cruickshank, Associate Director of Policy and Management Improvement for the MMS, Department of Interior.

STATEMENT OF WALTER CRUICKSHANK, ASSOCIATE DIRECTOR, POLICY AND MANAGEMENT IMPROVEMENT, MINERALS MANAGEMENT SERVICE, DEPARTMENT OF THE INTERIOR

Mr. CRUICKSHANK. Thank you, Madam Chairman, Mr. Underwood. I appreciate the opportunity to appear today to talk about the joint initiative between the Departments of Energy and the Interior to move Federal royalty oil into the Strategic Petroleum Reserve Program.

First, I would like to second Mr. Furiga's comment. I think our two agencies have been working exceptionally well together to make this project a success.

The SPR Royalty Initiative will be implemented in two phases. In the first phase, we have now concluded negotiations with some of the largest crude oil-producing companies in the Gulf of Mexico for deliveries of royalty oil to DOE for its production months of May through July of this year. We realize the importance of filling the SPR as quickly as possible during this period of low oil prices, and Phase 1 has been designed to accomplish this. By targeting the largest available royalty volumes and directly negotiating with the producer, we believe we can obtain efficient of significant volumes to the SPR in a minimum amount of time.

Mr. Furiga noted we have successfully completed negotiations with four companies to deliver approximately 43,000 barrels per day over the next 3 months. In Phase 2, we will expand the initiative to take the remaining volumes identified for this program and increase the fill rate for the Strategic Petroleum Reserve. We will conduct a competitive process in which the royalty oil at the lease will be offered in exchange for the delivery of crude oil meeting SPR specifications to locations at or near the SPR facilities. The objective is to include all potential market participants in order to maximize competition and minimize the cost of delivering crude to the SPR.

All OCS leases are included in this program except for the following: leases subject to section 8(g) of the OCS Lands Act. These leases are excluded because coastal States receive 27 percent of the royalty receipts associated with those leases, and to the extent the leases are dedicated to this initiative, there would be a loss of revenue to those States. We have also included section 6 leases, because those leases generally do not give the government the option to take royalties-in-kind. However, if the lessees agree, we will include those leases in this program.

We also have leases dedicated to supplying small refiners. As you know, the OCS Lands Act allows the Secretary to provide royalty oil to eligible small refiners if needed, and a significant borrowing of royalty oil has been set aside for this purpose. These leases will be included when and if they are dropped from the Small Refiner Program.

Finally, some 208 Gulf of Mexico leases are included in the Royalty Management Program's reengineering effort. In this initiative, we are partnering with industry, States, and tribes to streamline and simplify our processes for royalty compliance and revenue dispersement. This is a top MMS priority as we intend to reengineer our business processes to be cutting edge in the next century. Nevertheless, we expect many of these leases will be available for under the Phase 2 process in the year 2000.

The MMS role in this initiative is to support the lead agency, the Department of Energy, in some of the analyses and in the upstream logistics of delivering royalty oil. Specifically, the MMS role is to identify the leases from which oil royalties will be taken "in kind" and to generate the information associated with these leases that is necessary for program implementation. We will also notify lease owners of the decision to take the royalties-in-kind and inform them of their rights and responsibilities. We will continue to perform the lease measurement and production accounting functions and supply the Department of Energy with the data on lease production and the royalty entitlement. And, finally, we will assist DOE in conducting the Phase 2 competitive solicitation and evaluating the offers received in that process.

Through the combined Phase 1 and Phase 2 Programs, we plan to take 28 million barrels of royalty oil at the lease. At the time this program was announced, OMB estimated that this will reduce revenues to the Treasury by $170 million in this fiscal year and $200 million in the next fiscal year. The actual fiscal impacts will depend on the delivery dates and the market price of oil at that time, and, as you noted in your opening statement, the prices have already gone up.

It is also premature at this time to identify how many barrels will actually be delivered into the SPR facilities themselves. The primary determinant will be the location and quality differentials between the value of the royalty oil at the least and the value of the oil delivered to the SPR facilities.

In closing, let me state that we look forward to continuing to work with the Department of Energy to complete the transfer of the 28 million barrels of royalty oil to the SPR Program. We believe that this program will enhance the energy security of our Nation, and we also believe that this program illustrates that as managers of pubic assets, we can and must remain agile and flexible to respond to changing public needs and priorities.

Thank you, Madam Chairman and Congressman Underwood. This concludes my remarks, and I would be pleased to answer any questions.

[The prepared statement of Mr. Cruickshank may be found at the end of the hearing.]

Mrs. CUBIN. Thank you very much. And I would like to express my appreciation, as well, for the cooperation that you have had, not only between one another's agencies but also with the congressional staff and for the briefing that you came up for; it was very beneficial to me, and I wish I could have stayed for the whole thing, but, anyway, thank you for that.

I am going to start my questioning with Dr. Cruickshank, because I understand that you are missing the initial—that your Ph.D. is in mineral economics and that you are missing the initial meeting of—you are the president, I guess, of a professional society of those folks, and you are missing that initial meeting, and we appreciate that. If it weren't so difficult to get room time, we might not have had to have it today, but thank you for being here.

Could you estimate for me, Dr. Cruickshank, what the price impact of Phase 1 and Phase 2 will be?

Mr. CRUICKSHANK. The impact on oil prices?

Mrs. CUBIN. Right.

Mr. CRUICKSHANK. The Department of Energy may actually be more qualified to answer that question, but we think that the impact on prices in the oil markets will not be something that could actually determine; that there will be some small negligible impact on oil prices, but nothing that we could tie directly to this program.

Mrs. CUBIN. Like maybe 35 cents or something like that?

Mr. CRUICKSHANK. I believe the Department of Energy has done some estimates on that.

Mr. FURIGA. We have a rule of thumb, a million barrels taken off the market a year is a penny, so maybe we are talking 25 to 28 cents.

Mrs. CUBIN. Okay, thank you. Mr. Furiga, is SPR currently able to accept R-I-K oil from onshore producers in the event that additional contracts could be solicited for future refills?

Mr. FURIGA. We are talking onshore?

Mrs. CUBIN. Onshore.

Mr. FURIGA. Physically—if we are talking the Gulf Coast area, physically, we can. I am going to have to defer to Dr. Cruickshank on this, but it is my understanding that if we get into the onshore, there is a legal prohibition about transferring it to us, plus the fact that we have to consider the States' revenues that would be lost with onshore royalty oil.

Mrs. CUBIN. I think I am speaking more in terms of infrastructure than legalities and that sort of thing.

Mr. FURIGA. Infrastructure, we can receive domestic crude by pipeline. There are no truck unloading facilities. There have been proposals in the past to use stripper well production. The Stripper Well Association knows that we can't physically move stripper well production to the Reserve, but along the Gulf of Mexico we are connected to the industry infrastructure, and it is currently moving by pipeline. We can probably receive it. So, physically, the answer is yes, Madam Chairman.

Mrs. CUBIN. But not to a great degree, is that right? Are there any modifications in the SPR infrastructure that would be needed to expand that to a realistic level? I don't even really know if it is realistic that more contracts will be solicited; I hope so.

Mr. FURIGA. Oh, do you mean as far as capacity in the Reserve?

Mrs. CUBIN. No capacity.

Mr. FURIGA. Not capacity. Pipeline capacity?

Mrs. CUBIN. That is correct. Just what kind of infrastructure is therefore possible onshore?

Mr. FURIGA. We are connected in the eastern part of a Louisiana to the Capline Pipeline system which goes all up to Illinois. We are connected to the Seaway-Arco Pipeline systems west of Texas. We are connected to the Mobil Pipeline system and the Texaco Pipeline system. So, we are connected to a lot of commercial systems right to our sites. Now, there may be a problem, depending on the quantities we are talking about, with obtaining space on those pipelines. If someone wants to ship oil to us, which would be their responsibility, they would have to nominate their shipments, and there may not be room. Some pipelines in the recent past have been a proration status.

Mrs. CUBIN. Thank you. Dr. Cruickshank, as you know, I am a proponent of using the R-I-K to eliminate disputes over the valuation of crude at or near the lease when there is no arm's length transaction involved. In your testimony, you acknowledged that deliveries of the initial volumes for the SPR non-fill plan will be at St. James, Louisiana, not at the lease. Would you please elaborate for me the factors necessary to net back from St. James to the facility measurement point?

Mr. CRUICKSHANK. The way this program is actually going to work is that we are taking the royalty oil at the least and transferring title to the Department of Energy at the facility measurement point which is generally at or near the lease. The Department of Energy is then arranging—they are negotiating agreements with the companies for exchanges of the royalty oil at the lease for oil that meets SPR specifications delivered at St. James. And, so, in essence, the various costs of moving the quality and location differentials of moving from the lease to the market center is captured in the rate at which they are exchanging oil at the market center for the oil at the lease, but we are physically taking delivery of the royalty oil at the lease.

Mrs. CUBIN. At the lease. Would you mind explaining that to me again? I did not understand your answer.

Mr. CRUICKSHANK. Okay, we are taking delivery of the royalty oil at the lease, and that is where the lessee has met his obligation to the Department of Interior for paying royalties when we accept delivery of the royalty oil at the lease. What is then happening, in essence, is we have negotiated these agreements—or will in Phase 2 through a competitive process—invite people who want to take the royalty oil at the lease and physically take that and deliver us other oil at the market center or at the SPR facility. So, in essence, we are not physically moving the royalty oil from the lease to the SPR facility, but rather we are exchanging it, so the company is actually keeping the royalty oil at the lease and giving us some other barrels at the SPR facility.

Mrs. CUBIN. Okay, so there is no net back involved in that at all.

Mr. CRUICKSHANK. That is correct.

Mrs. CUBIN. Would you comment on that, too, Mr. Furiga?

Mr. FURIGA. Well, I can add that——

Mrs. CUBIN. About the negotiations with the operators.

Mr. FURIGA. Well, the Strategic Reserve obtains two types of crude oil: very high quality sweet crude, which means the sulfur is less than 0.5 percent and a very high quality sour crude; sulfur there is a maximum 1.99 percent. Those specifications were developed in conjunction with industry and studies that were done when the program started, and it kept up—the ratio runs about 60 percent sweet and 40 percent sour crude.

For Phase I, we are using the available space at our Bayou Choctaw site. That space is for sweet crude, high quality crude. Not all of the OCS production meets our specifications. So, we are meeting with the companies and, as Dr. Cruickshank said, we take title at the lease and then the company can either make an offer to deliver the lease oil, the royalty oil, if it meets our specifications or they can exchange the royalty oil for oil that does meet our specifications, again, for delivery to the SPR site. Industry is picking up the tab for delivery to our site. And, so that would quite naturally mean that you are not going to get a one for one just based on transportation, let alone a quality difference. We are getting very good crude in exchange for royalty oil.

Mrs. CUBIN. Thank you very much. Mr. Underwood, do you have any questions for the witnesses.

Mr. UNDERWOOD. Thank you very much, Madam Chairwoman. Basically, I guess, as I understand this administration's effort, there is widespread support in order to kind of alleviate some of the distress that is being felt by domestic oil producers, yet, as I understood your presentation, the purchase or the acceptance of this oil petroleum has only a 50 percent requirement that it come from domestic sources. How did we arrive at the figure or is that pretty much standard practice in that past or is there a way to up that figure or exactly what is the basis of that?

Mr. FURIGA. Mr. Underwood, I didn't mean to imply that we had established that 50 percent of the oil received has to be domestic. Under the Phase 1 agreements, the exchange rates as the numbers fell out indicate that 50 percent of the oil came using the royalty oil exchange will, in fact, be domestic crude, but our viewpoint is that a barrel is a barrel is a barrel. Oil is a fungible commodity. If we take a barrel off the market in the Gulf Coast, it doesn't matter if it is domestic or foreign, it still has that—if it is a million barrels of foreign, it has a penny impact; if it is a million barrels of domestic, it has a penny impact.

Mr. UNDERWOOD. Well, what happens to the—you know, I mean, I understand that in terms of the value to the government, but what about the independent producers? I guess, I am trying to understand if there is a gap between the way this effort is being sold and actually what we are doing. Is that really a great assistance to the independent oil producers?

Mr. FURIGA. I think it is a help. As I said, if we take a barrel of oil off the market, that affects all producers. Now, under Phase 1, we went to the largest producers. Under Phase 2, the competitive solicitation, independents will be in that particular solicitation, but to get the program off the ground, we chose to split it into Phase 1 and Phase 2. Phase 1 was confined to the largest producers; Phase 2 will be open to everybody.

Mr. UNDERWOOD. I am interested in a couple of statements, one about the issue of quality and how that is dealt with in terms of your calculations and also in terms of transportation, which may help me understand exactly what you are trying to do. Mr. Furiga, in your statement, you mentioned that crude taken "in kind" and delivered to the Reserve will be required to meet your standard quality specifications, and, then, on the other hand, Dr. Cruickshank, you stated that allowances will be made and deductions allowed to reflect differences in the quality of the oil delivered to MMS and the oil actually delivered to DOE. Isn't there some kind of contradiction in there about how we are actually dealing and how we are actually calculating the effect of the difference in the quality of the oil?

Mr. FURIGA. I don't think so. On the one hand, we have——

Mr. UNDERWOOD. Boy, I must be very simpleminded then.

[Laughter.]

Mr. FURIGA. On the one hand, we have——

Mr. UNDERWOOD. I need a Ph.D. in——

[Laughter.]

Mr. FURIGA. On the one hand, we have the Reserve's quality specifications, which, as I said, it is very high quality crude. The royalty oil, some of it does not meet those specifications or even come close. In arriving at these agreements with industry, we take into consideration the fact that their royalty oil is of a lower grade, and, therefore, of a lower value, and we know we are not going to get a barrel for barrel exchange when we are receiving high quality sweet crude and they have, for example, high sulfur sour crude; we know that. And, so there are formulas that we use; we have done exchanges before; we know how to do that, the people in New Orleans who are handling these contracts.

And then there is the transportation. The tariffs of the pipelines, for example, from the Gulf Coast up to the St. James terminal are published; they are known. We know what it is going to cost industry to transport that oil to our site. That value is subtracted off too, which, again, decreases the amount of the very high quality crude you are going to get compared to what they are giving up at the lease which doesn't meet the specifications.

Mr. UNDERWOOD. So, in your own statement, you said that the producer in Phase 1 will pay the transportation costs, but now you are indicating that, in fact, transportation costs—that the calculation will take into account the transportation costs.

Mr. FURIGA. Which the producer pays.

Mr. UNDERWOOD. Yes, run that by me again.

Mr. CRUICKSHANK. If I may add to the answer?

Mr. UNDERWOOD. Sure.

Mr. CRUICKSHANK. In essence, what is happening is that there a certain amount of oil at the lease that, in this case, the producer has, and he has promised to deliver some other volume of oil to the SPR. The two volumes are not going to be exactly the same, because the quality of the oil will be different and because the value of the oil at the market center is more than the value at the lease. So, in essence, he is going to shrink that volume. If he is taking a 100 barrels of oil at the lease, he is going to offer something less to us at the SPR facility to account for that difference in location and difference in quality. And, so, in essence, the cost of transportation, if you will, is embedded in that exchange rate. And, so we receive fewer barrels at the SPR than we are giving up at the lease.

Mr. UNDERWOOD. If I could just ask a question about the SPR in general. You said that you have 700 million barrel capacity?

Mr. FURIGA. Yes.

Mr. UNDERWOOD. And how much of that is filled at the current time?

Mr. FURIGA. We have 561 million barrels in storage.

Mr. UNDERWOOD. Okay. So, are the current activities in Yugoslavia going to affect that in any serious way over the next few months?

Mr. FURIGA. I am not aware of any plans to use the SPR as we have done in Desert Storm.

Mr. UNDERWOOD. Okay, thank you very much.

Mrs. CUBIN. Just because I am a little dense here, I want to get this straight as far as the quality factor and the transportation is concerned. Bottom line, if 28 million barrels are delivered at the platform, how many barrels go underground in the SPR?

Mr. FURIGA. I can't give you an exact barrel number, but it will be something less, I can guarantee you that. As I said, when Phase 2 is done, we will be pleased to provide the ratios. I can tell you that based on the exchanges we have done in the past, the ratios we have obtained in Phase 1 compare quite favorably to what we have experienced in the past, but it is not going to be barrel for barrel.

Mrs. CUBIN. Do you know what those ratios are?

Mr. FURIGA. I know what they are.

Mrs. CUBIN. Is that what you didn't want to say?

Mr. FURIGA. I would prefer not to state them in an open hearing; in a closed session, we would be very happy to——

Mrs. CUBIN. Okay. So, 28 million barrels at the platform, a lesser amount delivered underground, and that accounts for the quality and the transportation.

Mr. FURIGA. Yes.

Mrs. CUBIN. Okay. So, I don't see how, then, that transportation is a producer cost. It is not a producer cost.

Mr. CRUICKSHANK. No, the producer is arranging for the transportation, but he is, in essence, charging——

Mrs. CUBIN. Less.

Mr. CRUICKSHANK. [continuing] for it by keeping some of the barrels.

Mrs. CUBIN. Okay, that makes it clear to me then. Thank you very much.

Mr. UNDERWOOD. Mr. Inslee.

Mrs. CUBIN. Thank you. Mr. Inslee, did you have any questions? [Laughter.]

Mr. INSLEE. Thank you, Madam Chair. I don't have any questions. Thanks for the assistance from Guam.

Mrs. CUBIN. Oh, you know, when you are a middle-aged woman, you can't be held responsible for things.

Well, I would like to thank the panel very much, again, for your cooperation in working together and getting this done, and while all of us realize it isn't a solution to the problem that the domestic oil is facing, it certainly has been helpful, and I truly appreciate your cooperation, and I hope you have a good meeting for the rest of your convention, Dr. Cruickshank. Thank you very much.

This Subcommittee is adjourned.

Mr. FURIGA. Thank you.

[Whereupon, at 2:40 p.m., the Subcommittee was adjourned.]

[Additional material submitted for the record follows.]

STATEMENT OF RICHARD D. FURIGA, DEPUTY ASSISTANT SECRETARY, STRATEGIC PETROLEUM RESERVE, OFFICE OF FOSSIL ENERGY, U.S. DEPARTMENT OF ENERGY

Madam Chairman and Members of the Subcommittee:

I am pleased to represent the Department of Energy and to appear with my colleague from the Department of the Interior to testify on the resumption of oil acquisition for the Strategic Petroleum Reserve.

A joint DOE/DOI team has been putting this initiative together quickly and effectively. The efforts of the staff from our Office of Fossil Energy and from Interior's Minerals Management Service have allowed us to take advantage of low oil prices and begin adding to our Nation's energy security.

In fact, I am pleased to report that beginning this coming weekend the first crude oil will be delivered to the Strategic Petroleum Reserve under an expedited delivery request from Equiva Trading Company in exchange for royalty volumes from Shell and Texaco.

Before I go into more detail on the progress made to date and our plans for the immediate future, let me describe briefly the significance of the Strategic Petroleum Reserve to the energy and economic health of this Nation.

The Strategic Petroleum Reserve—An Investment in Energy Security

The Strategic Petroleum Reserve is the cornerstone of our capability to respond to an energy supply emergency.

Numerous times in the past three decades the world has experienced disruptions in the supply of oil exports. In 1973 the first energy crisis made most Americans aware that our economy is highly dependent upon the availability of imported oil, and that crude oil prices were, for the most part, no longer within our control. That price shock led to passage of the Energy Policy and Conservation Act in December 1975. Among other things, the Act authorized the creation of a petroleum reserve of up to one billion barrels.

Today, the Strategic Petroleum Reserve consists of four sites, two in Texas and two in Louisiana, with a capacity of 700 million barrels. All of the storage capacity is in 62 huge caverns that have been leached from salt domes thousands of feet below the surface.

The first crude oil was added to the Reserve on July 21, 1977. In the early 1980s, in the aftermath of the 1979 Iranian revolution and accompanying oil disruption, the Reserve was filled as fast as the facilities could accept crude oil; by the end of 1985, it contained 489 million barrels of oil. In the late 1980's and early 1990's, constrained by tightening budgets, fill continued albeit at a slower pace. In 1994, fill stopped completely at a peak inventory of 592 million barrels.

The Reserve has been used once under Presidential direction in response to oil supply concerns. In January 1991, at the onset of Operation Desert Storm and in conjunction with our allies in the International Energy Agency, the Department of Energy activated a drawdown of the Reserve, ultimately awarding competitive contracts for the sale of 17.3 million barrels. The Desert Storm sale, and other test sales, successfully demonstrated the Reserve's ability to function efficiently in a real world emergency situation.

In fiscal years 1996-97, driven by fiscal requirements, three non-emergency oil sales totaling 28 million barrels were carried out, leaving the Reserve at its current inventory of 561 million barrels.

Transfer of Royalty Oil to Restore SPR Inventory

The downturn in oil prices that began in late 1997 and intensified in 1998 and early 1999 continues to pose a serious threat to our domestic production capacity and, consequently, to our long-term energy security. At the same time, however, it has provided an unprecedented opportunity to begin re-acquiring crude oil for the Reserve at relatively low prices.

Secretary Richardson brought this issue before the Administration in late 1998. After a series of meetings with the Department of the Interior, the Office of Management and Budget, and the National Economic Council, it was agreed the Administration would move as quickly as possible to transfer 28 million barrels of Federal royalty oil—the same amount sold during 1996 and 1997 largely for deficit reduction purposes—to the Department of Energy for use in refilling the Strategic Petroleum Reserve. The oil to be transferred would be royalty oil from the Gulf of Mexico Outer Continental Shelf.

This approach to acquiring oil for the Reserve while prices are relatively low offers several advantages:

- The acquisition price would be below the price for which the Government had sold oil in FY 1996-97 and significantly below the Reserve's historic average oil acquisition cost.
- By resuming oil fill, we would help improve the ratio between the Reserve's inventory and the daily rate of oil imports which had begun to escalate in recent years.
- Finally, the royalty transfer plan would enable the Federal Government to add oil to the Reserve without requiring new appropriations, particularly important since funding has not been appropriated to purchase oil for the Reserve since 1990.

As Secretary Richardson said in announcing the initiative on February 11, 1999, "By putting royalty oil in the Strategic Petroleum Reserve today, we will get a high rate of return tomorrow—enhanced national energy security, increased strategic assets, and a very good deal for the American taxpayer."

Working together, the Department's Strategic Petroleum Reserve Office and the Minerals Management Service decided to transfer the oil in two phases.

In Phase 1 the Government negotiated with a small number of the largest producers on Federal lease tracts with a target of transferring up to 50,000 barrels of oil per day, starting no later than May 1, and ending on July 31, 1999. Phase 2 will take the remainder of the 28 million barrels from eligible producers who respond to a competitive solicitation. Deliveries are expected to start on August 1, 1999, at a rate of approximately 100,000 barrels per day and end in March or April 2000.

In both phases, the Strategic Petroleum Reserve will require that the oil delivered to the Reserve meet our standard quality specifications. In addition, the Strategic Petroleum Reserve is requiring that bids provide for delivering the oil directly to Reserve sites rather than to the normal transfer points at which the value of the royalty share is calculated for payment in cash.

Due to the complexity of gathering and transporting royalty oil with varying qualities produced from more than 1,000 Federal leases in the Gulf of Mexico, we do not expect to transport royalty barrels directly to the Reserve. Instead, we will arrange for exchanges of crude oil to meet the Reserve's storage specification and provide for efficient delivery.

Under these exchange agreements, the volume of oil received by the Strategic Petroleum Reserve will differ from and could be somewhat less than the volumes accepted by the Minerals Management Service. This is because the oil delivered to the Reserve is expected to be of a higher quality than the oil produced at the lease and additionally, the producer in Phase 1 or the contractor in Phase 2 will pay the transportation expenses.

For example, in the recently negotiated contracts, the crude oil to be received by the Strategic Petroleum Reserve will be a light, low-sulfur oil, significantly higher in quality than the oil produced from the Federal leases. This grade of crude oil is suitable for the "sweet" oil storage capacity available at our Bayou Choctaw site. Because the oil to be delivered is of higher quality than the royalty crude, the exchange ratio is somewhat less than 1:1 due to adjustments for crude quality.[1]

In the upcoming Phase 2, we expect to continue the exchange practice. When the Reserve receives a barrel of crude oil in exchange for an equivalent quality royalty crude, the total volume delivered will be close to the quantity transferred by the Minerals Management Service, adjusted only for gathering and transportation expenses.

Recent Actions and Current Plans

On March 31, 1999, we announced our contracts under the first phase of the royalty in kind program. Shell, Texaco, and BP-Amoco have agreed to deliver 38,600 barrels per day of very light, low-sulphur crude oil to our Bayou Choctaw, Louisiana, site in lieu of making a royalty payment to the Minerals Management Service. The 3-month contracts will result in approximately 3.5 million barrels being added to the Reserve.

Because these companies are all potential bidders during Phase 2 of this royalty-in-kind transfer, they have asked us to treat the exchange ratios for the royalty versus delivered oil as procurement sensitive information, and we therefore, have not included in our public testimony the exact volumes of royalty oil included in the contract.

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[1] Exchanging crude oil to enhance the quality of the oil in the Strategic Petroleum Reserve is not without precedent. In 1998, P.M.I. Norteamerico S.A. de C.V., of Houston, TX, a commercial arm of the Mexican oil company PEMEX, delivered 8.524 million barrels of higher-grade oil in exchange for 11 million barrels of heavier, higher-sulfur Maya crude oil.

Phase 2 of the royalty-in-kind program will begin with a solicitation that we plan to issue in late April or early May. Unlike the first phase, Phase 2 will be open to all bidders for 100,000 barrels per day of royalty oil from the Gulf of Mexico. We anticipate awarding contracts in June and beginning deliveries on August 1, 1999. Deliveries will continue until the total 28 million barrels of royalty oil is transferred to the Department of Energy.

Our success in Phase 1 of this program, and our continued close working relationship with the Department of the Interior, gives us every reason to believe the second phase will also proceed smoothly. We expect that the Department of Energy will add inventory to the Reserve, lower the average cost of oil acquisition, receive fair value during the exchange portion of the contract, and conduct its acquisition in a manner to counter balance the extremes of the supply and demand cycles rather than exacerbating their peaks and valleys.

This concludes my prepared statement, I will be happy to answer any questions Members may have.

STATEMENT OF WALTER CRUICKSHANK, ASSOCIATE DIRECTOR, MINERALS MANAGEMENT SERVICE, U.S. DEPARTMENT OF THE INTERIOR

Madam Chairman and Members of the Subcommittee, I appreciate the opportunity to appear today to present testimony on the Minerals Management Service's (MMS) efforts in support of the joint Departments of Energy (DOE) and the Interior (DOI) initiative to move Federal royalty oil into the Strategic Petroleum Reserve (SPR). My testimony today will briefly: (1) describe the initiative and its status; (2) outline MMS' role; (3) address some of the operational considerations in using Federal royalty in kind (RIK) oil to add to the SPR; and (4) explain our plans for the next phase of this project.

Description and Status of the Project. The SPR RIK Initiative will be implemented in two phases.

In Phase 1, DOE and MMS are now concluding negotiations with several of the largest crude oil producing companies in the Gulf of Mexico for potential deliveries of royalty oil to DOE and the SPR starting on May 1, 1999 for a 3-month period. We realize the importance of filling the SPR as quickly as possible during this time of relatively low crude oil prices and Phase 1 has been designed to accomplish this. By targeting the largest available royalty volumes and directly negotiating with the producer, we believe we can attain efficient delivery of significant volumes to the SPR in the minimum amount of time.

To date, we have successfully negotiated arrangements with three of the largest crude oil producers in the Gulf of Mexico—Texaco, Shell, and BP-Amoco—to begin delivering approximately 38,600 barrels per day of oil to add to the Federal Government emergency stockpile. Over the 3-month term of this first phase, these companies will deliver nearly 3.5 million barrels of oil to DOE at the St. James market center for further movement into the SPR facility at Bayou Choctaw, Louisiana. Continuing negotiations may provide additional royalty oil volumes to the SPR in Phase 1.

Phase 1 agreements provide for delivery at the St. James market center of volumes of oil that are less than the government's royalty volume entitlement at the lease. This reduction in volume reflects both transportation and the quality and location differentials between the generally higher quality of crude oil delivered to DOE at the market center and the royalty oil at the lease. Negotiations focused on the amount and value of these factors.

Under Phase 2, the SPR RIK Initiative will expand to potentially take the remaining volumes identified for the program and increase the fill rate for the SPR. DOE and MMS will conduct a competitive auction in Phase 2 in which royalty oil at the lease will be offered in exchange for delivery of crude oil meeting SPR specifications to locations at or near at least two SPR facilities. Royalty volumes on the order of 70,000 to 100,000 barrels per day are anticipated to be available for bidding under Phase 2. The objective is to include all potential market participants in order to maximize competition and minimize costs of delivering crude to the SPR. Phase 2 begins when Phase 1 ends, on August 1, 1999, and runs for a 6-month term with the potential for a second term. Planning for Phase 2 is currently underway.

All OCS leases will be available for inclusion in the program except for:

- Section 8(g) leases: These leases are excluded because the coastal States receive 27 percent of associated royalty receipts, and those States would lose an important revenue stream from SPR-dedicated leases.

- Section 6 leases: These leases generally do not include language giving the government the option to take royalties in kind. They will be included in the program upon lessee agreement.
- Leases dedicated to supply small refiners: These leases will be included when and if they are dropped from the small refiner program.
- Leases in MMS' royalty reengineering program: Some 208 Gulf of Mexico leases are included in this important exploration and testing of new methods to manage mineral royalties. Some of these leases may be available under Phase 2 in the year 2000.

DOI/MMS Role. The MMS' role in the SPR initiative is to support the lead agency—DOE—in economic analyses and in the "upstream" logistics of royalty oil delivery at Gulf of Mexico leases. The MMS' role is to:

- Identify the Gulf of Mexico leases for which oil royalties can be received in kind and generate lease information for program implementation.
- Notify lease owners of any decision to take their royalties in kind, and inform them of their rights and responsibilities when paying royalties in kind.
- Continue to perform lease measurement and production accounting functions and supply DOE with data on production and royalty entitlement.
- Assist DOE in negotiations with lease owners for delivery of RIK oil to the SPR under Phase 1 of the program.
- In Phase 2 of the program, assist DOE in developing and issuing a competitive solicitation for delivery of oil to SPR facilities. We will also assist DOE in evaluating bids received and selecting the winning bidders.

Operational Considerations. Operational and logistical considerations that have been addressed to date include the following.

Title transfer and contracting. Using the provisions of the OCS Lands Act, DOI will transfer title to royalty oil to DOE at the OCS facility measurement point, typically on the lease. DOE will award and administer contracts for delivery of crude oil to the SPR facility or nearby market center. In both phases, crude oil will move to the SPR by standard industry practice. We anticipate that the most common scenario will be the award by DOE of exchange contracts in which royalty oil will be provided to the contractor in exchange for a market-based volume of SPR crude either at or near the SPR facility or at the market center. DOE will arrange for any final transportation needed to move crude from an exchange point not located at one of the SPR sites.

Imbalances. The operator/lessee will be required to maintain a balancing account to track monthly imbalances that may occur in deliveries of royalty oil to DOI. The operator will work together with DOI and DOE to resolve monthly imbalances by increasing or decreasing deliveries in the subsequent month. However, MMS retains the right to settle imbalances via cash payment or accounting adjustment at the end of each contract term.

De Minimis Leases. A substantial number of offshore properties produce small amounts of crude oil, much of which is condensate associated with natural gas production. For example, nearly 30 percent of offshore properties produce less than 1 barrel per day. In Phase 1, we have negotiated for RIK deliveries primarily from high producing leases. In Phase 2, we have not yet decided whether to include all available leases or to exclude those leases producing de minimis amounts. The primary factors we are considering are the administrative costs for the government to analyze the economics and monitor compliance for each of these leases and the transaction costs for the industry to deliver RIK for the de minimis leases.

Next Steps. For the combined Phase 1 and 2 program, DOE/DOI plan to take up to 28 million barrels of royalty oil at the lease, which is estimated by OMB to have a fiscal impact of $170 mm in Fiscal Year 1999 and $200 mm in Fiscal Year 2000 (using OMB's FY 2000 budget ecomomic assumptions of price projections of $12.39 and $14.12, respectively) in decreased revenues to the Treasury. Actual fiscal impact will depend on actual delivery dates, quantity of oil transferred, and market oil price at the time.

It is premature to identify at this point how many barrels will be actually delivered into the SPR from the up to 28 million barrels of royalty oil identified for potential delivery to DOE at the lease. The actual amount of crude oil delivered to the SPR will depend on the specific details of negotiated agreements (Phase 1) and successful bids in the competitive auction (Phase 2). The primary determinant will be the location and quality differentials between the value of the royalty oil at the lease and the value of the oil delivered to the SPR sites. At least 15 percent of the 28 million barrels of RIK oil will be taken in the 3-month Phase 1 term.

We will be very busy this Spring as we work with DOE to develop and conduct the competitive bidding process under Phase 2 for royalty oil deliveries to the SPR. Specifically, we will assist DOE in developing and releasing a Request for Offers

(RFO); preparing an evaluation plan; arraying economic and lease data to support the economic analysis of bids; and evaluating, negotiating, and selecting bids. We anticipate that contracts will be awarded on or before July 1, 1999 for Phase 2 deliveries that will commence August 1, 1999.

In closing, let me state that we look forward to continuing to work with DOE to complete the transfer of 28 million barrels of royalty oil. We believe that this program will enhance the energy security of our nation. We also believe that this program illustrates that as managers of public assets we can and must remain agile and flexible to respond to changing public needs. Using our RIK option to partially fill the SPR is a good example of how we can retain such flexibility.

Thank you Madam Chairman and Members of the Subcommittee, this concludes my prepared remarks. I would be pleased to answer any questions you may have.