The original documents are located in Box C37, folder "Presidential Handwriting, 4/1/1976 (2)" of the Presidential Handwriting File at the Gerald R. Ford Presidential Library.

THE WHITE HOUSE

WASHINGTON

April 1, 1976

ADMINISTRATIVELY CONFIDENTIAL

MEMORANDUM FOR: JIM LYNN

FROM: JIM CONNOR

SUBJECT: 1976/1977 Budget Decision: Federal Energy Administration (FEA)

The President returned the originals of the attached memoranda in the outbox with the following notation:

"Have these gone up?"

Please follow-up with appropriate action.

cc: Dick Cheney

Attachments:
Meeting on FEA 3/25/76 (Briefing Paper)
Lynn memo 3/24/76 on above subject
Frank Zarb memo 3/24/76 re Strategic Petroleum Reserve Issues

THE WHITE HOUSE
WASHINGTON

Jim Lynn, 3/31/76

Have these you

up?

MEETING ON
FEDERAL ENERGY ADMINISTRATION

Thursday, March 25, 1976

2:00 P.M.

THE PRESIDENT HAS SEEN

THE WHITE HOUSE
WASHINGTON

Jim -

Frank Zarb asked that this memo be used for the FEA Meeting tomorrow --

The original was sent up to the President together with OMB's Briefing Paper and Decision Memo. (because we felt President should have time to study it) It is confusing for them to give him two decision memos in with a Briefing Paper. What do you think?

copy attached

Trudy

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET

DATE: 3/24/76

TO: Jim Connors

FROM: James L. Mitchell

For your review in preparation for meeting with the President on FEA issues Thursday, March 25, 2 p.m.

OMB FORM 38
REV AUG 73

THE PRESIDENT HAS SEEN....

FEDERAL ENERGY ADMINISTRATION

WASHINGTON, D.C. 20461

March 24, 1976

OFFICE OF THE ADMINISTRATOR

MEMORANDUM FOR THE PRESIDENT

FROM: FRANK G. ZARB (Hill acting for)

SUBJECT: Strategic Petroleum Reserve Issues

Although the energy debate of 1975 was marked by considerable controversy, the one area of solid agreement with the Congress was the need for a strategic reserve that could be used to soften the impact of an embargo and act as a deterrent to the possible imposition of an embargo. Differences with the Congress in this area centered not around the desirability of a strategic reserve, but around the structure and timing of the reserve.

The Energy Policy and Conservation Act contains your strategic storage program with several modifications:

- The act authorizes the 1 billion barrel reserve contained in your program, but places greater emphasis on a reserve of only a half of billion barrels.

- The emphasis on a smaller reserve in the early years is balanced off by statutory requirements that the one-half billion system be in place within seven years and that 150 million barrels be in place in three years. In short, the Congress opted for a smaller reserve within a definite time frame as opposed to a larger reserve with an open-ended schedule, while agreeing to additional storage up to your 1 billion level if the additional storage is judged to be necessary after seven years.

- As a result of pressure from the New England delegation, the act also mandates the storage of product in different regions of the country unless it can be demonstrated that large scale crude storage systems in the Gulf (which are dramatically cheaper than the steel tank storage that would have to be constructed for the regional reserves) can supply products in a timely manner in the event of an embargo.

- Finally, the act provides the authority you requested to require industry to shoulder the financial cost of the oil placed in the reserve, but limits the obligation to approximately 180 million barrels.

FEA has conducted comprehensive studies over the past 15 months regarding implementation of the strategic reserve and has reached the following conclusions regarding the above modifications to your current program:

- The seven and three year system requirements not only can be met, but also should be met. The latter judgment is based on the fact that meeting the schedules (as opposed to stretching out the system's development) will be dramatically cheaper in budgetary terms, have less environmental problems, and provides an opportunity to begin near-term discussions with selected OPEC countries regarding the possibility of bulk purchases of crude oil at below market prices.

- A strong case can be made that the more expensive regional storage is both unnecessary vis-a-vis the requirements of the Act and overly costly, even though there will be considerable political opposition.

- Steps should be taken to begin implementation of the requirement to have industry absorb all of the oil costs provided in the bill, even though there will be considerable opposition from the industry.

OMB is not in agreement with FEA's position regarding the schedule for meeting the three year statutory requirement of 150 million barrels. They would go for a stretched out schedule on grounds that the longer schedule will enable FEA to save $78 million in facilities costs, even though the OMB approach will cost $265-400 million more than the FEA plan when the cost of purchasing the oil is included in the budget calculation.

OMB does agree with FEA's position on the regional storage system and the industrial reserve, but would defer announcing these decisions until a later time. FEA is required to submit a report to the Congress on the 150 million barrel program by March 22, and believes that tentative decisions on these issues must be included in the report.

Apart from these issues, which are addressed in the attachments, FEA, OMB and Interior are not in agreement on the price FEA ought to pay for oil for the strategic storage system:

- OMB recommends that FEA allocate old oil ($5.25) to the system as the lowest cost option;

- FEA recommends a combination of royalty oil and oil purchased at the domestic average price;

- Interior objects to the use of royalty oil.

In FEA's view, its position is not only a valid compromise between the extremes of old oil and world oil prices (it would have the government paying slightly less than the price paid for crude by the oil industry), but also roughly equivalent to the price we would anticipate paying to OPEC producers if a below market bulk purchase price can be arranged. The OMB option would preclude any efforts to negotiate such arrangements.

The issue here, which is addressed in greater detail in the attachments, is what price to pay for the oil, not how to finance the purchase of oil. As you know, production from the Naval Petroleum Reserves will finance the purchases over time.

I believe that FEA has carefully analyzed the strategic reserve program and has developed a program that will not only meet the time requirements in the Act, but also fully optimize the system at the least cost. I am prepared to discuss these issues with you and other advisors at your earliest possible convenience.

Attachments

ISSUE 1: SCHEDULE FOR ESTABLISHING THE RESERVE

Issue and Discussion

The Energy Policy and Conservation Act requires FEA to store 150 million barrels of petroleum within 3 years, and to submit a report to Congress by March 21, 1976, describing plans for construction and fill of the Early Storage Reserve (ESR). Although all your advisors agreed with your program to establish a strategic reserve, there is no longer unanimity on scheduling because of perceived cost differences. Some favor a slower program than that which FEA believes is required by law and feasible to attain.

OMB prefers a slower approach with slightly lower facilities costs. Because FEA cost estimates show that acquisition of existing mines would cost more than the construction of new cavities in salt domes, OMB argues that FEA should:

- o Effectively exclude mines and new salt domes on the basis of marginal costs; and
- o Utilize only four salt domes with existing caverns and expand them by leaching new caverns.

FEA plans an early storage system using a mix of existing mines and salt dome cavities. New caverns can be expanded at these sites if technically feasible, or new salt domes would be utilized to increase the storage capacity of the total Reserve. FEA's plan is based on factors that FEA considers to be decisive. FEA's plan:

- o Is the only way to meet the three-year schedule (and thereby comply with Congressional intent as expressed in the Act);
- o Will, in fact, save $265 to $400 million compared to OMB's "go slow" approach because oil purchased during the period of price control will be significantly less costly than after controls expire and, further, oil purchased during the early control period is less costly than oil purchased later in the period;
- o Will, by providing more storage capacity sooner, give us more flexibility in discussions with OPEC countries regarding bulk purchase of oil below market prices, as we have recently discussed in context of Iranian and Russian deals;

- Allows consideration of more environmentally desirable alternatives;

- Is more cost effective because the sooner we have substantial storage, the sooner we have actual protection against an embargo and a lever to help deter an embargo (analysis indicates an earlier reserve is more cost effective than a later reserve); and

- Increases the Reserve's effectiveness and avoids high cost steel tank regional storage, because pipeline and port facility limitations are reduced by the larger number of sites (6-10).

In summary, FEA's plan achieves storage faster, at a lower overall system cost, meets environmental goals, and provides protection against an embargo at the earliest possible time.

Decision

FEA Plan ________________

OMB Plan ________________

ISSUE 2: SOURCE AND PRICE OF STORED OIL

Issue and Discussion

The Government is required to purchase oil for the Early Storage Reserve (ESR). Four options have been considered.

1. Buy imported oil at the world market price.

This option is the most costly of all the options. It would require appropriatiation of $1,634,000,000*. It would put the full social cost of the Government portion of the petroleum in the Reserve on the Federal budget.

2. Buy domestic or imported oil at the national average cost through participation in the Entitlements Program.

This is the next highest cost alternatives to the Federal Government and would cost $1,309,000,000. The Government would be buying oil on the same basis as other purchasers, and this option could be defended politically as the most equitable. However, it misses the opportunity of passing much of the cost of the program to the beneficiaries of it.

3. Store the royalty oil now taken in kind by the Government and sold to small refiners and obtain the additional oil needed in the open market at the national average price through participation in the Entitlements Program.

This is the second least costly alternative and the one preferred by FEA. It would cost $831,000,000. The Department of the Interior (DOI) strongly opposes diversion of royalty oil from the small refiners because they believe it would create a financial burden for the small refiners. However, according to DOI, royalty oil accounts for only 1/4 of the crude supply of the 38 small refineries. In fact, DOI plans to reduce individual refiners' benefits under this program by extending eligibility from 38 to 69 refineries. This would lessen the share of each participant in the current program. Denial of royalty oil to these refineries would not eliminate their source of supply as they presently exchange such oil for that actually run in their refineries. If it is deemed necessary, to subsidize some or all of these "small" refiners in the near-term, FEA's regulatory program can be adjusted to reflect a small industry bias.

---

* Cost estimates assume Government purchase of 95 million barrels, i.e., utilization of the Industrial Petroleum Reserve for 55 million barrles of the ESR.

4. Allocate old oil to the Government and buy it at $5.25 per barrel.

OMB prefers this option, but FEA opposes it. This is the least costly option as it would cost $640,000,000. This option would meet the greatest industry and congressional opposition as it was not anticipated that FEA would use regulatory programs to allocate cheap oil to itself.

FEA's Office of the General Counsel advises that legal challenge to this approach would not be frivolous and would pose a substantial risk of an adverse decision. This option carries considerable risk in that if allocation of cheap old oil to the Government is overturned in court (1) the opportunity to take royalty oil may be lost resulting in a cost of $286 million more than FEA's preferred alternative, and (2) the opportunity to negotiate a bulk purchase at reduced cost with a foreign country would no longer be available because the appropriated funds at $5.25 per barrel would be insufficient for such a bulk purchase.

<u>Decision</u>

Option 1 _______________ Concur

Option 2 _______________ Concur

Option 3 _______________ Concur
(FEA recommended option)

Option 4 _______________ Concur
(OMB recommended option)

ISSUE 3: INDUSTRIAL PETROLEUM RESERVE

Issue and Discussion

The Energy Policy and Conservation Act gives FEA discretion to establish an Industrial Petroleum Reserve (IPR) as part of the Early Storage Reserve (ESR) and/or the Strategic Petroleum Reserve (SPR).

- o FEA may require industry to acquire and store, in readily accessible inventories, oil equal to 3 percent of the total imported or refined in the previous calendar year (approximately 180 million barrels). Industry's prorated share of the 150 million barrel ESR, comparing 180 million barrels to 500 million barrels for the full SPR, would be 55 million barrels.

This provision was included in your proposals to Congress, and we strongly supported it in a letter to Senator Jackson, which he used to great effect in the Senate debates.

The ESR Report must contain plans to store 150 million barrels in 3 years. Therefore, the Report must describe:

- o Industry's portion of the Reserve, or
- o That funds for Government purchase or 150 million barrels will be needed.

FEA plans to announce in the ESR Report to Congress that:

- o IPR will be implemented and industry will be allowed to pass through the costs thereof;
- o Final decision on the IPR is subject to further consideration under procedures listed in the ESR;
- o The Government will budget for the purchase of 95 million barrels;
- o No appropriations will be requested for the portion of the Reserve to be provided by industry (55 million barrels).

FEA's plan would:

- o Put the cost of the storage program on the users of oil and the industry, i.e., those who will benefit during supply interruption;

- Reduce Federal outlays by $677 million for the ESR; and

- Increase our flexibility by discussing the IPR in the current ESR Report (the ESR can be implemented without congressional approval whereas the SPR plan is subject to congressional review and disapproval).

On the other hand, OMB seeks to make no decision at this time and delete the entire IPR discussion from the ESR Report, and to delay decision until the December report to Congress. This would require us to:

- Budget for the Government to purchase the entire 150 million barrels for the ESR; and

- Secure congressional approval before we can implement the IPR.

Comment

- All line agencies, including Treasury, agreed with FEA's proposal on the IPR or made no comment.

- While industry can be expected to object to maximum utilization of the IPR, its complaints should be mitigated by pass through of costs and allowing industry to use low-cost United States Government storage facilities.

Decision

FEA Plan ______________

OMB Plan ______________

ISSUE 4: REGIONAL STORAGE

Issue and Discussion

The Energy Policy and Conservation Act requires that the Early Storage Reserve (ESR) meet the needs for residual fuel and refined products in regions which depend upon imports for a substantial portion of their total energy requirements. The Regional Petroleum Reserve section of the Act allows FEA to substitute crude oil or other petroleum products for amounts of residual or other refined petroleum products stored in the region, if there is no delay or other adverse effect on satisfying the regions interruption. The only reasonable means to store in the regions would be in steel tanks, however, storage costs for tanks are $8 to $12 per barrel while underground storage costs are $1.40 per barrel. By fully utilizing our option to use substitutable central storage, we can hold costs for a 500 million barrel program to $700 million; if we use steel tank storage in the regions, program costs will rise to $2 billion.

Initial analysis indicates that the import product requirements of the Regions can be met by a combination of the measures listed below, at a significantly lower cost than physical storage within regions while still providing the level of regional protection required.

- o Substitution of crude for product, to supply Caribbean and domestic refineries, which could be stored underground in the Gulf Coast.
- o Conservation.
- o Emergency increase in refinery utilization.
- o Refinery yield shifts.

Since present analysis indicates that we can meet east coast needs for products during an interruption by storing crude oil in Gulf Coast salt domes and mines, we recommend not planning at this time to store refined products locally to meet the Regional Storage requirements. If further analysis indicates that small quantities of local storage may be needed, a recommendation will be made in the Strategic Reserve Plan report in December 1976.

Senator Kennedy, and other members of the New England delegations, have already voiced objections to our proposal not to use tanks. They argue that:

- They will not have a cushion to offset inaccuracy in the analysis.
- Seasonal peaks and contingencies are not provided for.
- Shipping may not be available and a waiver to the Jones Act will be required.

We have examined the shipping requirements and, based on information supplied by the Maritime Administration, have concluded that, for embargoes of two million barrels a day or less, a Jones Act waiver would not be required. However, in the event of a severe embargo of four million barrels a day, a carefully limited waiver to the Jones Act would probably be needed whether or not we had total storage of products in the New England region.

New England would probably be satisfied at this time by the storage of a nominal amount of oil. Senator Kennedy's staff has proposed using surplus Government tank farms on the east coast for product storage pending completion of a definitive analysis. We have three such tank farms totalling about two million barrels. However, storage of products in the United States Government facilities at this stage would set a precedent that may be irreversible, even if subsequent analysis shows it is not needed. Accordingly, our recommendation is that we not plan for any tank storage at this time.

Recommendation

Because of the costs involved FEA feels that regional storage requirements can be met through the substitution of crude which would be stored underground in the Gulf Coast for refined products.

All agencies reviewing this issue either agreed with the FEA position or had no comment. OMB concurred with FEA.

Decision

Concur ____________________

Non-concur ________________

THE PRESIDENT HAS SEEN...

MEETING ON FEDERAL ENERGY ADMINISTRATION
PROGRAM AND BUDGET ISSUES
Thursday, March 25, 1976
2:00 to 3:00 p.m. (1 hour)
The Oval Office

From: James T. Lynn

I. PURPOSE

To make decisions on program and budget issues raised by the FY-76 Budget Supplemental and the FY-77 Budget Amendment requested by the Federal Energy Administration (FEA) to discharge its responsibilities under the Energy Policy and Conservation Act you signed into law December 22, 1975.

II. BACKGROUND, PARTICIPANTS, AND PRESS PLAN

A. Background: The FY-76 Budget Supplemental and FY-77 Budget Amendment submissions by the FEA have been reviewed by the Office of Management and Budget (OMB). Selected issues have been called to the attention of White House staff and interested agencies. FEA and OMB agree on many of the issues raised by these submissions. This meeting will focus on three issues that require Presidential consideration and decision:

1. State energy conservation grants
2. Petroleum industry compliance audits
3. Strategic petroleum storage

B. Participants: James Lynn, Frank Zarb, Alan Greenspan, James Cannon, Paul O'Neill, John Hill, Jim Mitchell.

C. Press Plan: None

III. TALKING POINTS

A. Jim Mitchell, how can we make sure the State energy conservation grant program will actually terminate in three years as now prescribed by the Energy Policy and Conservation Act?

B. Frank Zarb, why should you start such an intensive, expensive oil industry audit effort during the 40-month period in which you should make substantial progress in reducing controls on the industry?

C. John Hill, is it realistic to plan to store 150 million barrels of oil in just three years, as prescribed in the Early Storage Reserve?

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

MAR 24 1976

ACTION

MEMORANDUM FOR THE PRESIDENT

FROM: JAMES T. LYNN

SUBJECT: 1976/1977 Budget Decision: Federal Energy Administration (FEA)

Enactment of the Energy Policy and Conservation Act (EPCA) in late December 1975 did not provide sufficient time to make changes to FEA's 1977 budget levels published in January. The FEA budget at that time was based on expiration of controls and did not include funds for a number of programs mandated by EPCA.

Since that time, FEA has proposed a 1976 Supplemental Request and a 1977 Budget Amendment over previously approved levels for implementation of the programs provided for in EPCA. Both OMB and FEA agree on many of the resource and policy issues raised by the proposed changes to FEA's budget. Two of these agreements warrant your attention:

- Employment will continue at the current level (292) for the petroleum allocation program until September 30, but will decrease to 35 positions by the end of fiscal year 1977, consistent with your signing statement for EPCA that indicated allocation and price controls would be dismantled and streamlined for certain sectors of the petroleum industry.

- FEA will meet the energy conservation and energy resource development requirements of EPCA within existing resources to the maximum extent possible.

OMB and FEA disagree, however, on three key issues, presented by OMB for your consideration in Tabs I, II and III. Briefly, the issues are:

I. <u>State energy conservation grants</u>

EPCA authorizes a three-year program beginning in 1976 at $50 million per year. FEA is authorized to provide technical assistance, planning grants, and implementation grants to the States if the States agree to:

- complete a feasibility report on energy conservation;
- prepare a plan designed to achieve 5 percent reduction in the consumption projected for 1980;
- implement five mandatory conservation programs, with an option to implement other programs in addition.

FEA and OMB agree that this new categorical grant program would be funded at $7.2 million in 1976 and $50 million in 1977, and that funds be limited to planning, coordination, and promotion of energy conservation programs.

But FEA and OMB disagree on the approach to be used for making grants. FEA prefers maximum flexibility and discretion to States in use of funds to encourage imaginative approaches to energy conservation. OMB prefers to emphasize the five mandatory programs which EPCA requires that participating States establish. Refer to Tab I.

DECISION: Approve agency request ______________

Approve OMB recommendation ______________

II. <u>Petroleum industry compliance audits</u>

EPCA provides for a 40-month extension of regulatory controls to May 1979. FEA's 1976 appropriation provides for 1,063 positions for the program. FEA's 1977 approved budget called for a wrap-up program decreasing to 44 positions by the end of the year, on the assumption that controls would terminate December 15, 1975.

Under EPCA, FEA is requesting an increase from 1,063 to 1,849 positions to broaden audit coverage of the industry and increase the staff time spent on each audit. OMB recommends an increase over the 1976 level to 1,326 positions because of an increase in the complexity of price controls under EPCA. OMB disagrees with the additional increase requested of 523 because of different judgments with respect to adequacy and credibility of the audit program. Refer to Tab II.

DECISION: Approve agency request ______________

Approve OMB recommendation ______________

III. Strategic petroleum storage

Your original proposal to Congress called for a flexible approach to a strategic petroleum reserve based upon:

- up to 1 billion barrels of storage
- funding from NPR receipts
- authority to require refiners and importers to store petroleum.

EPCA, while similar in concept, requires much faster development which includes:

- an Early Storage Program of 150 million barrels in three years (December 1978).
- a target of 500 million barrels in seven years and interim targets at 18, 36, 48 and 60 months.
- a requirement that the reserve be able to satisfy regional petroleum needs should an embargo occur.
- a requirement to transmit an Early Storage Plan to Congress by March 21, 1976.
- a requirement to transmit a plan for the overall system by December 21, 1976, which is subject to Congressional approval.

FEA has requested $279 million and 100 permanent positions in 1976 and $852 million and 150 permanent positions in 1977. The funds are mainly for storage facilities and the purchase of oil based on a three-year plan. Your approved 1977 budget transmitted to Congress in January included $100 million. OMB agrees with the request for positions, but recommends less funding at $227 million in 1976 and $481 million in 1977. OMB believes the Early Storage goal may not be attainable in three years at a reasonable cost. Refer to Tab III.

DECISION: Approve agency request ____________

Approve OMB recommendation ____________