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STATEMENT OF

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FEDERAL ENERGY ADMINISTRATION

before the

COMMITTEE ON INTERIOR AND INSULAR AFFAIRS

UNITED STATES SENATE

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Mr. Chairman and members of the Committee:

We appreciate this opportunity to testify on FEA's policy with respect to crude oil owned by state and local governments. This issue, particularly as it relates to California production, illustrates a fundamental limitation in the provisions of the Energy Policy and Conservation Act (EPCA) that has impacts far wider than those on government-owned crude oil.

The framework within which these issues must be treated is established by the EPCA. This Act provides for continued price controls on the first sale of domestically produced crude oil for a 40-month period. It establishes the weighted average first sale price of all domestic production during February 1976 at $7.66 and provides for an escalation of that composite price based on two components. The first is the GNP deflator, subject to a 7 percent limitation, and the second is a 3-percent-per-year production incentive. The EPCA also specifies that this composite price could be attained by different ceiling prices for different types of domestic crude production only on a finding by the President that such different ceiling prices are, first, administratively feasible and, second, justified on the basis that they are consistent with obtaining optimum production of domestic crude oil. Finally, the Act precludes an increase in the price of any volume of old crude production unless the President finds that such an increase would give positive incentives for enhanced recovery techniques or deep horizon development or is necessary to take into account declining production from such properties and is likely to result in a level of production beyond that which would otherwise occur without the increase.

On February 1, 1976, FEA adopted regulations aimed at implementing the composite price provisions of the EPCA for February. These provided for a rollback in the price of upper tier oil defined as product that had formerly been classified as new, released, and stripper well crude oil. Average first sale prices for old oil production were maintained at their former levels. Based on FEA's estimates of the prices for each tier ($11.28 per barrel for upper tier and $5.25 per barrel for lower tier) and the proportion of total domestic production represented by each tier (.40 upper tier and .60 lower tier), the composite first sale price for February was estimated to be the $7.66 per barrel required by the EPCA.

As set out in FEA's notice of June 30, 1976, actual data collected for the months of February and March indicated that the proportion of total production represented by the two tiers differed from FEA's estimates, with upper tier production actually accounting for approximately 43 percent of total production and lower tier accounting for approximately 57 percent during those two months. Accordingly, the actual weighted average first sale prices for domestic crude oil were \$7.82 in February and \$7.80 in March. Our projections disclose that if these same trends persisted during the months of April through July, it could have been necessary to actually roll back the first sale price of one or both tiers some time between August 1976 and January 1977 in order to comply with the adjustment provisions of the EPCA.

Accordingly, to avoid the possibility of having to actually reduce first sale prices in order to comply with the EPCA, FEA announced on June 30, 1976, a temporary freeze on the first sale prices of domestic crude production at June levels for the months of July and August. During this period, we will be able to obtain more recent data on actual prices and proportions of production represented by the two tiers. We will also be able to generate more accurate estimates of the rate of decline in lower tier production, to date assumed in our calculations to be 8 percent per year. These new data will permit us to make better estimates of the quantities required to project first sale prices that will comply with EPCA mandates.

The second stage of the EPCA price adjustments (issued April 8, 1976) implemented the permissible EPCA crude oil first sale pricing adjustment by providing for upward adjustments in the statutory composite price beginning March 1, 1976, to take into account the effect of inflation and to provide production incentives. Based on the written comments received and its own analysis, FEA determined that the production incentives provided in the EPCA should be applied equally to both tiers, subject to the rule that when the shift in proportions of upper and lower tier crude oil requires, in order to comply with the adjusted statutory composite price, the rate of adjustment to both tiers to no longer equal the rate of inflation, the rate of adjustment to the lower tier price will be reduced to the extent necessary to permit the rate of adjustment to the upper tier price to continue to reflect the rate of inflation, insofar as possible. FEA found that the overall effect of failure to maintain lower tier price levels in constant dollars and to reflect a portion of the available production incentive in those prices would be (1) to discourage the use of enhanced recovery techniques; (2) to fail to take into account declining production from "lower tier crude oil properties"; and (3) to reduce the overall level of production from properties producing lower tier crude oil below what would occur if the first sale price of such crude oil were increased.

The combined effect of the first and second stage rulemaking has been to use all the flexibility embodied in the EPCA pricing provisions to optimize domestic crude oil production, subject to the composite price limitations. The initial composite price was set by reducing upper tier prices the minimum possible amount, and the full leeway provided by the escalator provisions was applied to maximize the incentive for continued and increased production for the majority of domestic producing properties.

Nonetheless, the limitations imposed by EPCA are such that even this application of the available pricing flexibility is insufficient to assure optimum production from those domestic properties that are at or near the margin of economic feasibility. The composite price itself, the escalator provisions, and their application in regulations by FEA were designed only to apply to domestic production from what could be called normal operations. The inadequacy of the pricing provisions to allow for the appropriate treatment of marginal, high-cost producing properties was recognized in the Act itself where provision was made for increases in the escalator upon a showing that these increases were required to generate optimum production from high-cost sources. Until this added flexibility is approved by the Congress, increasing the price of any one type of crude oil such as California gravity differential or government-owned production can be done only by reducing the price of some other type of crude oil. Under these inherent restrictions, it is exceptionally difficult to conclude that FEA is optimizing domestic production as the result of such a pricing action. The relationships between prices and production are not so precisely known as to allow the prospective net effects of an increase in one area and a decrease in another area to be discerned with precision although we are attempting to describe such effects for various fields and types of crude oil. Significant quantities of both upper and lower tier production appear to be close to the economic limit, so that price decreases--even the few cents per barrel which might be engendered under the national EPCA composite price by an upward adjustment of government-owned royalty oil prices or California gravity differentials--could adversely affect substantial quantities of other domestic production.

Thus, under the constraints of the EPCA composite price formula, we have so far been unable to justify a given change such as increasing the price of heavy California crudes as a positive factor for increasing total domestic production. Any change must consider not only the increase in production in the areas benefiting from it, but also the reduction in production in other areas that will follow a reduction in those prices.

Let me make it clear that the problem stems not from any FEA unwillingness to increase domestic crude oil prices, but rather from our inability to do so in an equitable manner under the legal constraints of the EPCA. FEA and the Administration remain determined to optimize total domestic crude oil production and to reduce imports in every possible way under the EPCA limitation, because that is the mandate of the Congress.

FEA has recently completed hearings on proposals for price increases that would maximize production from high-cost sources. It is preparing for early submission to Congress proposals to increase the amounts of the escalator allowed under EPCA to accommodate these price increases without reducing the first sale price of any other domestic crude oil production.

In short, Mr. Chairman, the FEA has done all that it feels is justified within its authority under the law. Any relief from current restrictions must necessarily come from one or another form of congressional action. There are currently three avenues open to the Congress to provide such relief, and I would like to discuss the implications of each briefly. These three avenues are:

(1) enactment of the amendments to the FEA Extension submitted by Senators Bartlett and Montoya and

adopted in the Senate version of the FEA Extension Act;

(2) approval of FEA's Stage III crude oil pricing proposals to be submitted in the near future; and

(3) enactment of S.3660 with certain changes that I will outline.

The Administration supports enactment of the Bartlett and Montoya amendments to the FEA Extension Act. These would exempt stripper well crude oil and incremental production from enhanced recovery projects from price controls and remove this production from the calculation of the statutory composite price. These amendments would go far toward assuring that inherently high-cost stripper well and enhanced recovery projects--many of which are close to the economic limits--would be utilized to the fullest extent possible. FEA estimates that 70 percent of the 512,000 domestic producing wells are stripper wells. However, these account for only some 13 percent or about 1 million barrels per day of domestic crude oil production. Approximately half of total domestic crude oil production comes from fields in which enhanced recovery techniques are being used. Tertiary recovery projects account for approximately 160,000 barrels per day--all of it being high in cost.

It is important to note that every barrel of extra production called forth from such properties will displace a barrel of imported crude oil in meeting total U.S. demand for petroleum products. This, in conjunction with the conservation effect realized from slightly higher prices, will act directly to reduce our dependence on foreign sources of crude oil.

Enactment of the Bartlett and Montoya amendments would also--by operating to allow ceiling prices for domestic crude oil production remaining under controls to rise--provide some flexibility under the EPCA to increase state royalty oil prices, to reinstitute the now frozen second stage inflation and production incentives, and to facilitate the movement to a reservoir definition of property. All of these measures would serve to further enhance domestic production. Should these amendments be enacted, FEA would, to the extent allowed by the EPCA, use some of the pricing flexibility so generated to provide an increase in the price of California heavy crude oil production by permitting a reduction in the current gravity differential.

Also, if these amendments were enacted, FEA would be in a position to modify substantially its third stage rule-making proposals to the Congress because it would no longer need as large an increase in the escalator provisions to provide for the high-cost sources of production. It would be our judgment that the flexibility afforded by enactment of these amendments would be better used to accommodate such high-cost sources first, rather than applying the increased flexibility to all upper and lower tier prices.

FEA agrees with what appears to be the intent of S.3660 but finds that as written, S.3660 would be objectionable. The proposed new section 8(i)(1) of the Emergency Petroleum Allocation Act would create a third domestic tier for first sale prices for crude oil by allowing state and local government production to sell at the statutory composite price. However, the relative values of the different types of state and local production (e.g., 40 degree low sulfur crude and 15 degree high sulfur crude) could be greatly distorted if lower valued crude were allowed to sell for the same price as premium crudes. If all state and local production were not sold at the same price, it would be necessary to establish a complex system of pricing for different types of crude with the highest premium crude priced at the composite price level.

Proposed section 8(i)(1) of S.3660 in combination with proposed section 8(i)(2) would require that the price for upper tier oil be reduced by some 12 cents per barrel from an estimated $11.63 for June to $11.51. This reduction amounts to about two months of the excalation provided under the

EPCA, and its impact spread over the remaining period of controls would be to reduce production from upper tier properties below what it would have otherwise been.

About one million barrels per day, or almost one-third of upper tier production, comes from stripper well properties, all of which would be adversely affected by this rollback. The effect will be to transfer about $120 million per year of revenues from private producers to state and local governments, increasing their current revenues of $384 million per year from such production to $504 million per year. All of this $120 million will be reflected in reduced profits to private producers, less money available to offset the expenses of continued production, and fewer funds available for continued exploration for new oil. The impact of this annual transfer throughout the period of controls is bound to be a significant reduction in total domestic production. This will occur because, except for some 113,000 B/D of California production, the increased revenues will not flow to those operating the fields. This means there will be no incentive for increased production in these cases. There is no way that any increment to California working interest production can offset the production that will be lost from all private producers that would result from an upper tier price reduction of 12 cents per barrel.

This impact worsens if proposed section 8(i)(2) of the bill is deleted, thereby requiring that state and local royalty oil be included in the calculation of the composite price. In this event the upper tier price must be reduced by 16 cents per barrel from $11.63 to $11.47 per barrel. This reduction represents over 3 months of escalation available under the Stage II rulemaking. Enactment of S.3660 without section 8(i)(2) would clearly exacerbate the production decline involved.

Enactment of section 8(i)(3) in its present form would create gross inequities among refiners. It would provide an undeserved windfall to refiners able to obtain such volumes of crude oil. These would take the form of windfall profits to the extent that such volumes were refined into uncontrolled products, and lower than competitively priced products to the extent that FEA price regulations prevailed. Both effects would give those refiners an undue market advantage relative to refiners not having access to royalty oil exempt from entitlements requirements. Because they acquire well over half of all state and local owned oil, large and integrated refiners would reap most of the windfall profits and market advantages this section would confer.

Should proposed section 8(i)(3) be deleted and the remaining sections be enacted, a separate tier for calculation of entitlements would have to be introduced into the FEA entitlements program. This would increase substantially its complexity.

In summary, we deem S.3660 in its present form as undesirable because it would lower the average price of privately and federally produced domestic crude oil, thereby reducing total domestic production; and unduly advantaging some refiners, especially large and integrated ones, having access to such oil by eliminating it from entitlements computations.

FEA is currently analyzing a number of options to optimize domestic production. One of these, similar to S.3660, is to treat all government-owned or royalty oil, federal, state, and local, in the following manner. First, exempt the first sale of such crude oil from all price and allocation controls and allow it to sell at the market clearing price, approximating $13 a barrel, depending on the particular quality and location differentials involved. This represents the average landed cost of imported crude oil to refiners.

Second, remove the quantities of this crude oil from the computation of the composite price required by the EPCA. Third, to avoid rolling back the price of any other domestic crude oil production, make a one-time compensating upward adjustment in the composite price authorized by the EPCA.

When FEA completes its final analysis of the various alternatives, this being but one, and their impacts on domestic production, we would be glad to share the results with the Committee.

The additional revenue to governments would, of course, be reflected in higher prices to refiners. Depending on the effectiveness of competition, some, but not all, of this amount would be reflected in higher prices to consumers. However, even if all $1.01 billion per year were passed through to consumers, this would represent an increase in consumer costs of about 16.3 cents per barrel or less than 0.4 cent per gallon, spread evenly across all petroleum products.

Under this approach, the one-time compensating adjustment to the composite price required to avoid any crude oil price rollback would be approximately 12 cents per barrel. If this adjustment were not made, exemption of government-owned crude oil from price controls and from calculations of the composite price would require a 27-cent-per-barrel rollback in the price of upper tier oil. Exemption from price controls only and requiring government oil to be counted in the composite price without any compensating adjustment would cause a reduction of 97 cents a barrel in upper tier crude oil prices.

This particular alternative to S.3660, in conjunction with the enactment of the Bartlett and Montoya amendments, could go a long way toward maximizing domestic crude oil production subject to the EPCA limitations.

FEA estimates that the effect of the Bartlett and Montoya amendments will be to displace a million barrels per day of imports by 1980, and smaller quantities building up to that level during the intervening period. The cost of these measures to consumers would be less than 1 cent per gallon spread across all petroleum products, even if all the increased costs were passed through fully to consumers, which is unlikely because of competitive conditions in the marketplace. It seems clear that this modest investment in our increased domestic productive capacity is clearly worthwhile on both economic and security of supply grounds.

Mr. Chairman, I have provided separately detailed answers to the questions posed in your July 6 letter and request that they be incorporated in the record at this point. Mr. Chairman, that concludes my statement. I would be glad to respond to your questions.