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DOE ENERGY BRIEFING BOOK
CAMP DAVID MEETING
MARCH 19, 1979

THE PRESIDENT

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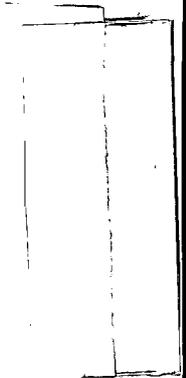
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CRUDE OIL PRICING

Issue

Should the Administration allow U.S. crude oil prices to rise to the world level by September 30, 1981 when the current price control system expires?

Background

At present, the wellhead price of approximately 70 percent of domestic crude oil production is controlled at levels from \$9.65 to \$2.55 per barrel below the currently announced world price of \$15.19 (delivered to the Gulf Coast). By reducing the average cost of crude oil and petroleum products in the U.S. below world levels, this system of price controls has:

- o stimulated increased U.S. demand for oil imports;
- o made necessary a cumbersome regulatory system to allocate and price domestic crude oil, and to equalize refiner acquisition costs; and
- o diminished incentives to maximize domestic production.

After June 1, 1979, the President acquires broad discretionary to revise or eliminate price controls. The President has already pledged at the Bonn Summit to bring U.S. crude oil prices to world levels by the end of 1980. In addition, the Secretary of Energy has the authority to take a variety of administrative actions which would result in higher prices for certain categories of domestic production.

Proposed Crude Oil Pricing Policy

Three alternative crude oil pricing policies are currently under consideration. The first would allow U.S. crude oil prices to rise to the world level on June 1, 1979 when the President assumes this authority. The second provides for a variety of administrative actions that would bring the average crude oil cost in the U.S. to the world level by September 1981 when controls expire. The third provides for a more limited set of administrative actions to bring U.S. prices to the world level by 1985 by extending the price control system.

DOE proposes that the second policy option be adopted. A crude oil pricing policy designed to bring U.S. average crude costs to the world level by September 30, 1981 would consist of the following eight elements.

- o Newly discovered oil would rise to the world price in April 1979.
- o One hundred percent of the production which qualifies as "marginal" under the proposed legislation supported by House Majority Leader Wright would be released to the upper-tier price on May 1, 1979.
- o Controls for remaining lower-tier oil would be revised to provide incentives for sustained production. Specifically, all existing cumulative deficiencies would be erased, base period controls levels would be updated to 1978, and an imputed linear decline rate of 2 percent per month would be allowed. Lower-tier oil properties with tertiary projects installed on January 1, 1980 would be allowed to use an imputed decline rate of 3 percent per month.
- o The upper-tier price would gradually rise in monthly increments beginning January 1, 1980 through September 1981 when it would reach the landed price for crude oil imports announced for October 1979 (\$16.39).
- o The lower-tier price would be increased by \$1 a barrel beginning in April 1979.
- o Incremental production from qualified tertiary recovery projects would be released to the world oil price beginning July 1, 1979. To finance these projects, producers would be allowed to release specified volumes of lower-tier oil to the upper-tier price. There would be a \$2.25 billion ceiling on total revenue increases from this mechanism from July 1, 1979 to October 1, 1981 and a \$20 million limit per project.

- o A tax would be imposed to capture 75 percent of the additional producer revenues stemming from increases in the world price beyond those announced as of January 1, 1979.
- o Controls would be allowed to expire in September 1981.

Discussion

Adopting the oil pricing policy outlined above would have the following results:

- o The average U.S. Crude Oil Acquisition cost would rise from 83 percent of the world price in March 1979 to 98 percent of the world price on September 30, 1981 when controls expire.
- o Oil savings would total 1.41 million barrels per day by 1985. Of this savings, approximately 1.17 million barrels per day due to increased domestic production and .241 million barrels per day to demand restraint caused by higher prices.
- o Producer revenues would increase by \$2.3 billion in 1979 and \$4.1 billion in 1980. From 1979 through 1985, additional producer revenues would total \$57.8 billion. By way of comparison, immediate decontrol with a tax would increase producer revenues by \$6.3 billion in 1979, \$10.3 billion in 1980, and \$66 billion from 1979 through 1985. Limited administrative actions with extension of controls would increase producer revenues by \$1.8 billion in 1979, \$3.9 billion in 1980 and \$66 billion from 1979 through 1985.
- o The rate of inflation (CPI) would increase by .10 percent in 1979, .36 percent in 1980, and .35 percent in 1981. In contrast, immediate decontrol would increase the CPI by .64 percent in 1979 and .42 percent in 1980. Limited administrative action with extension of controls would increase the CPI by .10 percent in 1979, .13 percent in 1980, and .20 percent in 1981.
- o On September 30, 1981, the entire regulatory system of price controls, allocations, and entitlements would be eliminated.



Department of Energy
Washington, D.C. 20585

March 19, 1979

MEMORANDUM FOR THE PRESIDENT

FROM: JIM SCHLESINGER

SUBJECT: DECISION ON DOMESTIC CRUDE OIL PRICING POLICY

SUMMARY AND RECOMMENDATION

This memorandum presents three options for your consideration on domestic crude oil pricing policy. The options presented here represent the most effective means for implementing the three basic policy choices open to you:

- o to raise domestic crude oil prices to the world level immediately.
- o to raise domestic crude oil prices at a rate which would bring U.S. prices to world levels by September 1981 when controls expire.
- o to allow price increases for certain categories of domestic crude oil while maintaining price controls to 1985.

Option A provides for immediate decontrol of domestic crude oil prices June 1, 1979. In addition, it provides for a tax that would capture 75 percent of the oil producer revenues stemming from any OPEC price increases beyond the 14.5 percent announced for 1979.

Option B provides for liberal increases in the price of domestic crude oil through a variety of administrative changes in the existing regulations. These increases are designed to bring average crude oil costs in the U.S. to the world price by September 1981 and so allow expiration of the price controls. It also provides for a tax which would capture 75 percent of the increase in oil producer revenues

stemming from any OPEC price increases beyond the initial 14.5 percent increase announced for 1979.

Option C provides for a variety of administrative changes in the existing regulations which are designed to increase domestic oil production and prices with a modest near-term increase in the rate of inflation. It also provides for extension of controls and gradual increases in domestic prices to the world level by 1985.

After careful consideration of each of these options and their relationship to the energy and economic policies, and international commitments of your Administration, I recommend that you select Option B.

BACKGROUND

Price controls on crude oil date back to President Nixon's action in 1971 and have been required since 1973 by the Emergency Petroleum Allocation Act, as amended in 1975 by the Energy Policy and Conservation Act (EPCA). Currently about 70 percent of all domestic crude oil production is subject to the EPCA price ceilings and categorized as lower-tier (old oil) or upper-tier (new oil). The remaining 30 percent of domestic production (Alaskan, National Petroleum Reserve, and stripper well production) sells at or near the world price.

U.S. crude oil production currently meets 52 percent of total national petroleum demand. The approximately 70 percent of domestic crude production now under controls sells at wellhead prices ranging from \$9.65 to \$2.55 per barrel less than the currently announced world oil price of \$15.19 (delivered to the Gulf Coast).

Current regulations limit increases in the weighted average ("composite") price of domestic crude oil to 10 percent per year. However, since April 1977, the Administration has limited increases in the composite price to the rate of inflation, considerably below the statutory limit of 10 percent. After June 1, 1979, you acquire broad discretionary authority over price controls and, although there is some disagreement in the Congress, in our view you will be able to remove price controls altogether without giving Congress the right to disapprove such actions. All legislative

Current Lower- and Upper-Tier
Prices and Volumes

| | <u>1978 Volume (million bbl/day)</u> | <u>Percent 1978 U.S. Consumption</u> | <u>1978 Ceiling Wellhead Price</u> |
|-------------------------|--|--|--|
| Lower-Tier (old oil) | 3.1 | 21% | \$ 5.68 |
| Upper-Tier (new oil) | 3.0 | 20% | \$12.64 |

authority to impose price controls expires on September 30, 1981. Each of the options would involve actions taken by DOE in rulemaking proceedings after development of a public record. One such rulemaking, the so-called marginal well proposal, has almost been completed.

Price controls reduced producer revenues in 1978 by about \$12 billion below the level they would have been had no price controls been in effect and U.S. crude oil had sold at the world price. Almost 80 percent of this \$12 billion reduction in producer revenues is due to price controls on lower tier oil.

The entitlements program was established in 1974 in an attempt to equalize the crude oil acquisition costs of refiners. Without this program, refiners with greater access to domestic crude oil at low controlled prices would have a substantial advantage over refiners more dependent on imported oil at world prices. The entire system of price setting mechanisms and refiner cost equalization, while necessary so long as crude oil price controls remain in effect, is universally regarded as complicated and administratively cumbersome. In addition, the distribution of the large pool of funds collected under the entitlements program represents a continuing policy problem for the Administration. It represents an ongoing source of revenues for a variety of subsidization schemes, including small refiners and residual fuel oil imported on the East Coast.

POLICY CONSIDERATIONS

Your decision on domestic crude oil pricing will affect three central elements of Administration policy--energy policy objectives, economic policy objectives, and your pledges at the Bonn Summit. Those policy objectives are as follows.

Energy Policy

1. Replacement cost pricing.
2. Reducing U.S. dependence on oil imports.
3. Providing incentives to stimulate domestic oil production conservation.
4. Ensuring equity to consumers and producers in the distribution of any windfall gains associated with increases in the price of controlled oil.
5. Eliminating the complex system of price controls, allocation, and entitlements.

Economic Policy

1. Reducing inflation, particularly restraining increases in the Consumer Price Index in 1979.
2. Improving the balance of trade and the strength of the dollar.
3. Increasing competition through removing unnecessary regulation.

Foreign Policy

1. Meeting the Bonn pledge to raise the price for oil in the U.S. to world levels by the end of 1980.
2. Addressing the general international concern over inflation, including the Bonn pledge to make reduction of inflation a top priority of U.S. economic policy.

The three options, described in detail below, are evaluated with these policy objectives in mind.

OPTION A -- Immediate Decontrol With A Tax

Objective

Option A is designed to raise the U.S price for crude oil to the world level as soon as you have the authority to do so, and to tax away increased revenues arising from higher world oil prices.

Description

- o On June 1, 1979, the price controls would be lifted from all domestically produced crude oil.
- o A tax would be imposed on all domestically produced oil selling at the world price to capture 75 percent of any additional producer revenues due to increases in the world price beyond those announced as of January 1, 1979. Newly discovered oil and incremental tertiary production would be exempted from the tax.

OPTION B--Administrative Decontrol With A Tax

Objective

Option B is designed to increase the average price for domestic crude to gradually increase U.S. crude oil costs to the world level by September 1981 through a variety of changes in the existing regulatory framework. This option also contains a tax designed to capture most of the additional revenues to domestic producers stemming from future increases in the world oil price.

Description

Option B consists of the following eight elements.

- o Newly discovered oil would rise to the world price in April 1979.
- o One hundred percent of the production which qualifies as "marginal" under the proposed legislation supported by House Majority Leader Wright would be released to the upper-tier price on May 1, 1979.

- o Controls for remaining lower-tier oil would be revised to provide incentives for sustained production. Specifically, all existing cumulative deficiencies would be erased, base period controls levels would be updated to 1978, and an imputed linear decline rate of 2 percent per month would be allowed. Lower-tier oil properties with tertiary projects installed on January 1, 1980 would be allowed to use an imputed decline rate of 3 percent per month.
- o The upper-tier price would gradually rise in monthly increments beginning January 1, 1980 through September 1981 when it would reach the landed price for crude oil imports announced for October 1979 (\$16.39).
- o The lower-tier price would be increased by \$1 a barrel beginning in April 1979.
- o Incremental production from qualified tertiary recovery projects would be released to the world oil price beginning July 1, 1979. To finance these projects, producers would be allowed to release specified volumes of lower-tier oil to the upper-tier price. There would be a \$2.25 billion ceiling on total revenue increases from this mechanism from July 1, 1979 to October 1, 1981 and a \$20 million limit per project.
- o A tax would be imposed on all domestically produced oil selling at the world price to capture 75 percent of any additional producer revenues due to increases in the world price beyond those announced as of January 1, 1979. Newly discovered oil and incremental tertiary production would be exempted from the tax.
- o A tax would be imposed on all domestically produced oil selling at the world price to capture 75 percent of any additional producer revenues due to increases in the world price beyond those announced as of January 1, 1979. Newly discovered oil and incremental tertiary production would be exempted from the tax.
- o Controls would be allowed to expire in September 1981.

OPTION C--Administrative Action with Continuation of Controls

Objective

Option C is designed to correct the existing regulatory system and provide some incentives for increased production while gradually bringing U.S. crude oil costs to the world level by 1985.

Description

Option C consists of the following six elements.

- o Newly discovered oil would rise to the world price in April, 1979.
- o Forty percent of the production which qualifies as "marginal" under the proposed legislation supported by House Majority Leader Wright would be released to the upper tier price in April, 1979.
- o Controls would be revised for all remaining lower-tier oil to gradually phase out this production by 1985. Specifically an imputed linear decline rate of approximately 1.5 percent per month would be allowed.
- o The upper-tier price would rise in monthly increments beginning July 1, 1979 designed to reach the October 1979 landed price for crude imports on September 30, 1981.
- o On October 1, 1981, producers would be allowed to use an imputed linear decline curve designed to gradually phase out upper-tier production by 1985.
- o EPCA price controls would be extended through 1985.

ANALYSIS

This section analyses the three options in terms of their effects on producer revenues, domestic production and oil imports, the rate of inflation (CPI), and the gap between U.S. and world oil prices in 1981. A critical factor in the analysis is the behavior of world oil prices beyond the OPEC increases already announced for 1979. There is no way

to project these prices with certainty. This analysis assumes that the world price of oil is \$3 higher than the OPEC prices for 1979 announced last December and remains constant in real terms at that level (i.e., it rises with inflation) thereafter.

Producer Revenues

Producer revenues increase significantly under all the options. In the near-term, Option A results in the largest increase in producer revenues, while producer revenues under Options B and C differ only slightly over this period. Cumulative increases in producer revenues through 1985 are significantly higher for Options A and C than for Option B. Revenues are higher under Option A because of the immediate increase in domestic crude oil prices to world levels. Revenues are higher under Option C because that option does not include a tax.

Producer Revenues*
(Billions of 1978 \$'s: \$3.00 Case)

| | <u>1979</u> | <u>1980</u> | <u>1981</u> | <u>Cumulative 1979-1985</u> |
|--|-------------|-------------|-------------|---------------------------------|
| Base Case | \$33.7 | \$34.8 | \$35.4 | \$251 |
| Option A Immediate Decontrol with a Tax | +\$ 6.3 | +\$10.3 | +\$10.0 | +\$ 66 |
| Option B Administrative Decontrol with a Tax | +\$ 2.3 | +\$ 4.1 | +\$ 7.0 | +\$ 58 |
| Option C Administrative Action with Extension of Controls | +\$ 1.8 | \$ 3.9 | +\$ 7.2 | +\$ 66 |

*After windfall tax; before income, royalty, and other taxes. The total after tax increases in producer revenues will be approximately 45 to 48 percent of these totals.

Macroeconomic Effects

Although none of the options has a large effect on GNP, they do differ in their effect on inflation over the period 1979 to 1982. Allowing domestic crude oil prices to rise to world levels quickly or gradually will result in a cumulative increase in the CPI of approximately 1 percent. The options differ primarily in the apportionment of this increase over time.

Option A brings U.S. crude oil prices to world levels in 1979 and thus its inflationary effects are concentrated in 1979 and 1980. Option B brings U.S. prices to world levels by September 1981 and so has a more gradual effect on inflation from 1979 to 1982. Option C, by extending price controls beyond 1981 has yet a slightly smaller effect on inflation from 1979 to 1982 than Option B.

Oil Savings

All options produce substantial oil savings as early as 1980. Option B, however, produces the largest increase primarily because of the strong incentives it provides for tertiary recovery supply. Supply responses estimated for Options A and C are similar, but total oil savings is higher under A due to the substantially greater reduction in demand from higher prices.

Progress Toward the World Price

Under the present system of domestic price controls the average cost of crude oil to a U.S. refiner is 17 percent less than the world price. This difference between the U.S. price and the world price has long been criticized as a major factor in stimulating U.S. demand for imported oil. U.S. consumers do not face the full replacement cost of their increased petroleum use because the increase in oil imports (at the world price) resulting from their increased demand is averaged in with price controlled domestic production.

Option A would bring average crude oil costs in the U.S. to the world level on June 1, 1979. Under Option B, the U.S.

Macroeconomic Effects
(\$3.00 case)

| | Rate of Change in the CPI (4th quarter to 4th quarter) | | | | Change in Real GNP (Billions of 1972 \$'s) | | | |
|---|---|-------------|-------------|-------------|---|-------------|-------------|-------------|
| | <u>1979</u> | <u>1980</u> | <u>1981</u> | <u>1982</u> | <u>1979</u> | <u>1980</u> | <u>1981</u> | <u>1982</u> |
| Base Case | 7.68 | 6.76 | 6.64 | 6.26 | \$1,409 | \$1,460 | \$1,523 | \$1,569 |
| Option A Immediate Decontrol With a Tax | + .64 | + .42 | + .02 | -- | -.7 | -5.6 | -8.0 | -8.0 |
| Option B Administrative Decontrol with a Tax | + .10 | + .36 | + .35 | + .12 | -- | - .8 | -3.8 | -6.8 |
| Option C Limited Administrative Action With Extension of Controls | + .10 | + .13 | + .20 | + .26 | -- | neglible | -- | -2.2 |

U.S. Oil Savings
(thousands of barrels per day)

| | | <u>U.S. Production</u> | <u>Demand Restraint</u> | <u>Total Oil Savings</u> |
|---|------|------------------------|-----------------------------|------------------------------|
| Base Case | 1980 | 8,515 | -- | 9,080 |
| | 1982 | 8,241 | -- | 10,020 |
| | 1985 | 8,190 | -- | 10,830 |
| Option A Immediate Decontrol With a Tax | 1980 | + 157 | -383 | 540 |
| | 1982 | + 321 | -319 | 640 |
| | 1985 | + 867 | -233 | 1,100 |
| Option B Administrative Decontrol with a Tax | 1980 | + 211 | -139 | 350 |
| | 1982 | + 405 | -315 | 720 |
| | 1985 | +1169 | -241 | 1,410 |
| Option C Limited Administrative Action with Extension of Controls | 1980 | + 157 | - 73 | 230 |
| | 1982 | + 321 | -219 | 540 |
| | 1985 | + 867 | -233 | 1,100 |

Gap Between U.S. Average
Refiner Acquisition Cost
and World Price (1978 \$)
(\$3.00 Case: Delivered Prices)

| | <u>Gas as of 1st Q 1979</u> | <u>Gap as of 3rd Q 1981</u> | <u>Percent of 1st Q -1979 Gap Remaining in 3rd Q 1981</u> | <u>Average U.S. Acquisition Cost as a Percentage of World Oil Price 3rd Q 1981</u> |
|---|---------------------------------|---------------------------------|---|--|
| Base Case | \$3.02 | \$2.28 | 75% | 87% |
| Option A Administrative Decontrol with a tax | | \$ 0 | 0% | 100% |
| Option B Limited Administra- tive Action | | \$.43 | 14% | 98% |
| Option C Administra- tive Action with Extension of Controls | | \$1.38 | 46% | 92% |

average crude oil cost would gradually rise until it is within 2 percent of the world price in September 1981 when controls expire. Under Option C, most of the current gap between the U.S. average cost and the world price would still remain in September 1981.

RECOMMENDATION

After careful consideration of the relationship of this decision to the Administration's energy, economic and inflation policies, and international commitments on domestic oil pricing policy, I recommend that you adopt the oil pricing policy outlined in Option B. Under this approach, the Administration would take a variety of administrative steps to increase the average price for domestic crude oil in order to stimulate production and gradually bring domestic oil prices to the world level by September 1981.

I base my recommendation on the following factors:

- o Option B has acceptable near-term effects on the rate of inflation. The effects on the CPI in 1979 and 1980 under Option B, while significant, are only slightly higher than those expected under the more limited administrative actions and continuation of controls contemplated in Option C. The substantial near-term inflationary effects of Option A make this choice far less attractive than Option B.
- o The elimination of the difference between the crude oil price to U.S. refiners and the world price under Option B will allow expiration of the entire regulatory system of price controls, allocations, and entitlements in September 1981.
- o Option B, by raising the average domestic crude oil price to the world price by September 1981, meets, at least in spirit, the Bonn Commitment to raise U.S. prices to the world level by the end of 1980.
- o The tax proposed in Option B will prevent any large windfall gains to producers from future OPEC price increases.

A decision to move toward replacement cost pricing for domestic crude oil is a vitally important component of the energy policy of your Administration. Adoption of the oil pricing policy outlined here would result in substantial oil savings and permit the dismantling of a large, complicated, and troublesome system of regulatory controls. I strongly recommend setting a firm course away from a system of price controls which perversely subsidizes oil imports and moving toward a more rational, effective crude oil pricing policy.

LEAD IN GASOLINE

Proposal

Under this proposal, the Environmental Protection Agency (EPA) would permit refiners to increase lead levels in leaded gasoline now, and defer the further phasedown in lead levels scheduled for October 1, 1979, to save up to 70,000 barrels per day of energy use, and avoid the loss of up to 450,000 barrels per day of gasoline production starting in October.

Background

Current Lead Limit

About 18 percent of U.S. gasoline production capacity is now subject to an EPA requirement to limit lead in gasoline to no more than .8 grams per gallon. The percentage of production under this limit is scheduled to increase to about 22 percent by the end of the second quarter of 1979 and to about 34 percent at the end of the third quarter.

Based on a survey of the 18 largest refiners, DOE estimates that suspension of the .8 limit would result in increased gasoline production of 28,000 barrels per day in the second quarter and 42,000 barrels per day in the third quarter. DOE estimates that suspension of the .8 requirement also will save 15,000 to 20,000 barrels per day in oil consumed in refinery processing.

October Phasedown

On October 1, 1979, all refiners are to meet an EPA requirement to reduce lead in gasoline to .5 grams per gallon.

Compliance with that standard would reduce gasoline production by 350,000 to 450,000 barrels per day. It also would increase oil consumed in refinery processing by about 50,000 to 70,000 barrels per day.

Discussion of Proposal

- o Suspending the .8 grams requirement would have negligible environmental impacts. The additional gasoline production of 28,000 to 42,000 barrels per day will be important in helping to avoid gasoline shortages this summer.

MOGAS DECONTROL

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MOTOR GASOLINE DECONTROL

PKY

Issue

Should the Administration make a commitment now to decontrol motor gasoline on September 30, 1979 when the summer driving season will be over?

or

Background

SW

Controls on motor gasoline have discouraged investment in necessary refinery capacity at the same time that environmental regulations have increased the need for additional capacity. Environmental regulations will increase demand for unleaded gasoline by at least 3.5 million barrels a day by 1985. Because of this increase, the nation will experience a shortage of refined products after 1980 unless additions are made to refinery capacity.

Controls have also disrupted the gasoline market, giving protection to retailers that would otherwise be unprofitable and raising competitive barriers for more efficient firms. These perverse market effects raise particular problems for independent marketers who, despite their initial support for controls, now feel they are being driven out of business by their continuation.

Decontrol would produce several advantages over a continuation of the present system:

- o It would eliminate the distortions and anti-competitive effects of existing controls.
- o It would be more likely to assure that refiners will make investments necessary to avoid supply shortages.
- o Since use of leaded gasoline poisons the catalysts in automobile pollution control systems, shortages in unleaded supply could impede efforts to attain air quality standards. Because decontrol will stimulate investments in production capacity, over the long run these shortages will be less likely to occur. DOE and EPA have agreed that DOE will initiate a rulemaking aimed at controlling the

price differential between leaded and unleaded gasoline in order to minimize any short-term environmental impacts of decontrol.

While the expected price increase under decontrol would be less than half a cent, decontrol would remove the inequities and inefficiencies of the existing system. Over a longer period, prices should actually be lower because decontrol would increase competition. Nevertheless, decontrol at this time would not be advisable because of the shortfalls in Iranian oil production and the upcoming summer driving season. In addition, decontrol is subject to Congressional veto until after May 31. Decontrol should therefore be postponed until September 30 when the peak driving season is likely to be over.

Options

If a decision is made to lift controls next fall, the Administration has three options.

- o Make no announcement with respect to decontrol until later this year.
- o DOE could promulgate a rule now that will decontrol gasoline as of September 30.
- o Publicly commit to decontrol on September 30 but take no further action now.

Discussion of Options

Option 1

- o By making no announcement now, you preserve maximum flexibility, and avoid the possibility of having to reverse direction if the gasoline market remains tight even after the summer driving season.
- o Refiners will be less likely to invest in new capacity as long as the Administration remains silent on decontrol.

Option_2

- o A rule would represent the most credible commitment to decontrol, and would be most likely to stimulate additional refinery investments.
- o However, rulemaking now affords the least flexibility for adjusting the timing of decontrol to future market conditions.
- o In addition, any commitment to decontrol prior to May 31 increases the possibility that opponents to decontrol will attempt to get Congress to extend its veto authority beyond that date.

Option_3

- o A public commitment could encourage some investment by setting a reasonably certain future date for decontrol.
- o A commitment without a rulemaking would still permit the Administration to change course should market conditions change drastically.
- o A verbal commitment, like a rulemaking may increase the possibility that Congress will extend its veto authority over decontrol.

Recommendation

Commit to decontrol in the fall of 1979, after the peak summer driving season is over. A public commitment now to decontrol will remove an obstacle to refinery investments. Also, failure to commit to gasoline decontrol in a major address on energy will be considered backing away from a long-term Administration policy.



Department of Energy
Washington, D.C. 20585

March 19, 1979

MEMORANDUM FOR: THE PRESIDENT
FROM: JIM SCHLESINGER
SUBJECT: Elimination of Mandatory Controls on Motor Gasoline

This memorandum discusses the need for eliminating controls on motor gasoline and the appropriate timing of government action. It is widely recognized that these controls have had a negative effect on gasoline production capacity and the independent gasoline retailers they were designed to protect. DOE's recently promulgated "tilt" rules will help correct some of the distortion which has resulted under price controls, but only deregulation can restore the full measure of market competition necessary to bring on needed production and to remove marketing inefficiencies.

Because of the protracted debate on the Energy bill and Congressional reluctance to entertain energy issues beyond the NEA, the Administration did not propose decontrol last year even though the National Energy Plan announced in April 1977 that motor gasoline would be deregulated. Considering the tightness of the current gasoline market, it appears best to implement decontrol after this summer's driving season, when gasoline demand will not create substantial price pressure.

DISCUSSION

Refinery Investment and Shortages

Environmental regulations have increased the need for new refining capacity by requiring unleaded gasoline for post-1974 vehicles, and reducing the amount of lead that can be

used in regular gasoline. Because automobile emission control devices require unleaded gasoline, unleaded demand will increase by at least 3.5 million barrels a day by 1985. Full implementation of EPA's lead phasedown, which will require refiners to reduce the average lead content of leaded gasoline, will reduce refining capacity to produce gasoline by 350 to 450 thousand barrels a day in late 1979. Without investment in new facilities and upgrading existing facilities, the nation will experience a shortage of refined products after 1980.

On March 1, DOE promulgated modifications of the existing price controls, referred to as "tilt". The tilt allows refiners to pass through to consumers more of the costs associated with the production of gasoline. However, it does not allow refiners to pass through charges for return on investment. Thus, while tilt will tend to optimize gasoline production from existing refinery installations, it is not likely to induce full expansion of production capacity.

Impact of the Control System on the Gasoline Market and on Competition

Existing controls have had a disruptive effect on the gasoline market, reducing competition and hurting independent retailers. Although recent improvements have been made, the control system still requires refiners to apportion their sales to customers according to a historic base period. As a result, some retailers are assured a steady supply of cheap gasoline while others are tied to high cost sources. Retailers that would otherwise be unprofitable are given automatic protection while more efficient firms face competitive barriers. These perverse market effects raise particular problems for independent marketers who, despite their initial support for controls, now feel they are being driven out of business by their continuation.

THE MERITS OF DECONTROL

Decontrol would produce several advantages over a continuation of the present system:

- o Market Distortions: Decontrol would be more likely to eliminate the distortions and anti-competitive effects of the existing control system. The fact that serious distortions exist

even though petroleum product regulations have been adjusted at least 200 times attests to the difficulty of fixing the present system.

- o Refinery Investments: Decontrol would be more likely to assure that refiners will make investments necessary to avoid supply shortages. Because the tilt will continue to limit the return on refinery investments, it will not encourage the necessary level of the short term improvements in existing capacity or the long term additions to capacity that would occur under decontrol.
- o Prices: Additional price increases under decontrol would be small, probably less than half a cent a gallon, as long as gasoline supplies are adequate. Over a longer period, prices should actually be lower because decontrol would increase competition by removing restraints on supplier-purchaser arrangements.

On the other hand, if supplies run short, which could happen because of EPA's lead phasedown regulations or a continued shutdown of Iranian production, decontrolled prices could rise to as high as \$1.00 per gallon. However, the Administration could prevent such a price rise by reimposing mandatory price and allocation controls when the first shortages appeared or by granting environmental waivers.

- o Environmental Considerations: Since use of leaded gasoline poisons the catalysts in automobile pollution control systems, shortages in unleaded supply could impede efforts to attain air quality standards. Because decontrol will stimulate investments in production capacity, over the long run these shortages will be less likely to occur under decontrol.

On the other hand, any large, short-term differential between leaded and unleaded gasoline could increase the improper use of leaded gasoline. However, DOE and EPA have agreed that DOE will initiate a rulemaking aimed at controlling the unleaded/leaded price differential. The rule, which will be in place by June 1, would remain in effect under decontrol.

While the expected price increase under decontrol would be less than half a cent, decontrol would remove the inequities and inefficiencies of the existing system. Reform of the current regulatory system on the other hand, would only produce temporary benefits while the basic problems of existing regulations would remain.

Nevertheless, decontrol at this time would not be advisable because the shortfalls from Iranian oil production will probably make gasoline supplies unusually tight during the upcoming summer driving seasons. Moreover, decontrol would be subject to Congressional veto until after May 31. For these reasons, I recommend that you postpone lifting controls until after September or early October, after the peak driving season.

TIMING OF A DECONTROL ANNOUNCEMENT

If you decide to lift controls next Fall, you could choose to:

- make no announcement with respect to decontrol until later this year;
- publicly commit the Administration to decontrol on September 30 but take no further action now; or
- promulgate a rule now that will decontrol gasoline as of September 30.

By making no announcement now, you preserve maximum flexibility, and avoid the possibility of having to reverse direction if the gasoline market remains tight even after the summer driving season. On the other hand, refiners will be less likely to invest in new capacity if the Administration remains silent. The commitment to decontrol would be credible if DOE were to promulgate a rule now making decontrol effective on September 30th, but this option provides the least flexibility. In contrast, to publicly commit the Administration to decontrol on September 30 while delaying an actual rulemaking, would permit us to change course should the market situation change drastically. At the same time a public commitment would put refiners on notice of reasonably certain future action. You should recognize however, that any announcement concerning decontrol prior to May 31 increases the possibility that opponents to decontrol will attempt to get Congress to extend its veto authority beyond that date.

Recommendation

A public commitment now to decontrol in September will remove an obstacle to refinery investments. Also, if you make a major address on energy, failure to commit to gasoline decontrol will be considered backing away from a long-term Administration policy. For these reasons, I recommend that you commit in an energy speech to decontrol gasoline prices after the next driving season.

ALASKAN SWAPS

Issue

What action should the Federal government take to reduce the current surplus of crude oil on the West Coast?

Background

Since 1977, Alaskan North Slope (ANS) production has increased from 300,000 barrels per day to 1.2 million barrels per day. As a result, a regional surplus of crude oil has existed on the West Coast since the latter part of 1977. This surplus has now grown to the point where 400,000 barrels per day of Alaska production must be transported at roughly \$3/bbl through the Panama Canal to other U.S. markets.

The major factors contributing to this regional surplus are the relatively isolated nature of the West Coast market; the lack of efficient transportation systems, especially pipelines, to move the crude to other U.S. markets; and strict environmental limitations on sulfur content. However, it is in this region of the country that the largest potential exists for significant near-term increases in domestic crude production.

Because of the high cost of shipping ANS crude to the Gulf Coast (\$3 per barrel), wellhead values have fallen in Alaska and to some extent in California. These lower wellhead values, combined with transportation and refinery conversion bottlenecks, have discouraged both producers and State governments from taking action to expand production in Alaska and California. If the surplus continues both State and Federal oil and gas leasing programs could receive strong opposition.

Prospects for reducing the surplus rested largely with completion of the Sohio (Pactex) pipeline. However, Sohio has made a decision not to construct the Pactex pipeline. Numerous other proposals have been made to move crude oil from the West Coast to inland markets. Included among these are the Northern Tier Pipeline, the Trans-Mountain Pipeline Reversal Project, the Foothills (Alaska Highway) Pipeline Project, and the Canadian West Coast Oil Port and Pipeline (Kitimat) Project. However, all of these projects face considerable regulatory uncertainty and potential environmental opposition.

If a long-term solution to the West Coast surplus is not found, the U.S. may forego significant ANS production increases. Production may plateau at 1.2 to 1.35 million barrels per day indefinitely, or even decline after 1990.

Options

- o Allow exports (or swaps) above 1.2 million barrels per day.
- o Allow unlimited exports or swaps.

Discussion of Options

Option 1

- o Encourages producers and the States of Alaska and California to take action to increase production.
- o Provides significant balance of payments and real resource benefits to the U.S. economy. Oil production could increase by 300,000 barrels per day between now and 1985, and 600,000 barrels per day after 1985. The transportation savings alone will provide a present value savings to the economy of \$0.3 to \$3.6 billion. The savings would increase to \$5 to \$8 billion if the increased production is achieved.
- o The 1.2 million barrels per day limit would continue economic incentives for refinery conversions and construction of a West-to-East pipeline.
- o There appear to be no significant national security problems from allowing exports.

Option 2

- o This option would yield higher benefits than Option 1 (an additional \$0.7 to \$2.4 billion).
- o Although domestic tanker rates would fall by as much as 20 to 30 percent, no significant employment problems are expected in the American tanker market.
- o This option would engender considerable more political opposition than options.



Department of Energy
Washington, D.C. 20585

February 8, 1979

MEMORANDUM FOR THE PRESIDENT

FROM: JIM SCHLESINGER

SUBJECT: Allowing Exports of Alaskan North Slope
Oil

This memorandum discusses a proposal for exporting Alaska North Slope (ANS) oil in order to increase North Slope production, displace imports of foreign oil, and alleviate the West Coast oil glut. These goals have been and continue to be difficult to achieve because of current legislatively imposed barriers.

An export policy should be designed to:

- o Increase production of ANS oil: Increased ANS production would improve the balance of payments and reduce the Nation's dependence on foreign oil.
- o Stimulate production of California oil: Unless appropriate measures are taken, increased ANS production will further depress West Coast oil prices and reduce West Coast production.
- o Reduce the Cost of Shipping ANS Oil to Market: Lower transportation costs will increase the oil's wellhead value and increase Federal and State tax and royalty revenues from ANS production.
- o Appeal to Congress and the Nation: Federal policy must address the public's concern that allowing exports will increase dependence on foreign oil. It should also anticipate opposition from groups that believe the ANS producers originally misled the public about the nature of West Coast demand.

Briefly, I suggest that swaps be allowed for production above the current level of 1.2 MMB/D, but that further lifting of the restrictions on exports be postponed until the political reaction to an export policy can be better determined.

BACKGROUND

The legislation authorizing construction of the Alaska pipeline prohibited producers from exporting ANS oil without Congressional approval. At the time the act was passed, ANS producers maintained that demand on the West Coast would absorb full ANS production. Today, however, ANS production exceeds West Coast demand by 400-500 MB/D.

Because of export restrictions, Alaska oil which could be shipped inexpensively to Japan on foreign tankers is being shipped in U.S. bottoms to the Gulf Coast. As a result, the wellhead value of ANS crude is diminished by about \$2.00 a barrel, as shown in Appendix I. Because of this diminished value, the export ban has discouraged additional ANS production. If the export ban is not lifted, production could decline from the present level of 1.2 MMB/D to as low as .8 MMB/D by 1990.

ALLOWING EXPORTS OF ANS OIL

A policy which removed all restrictions on the export of ANS oil would increase ANS production in 1990 by up to 1 MMB/D above planned production* and improve the balance of payments by up to \$14 billion in that year. It would also provide a stimulus to California production by immediately eliminating the surplus of West Coast oil. The total transportation savings from such a policy would be worth up to \$6 billion between 1980 and 2000 (discounted present value), as shown in Table 1. These savings are based on the use of foreign tankers, particularly VLCC's, which have substantially lower transportation costs than the American tankers currently required under the Jones Act to move American oil between American ports. As indicated in Appendix II, allowing exports would not render the U.S. more vulnerable to an oil embargo.

Nevertheless, political opposition to allowing unrestricted exports is likely to be strong, particularly among members of Congress who believe the ANS producers misled the public about the nature of West Coast demand. I therefore recommend that the Administration initially limit exports to ANS production above 1.2 MMB/D, the level of current production, and retain the option of increasing exports at a later date.

* Estimate made by Alaska officials.

TABLE 1

BENEFITS OF LIFTING
THE EXPORT BAN*
(Present discounted value 1980-2000
in billions of 1978 dollars)

| | <u>UNRESTRICTED EXPORTS</u> | <u>EXPORTS ABOVE 1.2 MMB/D</u> |
|--|---------------------------------|------------------------------------|
| Benefits to: | | |
| o State of Alaska | \$0.4 - 4.0 | \$0.1 - 2.6 |
| o Federal Government | 0.6 - 8.4 | 0.2 - 5.6 |
| o ANS Producers | 0.5 - 3.9 | 0.1 - 2.3 |
| Resource Savings Due to Reduced Transpor- tation Costs** | \$1.0 - 6.0 | \$0.3 - 3.6 |

* Preliminary estimates. The range in the estimates reflects different assumptions about the level of ANS production and whether the SOHIO pipeline will be built. The savings from allowing exports are lower if it is assumed that the pipeline would be built in any event. The savings are higher if it is assumed that the ANS production level is high.

** The gains to ANS producers, the State of Alaska and the Federal government exceed the total resource savings because some of the gains are transfers from West Coast consumers and tanker owners.

This approach would provide the same incentive for additional ANS production and balance of payments benefits similar to an unrestricted export policy, but would face substantially less opposition. The initial restriction would enable the Administration to argue that exports were limited to most of the production that would not occur under an export ban.

Nevertheless, the limit would have certain drawbacks. Because production cannot be expanded by much more than another 100 MB/D within the next two to three years, the limit would delay actual exports above the 100 MB/D level even though investments in new capacity would begin immediately. In contrast, as unrestricted export would allow immediate benefits in terms of lower transportation costs and a larger incentive for West Coast production. If the 1.2 MMB/D restriction were permanently retained, the economic benefits of an export policy would be reduced by 40 to 70 percent and California production could be up to 100 MB/D lower. The Administration should therefore retain the option of removing the 1.2 MMB/D limit at an appropriate time.

IMPLICATIONS FOR THE U.S. MARITIME INDUSTRY

The U.S. maritime industry has a keen interest in the Administration's policy on Alaska exports. ANS shipments currently constitute 50 percent of the total ton-miles carried on U.S. flagships in the intercoastal trade. Sufficient new domestic capacity has not been built to accommodate this traffic in large part because of uncertainties over whether the export ban will be lifted and whether the SOHIO pipeline will be built.

If exports were allowed above 1.2 MMB/D, tanker rates would remain at about the current level and employment in the maritime industry would probably not change. Lifting the export ban completely would reduce domestic shipments and U.S. tanker rates by about 25 percent. Demand for small tankers currently carrying ANS oil would probably continue to be strong, although some large tankers might have difficulty finding other business.

REQUIRING EXPORTS TO BE SWAPPED FOR IMPORTS OF ANS OIL

The United States may have some interest in linking any export policy with a swap requirement. Under such a requirement, ANS producers would have to assure that exports are matched with equivalent imports from Mexico before an export

license is issued. The swap would allay the public's concern over increased dependence on Middle East petroleum supplies and appeal to interests in the U.S. that favor stronger Mexican ties.

Mexico and Japan would also benefit from the swap to the extent they could obtain a share of the transportation savings. The distribution of the transportation savings would depend upon the outcome of negotiations between the ANS producers, the Mexicans and the Japanese. Mexico could gain additional economic advantages if it chose to use swaps to meet its oil commitments to Japan. The swap proposal would also produce domestic political benefits to the Mexicans by enabling them to ship oil directly to the United States while apparently diversifying their markets.

Although a swap requirement could produce benefits for both the U.S. and Mexico, it could also restrict the volume of ANS exports if Mexico limited the oil available for swaps. I therefore recommend against a mandatory swap requirement, particularly in view of the fact that the market can arrange swap transactions without government assistance.

USE OF ANS EXPORTS TO SATISFY U.S. COMMITMENTS TO ISRAEL

It may be desirable to use ANS oil to meet our commitment to supply Israel should it be unable to procure sufficient supplies from other nations.* The Administration could announce a general principle limiting exports to production above 1.2 MMB/D but create an exception for exports to Israel, embodying both concepts in a single piece of legislation. This approach would have political appeal because it would retain the 1.2 MMB/D limit except for exports to Israel. This policy would have the additional advantage of allowing immediate exports to the extent Israel actually called upon the U.S. to supply it with oil.

Alternatively, the Administration could seek general legislation relaxing export restrictions if the need to supply Israel materialized. Popular support for aiding Israel could be used to build Congressional support for a broader lifting of the export ban.

* The range of available options for supplying Israel are discussed in an earlier memorandum to you.

IMPLEMENTING THE EXPORT POLICY

If you concur with the recommendations in this memorandum, the following steps would need to be taken to implement an export policy:

Negotiate with ANS producers to secure expressions of intent to increase leasing and production: Without firm expressions of intent by ANS producers to increase production, an export policy would have little value. Hence, the first step to implement any export policy would be to gain agreement on increased production--at first to 1.5 MMB/D and subsequently to 1 MMB/D above planned production--in exchange for lifting the export ban. Depending upon the export strategy ultimately selected, the Department may have to prepare an environmental impact statement.

Discuss the swap proposal with Japanese and Mexican officials: Before publicly announcing a swap proposal, the Administration should confirm informal indications that Mexico and Japan are interested in participating in swap transactions.

Select the Best Congressional Strategy for Implementing an Export Policy: Under the Export Administration Amendments, either House of Congress can veto an export proposal within 60 days. In addition, the Amendments require that you make a finding that allowing exports would decrease "the average crude oil acquisition costs of refiners." Allowing exports alone would not reduce these costs. Although adjustments in the entitlements system or in the terms of the swap transaction could be made to meet this requirement, such adjustments, discussed in Appendix III, would be complicated.

One approach would be to postpone authorizing exports until June 1979, when the Export Administration Amendments are scheduled to expire. Unless the Amendments were extended, exports would be governed by the Alaska Pipeline Act which does not require a finding that exports would reduce refiner costs. Moreover, under the Pipeline Act, a swap proposal must be vetoed by both Houses or it will take effect. Because it would take the producers, Japan and Mexico several months to arrange the details of a swap transaction, the first application for an export license could not be ready until next June in any case. In addition, construction of new pipeline capacity would not be delayed by waiting until June to authorize swaps because any major construction would have to wait until after the winter of 1979.

On the other hand, it may be necessary to seek legislation repealing the restrictive provisions of the Export Administration Amendments earlier if you are called upon to allow exports to Israel. A choice between these strategies should be made after any policy for supplying Israel is formulated and Congressional sentiment is assessed.

Recommendation. I recommend you approve a policy that would allow exports of Alaska Crude above 1.2 million barrels a day. The detailed formulation of the proposal and legislative strategy would depend on Congressional, Alaskan, and foreign nation reactions to different alternatives. If you approve this recommendation, a number of Federal agencies can take the steps outlined above.

APPENDIX I

Approximate Wellhead Value of ANS
and Mexican Oil

| <u>ANS Oil</u> | <u>Transportation Cost/BBL</u> | <u>Approximate Landed Price of Oil at Destination/BBL</u> | <u>Trans-Alaska Pipeline Tariff</u> | <u>Approximate Wellhead Value/BBL</u> |
|---------------------------------------|------------------------------------|---|---|---|
| Shipped to Gulf Coast | \$3.10 | \$15.05 | 6.20 | \$5.75 |
| Shipped to Gulf via Sohio Pipeline | 2.00 | 15.05 | 6.20 | 6.85 |
| Shipped to Japan | .30 | 14.25 | 6.20 | 7.75 |
| <u>Mexican Oil</u> | | | | |
| Shipped to Japan | 1.00* - 2.24** | 14.45 | - | 12.21-13.45 |
| Shipped to Gulf Coast | .26 | 15.25 | - | 14.78*** |

*Via proposed Mexican pipeline (estimated)

**Via the Panama Canal

***Estimate includes \$0.21/BBL U.S. import fee.

APPENDIX II

NATIONAL SECURITY IMPLICATIONS OF AN EXPORT POLICY

Allowing exports of ANS oil would not adversely affect the Nation's security in the event of an OAPEC oil embargo. This conclusion is the same whether or not the International Energy Program (IEP) is triggered. The IEP specifies the amount of imported crude each participant, including the U.S., would receive during a major crude supply interruption. Supplies are allocated using a formula which takes into account both the consumption and net imports of participating Nations. If an OAPEC embargo is directed solely at the U.S., other Nations would have to reduce their consumption to share the shortfall. If the embargo is directed at all participating nations, the U.S. would have to reduce its imports and possibly export oil to satisfy its IEP commitment. In either case, our obligations would be the same whether or not ANS exports were allowed.

If the IEP did not function, or if the embargo were too small to trigger the IEA, the U.S. would still be protected because ANS export contracts would contain cut-off provisions. The Export Administration amendments require that all export contracts contain a clause allowing the contract to be terminated if a supply interruption is threatened or actually occurs.

Since there is a surplus of foreign ships during an embargo, the U.S. would not have trouble finding tankers to transport ANS crude to domestic markets. The Secretary of Defense has authority under the Jones Act to allow foreign tankers to be used in domestic trade in a national emergency. Because there will be a surplus of foreign tankers, the cost of shipping will probably be lower than if domestic tankers were used.

APPENDIX III

MEASURES TO SATISFY THE REQUIREMENTS OF THE EXPORT ADMINISTRATION ACT

Crude oil can be exported under the Export Administration Act only if the President makes a finding, among others, that exports "will have a positive effect on consumer oil prices by decreasing the average crude oil acquisition costs of refiners."

If ANS exports were authorized before the Export Administration Amendments expire, the entitlements system can be adjusted so that this finding can be made. ANS producers would be required to purchase entitlements in proportion to the amount of oil they export. The proceeds from these purchases would then be distributed through the entitlements system to reduce the average acquisition cost of oil sold domestically. Assuming these lower costs were passed along to consumers, the requirements of the Export Administration Act would be met by this entitlements plan.

Alternatively, ANS producers could be required to discount the price of oil they sold in the U.S. as a precondition to receiving an export license. The value of the discount would be determined by the level of each producer's exports. The benefit from the discount would be distributed equitably to all refiners through the entitlements system, lowering average refiner acquisition costs and satisfying the Export Administration Act's requirements.

SHALE OIL TAX CREDIT

Issue

Should the Administration support a \$3 per barrel tax credit for shale oil production?

Background

The known U.S. resource of oil in rich oil shale (greater than 25 barrels per ton of shale) is 400 to 600 billion barrels, or five to seven times greater than the median speculative estimate of conventional oil resources in the United States. Development of shale oil has not occurred to date because of the uncertain economics and unresolved environmental issues.

An active U.S. government leasing program, undertaken in the early 1970's, has led to development of several prospective projects approaching a production demonstration stage. High projected production costs (\$20 per barrel and more), however, have deferred construction of major demonstration facilities. Several companies have stated that they would proceed with production if a \$3 per barrel tax credit were enacted.

The Administration proposed, as a part of the May 1978 energy initiatives, a \$3 per barrel tax credit limited to the first 10,000 barrels per day of production per plant. An unlimited tax credit of \$3 per barrel was overwhelmingly approved by the Senate Finance Committee in 1977 and ultimately was adopted by the full Senate as a part of the Senate version of the NEA tax bill.

During the final sessions of the Energy Tax Conference in October 1978, a tentative compromise was worked out with members of Senate Finance Committee. That compromise proposal would provide a tax credit unlimited with respect to the amount of production, but which would be phased out as real world oil prices increased above \$20. Procedural difficulties precluded its enactment at the end of the last congressional session.

Options

1. To announce support of a shale oil tax credit as a part of the Energy message and submit legislation immediately thereafter.

2. Defer Action

Recommendation

Adopt Option 1

Reasons for Recommendation

Analysis by DOE indicates that the \$3 tax credit would provide significant net economic benefits to the U.S. The tax credit would induce earlier demonstration and thereby accelerate commercial development in the event of sharp rises in real world oil prices. Demonstration of shale oil production capability would moderate pressures on world oil prices and return substantial monetary benefits to the U.S. compared with no action.

The credit would have a value of approximately five and one half dollars per barrel. The shale oil producer could expect to receive, with the tax credit, about \$22 per barrel, assuming fourth quarter OPEC price increases. The credit should make near-term shale oil demonstration and production economic.

The direct cost to the Treasury of the tax credit would be small initially and would decline over time as inflation erodes the value of the \$3 per barrel credit. The maximum projected annual outlays by 1990 would be \$200 million in current dollars (\$115 million in 1979 dollars).

The proposed tax credit would begin to phase out when real world oil price exceeded \$20 and end completely at world oil prices of \$23. It is probable that the tax credit would be phased out completely by the late 1980's or early 1990's. The proposed bill has an absolute termination date of the end of 1999.

A subsidy by a tax credit mechanism is appropriate in this instance because:

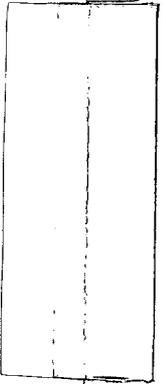
- o the government would not be required to make judgements on competing technologies--judgements which government is ill-suited to make;
- o no expenditure of funds would be necessary unless shale oil is actually produced; and

- o the tax credit provides a mechanism supported by the industry and the Senate for demonstrating the economic and technical feasibility of oil shale.

Senator Talmadge has prepared a draft bill for introduction this year. A bill similar to Senator Talmadge's bill has been submitted in the House by Representative Johnson of Colorado.

After several years of opposing shale oil development in Colorado, Senator Hart appears to be ready to move on a tax credit proposal. Governor Lamm is also willing to support an oil shale tax credit. With some reasonable adjustments to the tax credit, the Administration could gain support from Colorado elected officials.

Lack of support for oil shale tax credit in a Presidential message would be viewed as a retreat from the previous Administration position on oil shale. It would be interpreted as a move away from a major supply initiative at the very time that support for such a credit has developed in the State with the largest oil shale resources.





Department of Energy
Washington, D.C. 20585

MEMORANDUM FOR THE PRESIDENT

FROM: JIM SCHLESINGER
SUBJECT: BOLD ENERGY INITIATIVES

This memorandum suggests a number of bold initiatives you might want to consider for inclusion in the energy message.

During the course of numerous Congressional hearings in which I have participated in recent weeks, Democrats and Republicans alike have repeated the theme that the American people are now ready to make meaningful sacrifices as part of a concerted national effort to come to grips with our energy problem. The issue is usually framed in terms of the need for tough initiatives designed to convince the public that there is indeed a problem.

While the enthusiasm of many calling for dramatic action may fade in the face of specific proposals, there has been a growing recognition in Congress and in the press of the need for such action.

Even if the more difficult proposals were not enacted, the fact that you proposed them would demonstrate the seriousness of our energy problem and your resolve to act decisively. Since the price impact of some proposals on low income families could be significant, this memorandum also includes initiatives which address these possible equity problems.

DEMAND RESTRAINT INITIATIVES

1. Gasoline Tax

Problem: In view of growing oil stringencies, liquid fuels derived from petroleum are now and will continue

to be in the future the energy sources in shortest supply. Gasoline, for which demand continues to grow at 3 percent per year, constitutes 40 percent of the nation's entire demand for liquid fuels and 20 percent of our total energy use.

Initiative: A tax of 50 cents per gallon on retail gasoline sales would save 400,000 barrels of oil per day (B/D) in 1979 and 1.2 million B/D by 1985. A gasoline tax of this magnitude would be the most controversial and potentially effective action in the energy message.

Average Daily Gasoline Consumption
(millions of barrels per day)*

| | <u>Without Tax</u> | <u>With Tax</u> | <u>Savings</u> | <u>Revenues From Tax</u> |
|-----------------|------------------------|---------------------|----------------|------------------------------|
| 1979 (July-Dec) | 7.6 | 7.2 | .4 | \$27.6 billion |
| 1980 | 7.7 | 7.0 | .7 | \$53.4 billion |
| 1985 | 8.1 | 6.9 | 1.2 | \$52.8 billion |

Revenues from the proposed gasoline tax could provide a mechanism for offsetting expected increases in social security taxes, reducing the Federal income tax, financing real wage insurance or possibly property or sales tax relief. Such use of these funds could help minimize the inflationary impact of such action. As an example of relative magnitudes, the expected 1981 increase in social security payments (payroll deductions) is \$10 billion.

§. Full Cost Parking for Federal and Private Sector Employees

Problem: The Federal Government currently subsidizes parking for its employees who pay nothing or very low rates (usually no higher than \$15 per month in central business districts where commercial rates are \$4 per day). Many employees in the private sector also take advantage of subsidized parking.

*For 1979 and 1980, a demand elasticity of 0.15 was assumed. For 1981, a demand elasticity of 0.3 was assumed.

Initiative I: The President would implement the plan recently developed by OMB to increase parking fees for Federal employees. The plan would begin recovering half the cost of parking on October 1 (coinciding with the federal pay raise), and the full cost one year later. For areas where the cost is less than \$10/month (and therefore would have little impact on behavior), the plan contains strict regulations for giving priority to carpools. A draft OMB circular on this subject has been approved and could be sent out for agency comment within a week. It could also be sent to the presidents of major corporations, with a letter signed by the President, asking them to take similar action. Energy savings attributable to the Federal program alone would be negligible, but the example-setting value could be significant, since commuting accounts for 34 percent of auto-miles travelled.

Initiative II: Congress could require that employer subsidized parking spaces (whether public or private) be treated as income for tax purposes. Employees would not treat employer contributions to mass transit or carpooling expenses as income. Additionally, consideration could also be given to allowing employers to deduct such subsidies for mass transit and vanpooling.

SUPPLY/PRODUCTION INITIATIVES

1. Legislative Solution to Elk Hills Litigation

Problem: In 1944, the United States entered into an agreement with Chevron U.S.A., Inc., concerning the development of the Elk Hills Naval Petroleum Reserve. Current production at Elk Hills is approximately 145,000 barrels. The Government is presently involved in litigation with Chevron with respect to certain disputed lands which could add another 30,000 B/D to Elk Hills production within 90 days of resolution of this dispute. Without an out-of-court settlement, it is estimated that it will take several years for the Ninth Circuit to render a decision on this matter.

Initiative: The President could request Congress to legislate a solution to the controversy in the interests of adding another 30,000 B/D to domestic production. Such legislation may stimulate a greater willingness on the part of Chevron to settle the lawsuit and, if necessary, could be enacted well before the court case is settled.

2. SOHIO Pipeline Legislation

Problem: On March 13, 1979, the Standard Oil Company of Ohio (SOHIO) announced its intention to abandon plans for a pipeline to carry up to 500,000 barrels per day of "surplus" Alaskan crude oil from California to Texas. The four years of delays associated with obtaining some of the 715 required permits resulted in a decision by SOHIO that the project was no longer economically viable. In spite of Administration and public support, including a favorable local referendum, the California Air Resources Board and the South Coast Air Quality Management District were unable to resolve their conflicts over State air permits. In addition, court challenges to the adequacy of the Environmental Impact Report (a California requirement) added potential further delays.

Initiative: Propose legislation to expedite the permitting of the SOHIO project. The proposed legislation would preempt, to the extent necessary, state and local licensing and permitting authorities and substitute expedited Federal procedures. The legislation could be drafted so that the state of California would have until a date certain to issue necessary permits. If state action were not forthcoming, then Federal action would occur within a specified time frame. Under the Federal preemption arrangement, expedited judicial review could also be provided. Moreover, the legislation would indicate that the current Federal EIS and state EIR are adequate to meet all Federal and state environmental impact requirements.

3. General Siting Legislation for Major Projects

Problem: The SOHIO pipeline is only one example of the energy facility siting problems facing the country. The siting, permitting, and construction of any new energy facility has become increasingly difficult in recent years, due to the complexity of the permitting system and to the substantial delays many companies experience at the Federal, State, and local levels. Such delays can be particularly critical in cases where the delayed projects are of national significance, e.g., Trans Alaskan Pipeline, SOHIO Pipeline, Alaskan Gas Pipeline, etc. In the long-term, useable national energy supplies could prove insufficient if major transportation systems continue to encounter difficulties.

Initiative: A Critical Energy System Siting Act should be proposed which provides for a Presidential review of energy facilities and identification of those which have national significance. This proposal--limited to critical pipelines, refineries, port facilities and SPR sites--would subject these facilities to an expedited permitting process whereby all involved permitting authorities (i.e., Federal, State and local) would be required to provide recommendations on the project to the President within a specified time period. The President would then be responsible for deciding whether or not the facility should be approved. Should the decision be in favor of approval, all permitting authorities would be required to issue the appropriate permits by a specified date.

4. Increased Use of Gasahol

Problem: Gasahol is a blend of 90% gasoline and 10% ethanol made from agricultural products and waste. Current production capacity is 30 million gallons per year. The National Energy Act (NEA) exempts gasohol from the 4 cent per gallon Federal excise tax on gasoline until 1984. The NEA tax exemption is stimulating demand for gasohol, but it is not likely to encourage investment in new alcohol fuel plants because the subsidy will expire before the plant can be amortized. Consequently, unless investment in new plants is encouraged, supplies of ethanol are not expected to exceed 300 million gallons in 1982 (displacing roughly 20,000 barrels per day of gasoline). The 300 million gallon level will result from expansions to existing facilities and retrofits of old distilleries.

Initiative I: Extend the National Energy Act 4 cents per gallon excise tax exemption beyond 1984 to 1990. This would have the impact of stimulating investment in new plants, resulting in increased alcohol production, displacing increased quantities of gasoline. With such an extension, production by 1985 could exceed 600 million gallons annually, displacing roughly 40,000 B/D of gasoline.

Initiative II: Purchase Gasohol for use in Federal vehicles. The Federal government operates over 425,000 motor vehicles which annually consume more than 300 million gallons of gasoline. Roughly 45% of these vehicles receive their fuel from federally operated facilities, and thus

could be required to use gasohol. The ethanol required to fuel that 45 percent with gasohol would be 10 million gallons per year. Though the quantity of gasoline displaced is relatively small, this program could demonstrate a federal commitment to alternative fuels and would provide a good mechanism for gaining information about the performance of gasohol.

5. Gasoline from Coal

Problem: Technology is currently under development to produce synthetic gasoline from coal. With recently developed catalysts, high octane premium gasoline can be produced at costs approximately 50 percent higher than conventional gasoline.

Initiative I: Undertake a commercial scale project for converting coal to gasoline. With increased funding, DOE can initiate construction of a commercial coal liquids plant using the currently available methanol technology. In parallel, DOE can accelerate the scale-up of the final process steps to convert the output to high octane gasoline. This plant could be built directly for the government by an industrial contractor using the Defense Production Act (like the World War II synthetic rubber plants) or through joint funding as in the SRC plant projects. By moving ahead on an expedited basis, such a plant could be on line in the mid-1980's producing more than 20,000 barrels per day of premium unleaded gasoline at a cost comparable to gasoline from petroleum costing \$25 to \$30 per barrel. The plant could also produce about 150 million cubic feet per day of pipeline quality (high-Btu) gas. Several industrial firms have already indicated an interest in such projects.

Initiative II: Exempt gasoline produced from coal from the \$.50 cents per gallon gasoline tax. This would more than cover the \$.25 cent per gallon added cost of producing such gasoline, and result in substantial private sector initiative in this area.

6. Petroleum Substitutes Blending Requirements

Problem: The U.S. will be short of domestically produced liquids throughout this century. Technologies either exist or are under development to produce coal liquids, oil shale, and biomass which can substitute for petroleum. If

the technology and industrial capacity to produce petroleum substitutes on a commercial scale are to exist by 1990, industry must begin planning and developing commercial-scale projects. Greater incentives are needed to offset the risks of current investment in these future technologies. These incentives can be provided to individual substitutes like gasohol and gasoline from coal, or more generally, to all substitutes. The previous two initiatives were aimed at the gasoline problem directly. This initiative would increase the use of substitutes generally.

Initiative: Legislation would be proposed to require that a percentage of all gas and oil consumed in the U.S. be supplied from domestic non-petroleum resources. This legislation would set 1980, 1985 and 1990 percentage requirements for such substitutes. The requirements would be imposed on all refiners and other users of crude oil, as well as importers of petroleum products. Each year, crude oil users and product importers would be required to use or purchase quantities of domestic petroleum substitutes equivalent to the mandated percentage of their annual throughput. To ensure compliance, a per-barrel deficiency fee would be imposed on any product sold by a refiner who did not meet the prescribed goal.

This goal would begin at a relatively low level for 1980 of 20,000 B/D and increase over time to 100,000 to 200,000 B/D by 1985 and 500,000 to 1.0 million B/D by 1990. This goal would represent approximately 2 to 3 percent of anticipated petroleum and natural gas consumption.

In the early years of the program gasohol would be stimulated, oil shale would be available next, and other technologies would come on line later.

7. Waste Oil Reuse Program

Problem: Historically, a substantial portion of lubricating oils were re-refined. Today, almost all lubricating oil comes from virgin crude production. The demand for lubricating oil is presently 188,000 barrels per day and is increasing at the rate of almost 2 percent per year. The U.S. could potentially re-refine over 51,000 additional barrels of lubricating oil per day, the disposal of which is presently creating environmental problems.

Initiative: The President should direct the National Bureau of Standards to accelerate its used oil testing procedures and standards program, publishing the long-overdue equivalency standards by the end of the year. The President could also direct DOD to purchase all of the re-refined oil from a commercial scale (30 thousand gallons per day) plant that can be built today, using a new process developed by the DOE Bartlesville Energy Research Center. Husky Oil Corporation is interested in building the commercial plant, and this action, together with the standards, would give the new technology a quick start. DOD could further be directed to preferentially buy re-refined oil from any plant provided it meets specifications.

8. SRC Program Funding

Problem: Utilities burning fuel oil for base load power should be induced to switch as rapidly as possible to coal. Many utilities cannot switch to coal without expensive environmental controls. Some could not switch even if economics were favorable because of siting or other constraints. If clean-burning solid or liquid fuels were available, there could be substantial new opportunities for coal conversion.

Initiative: Develop both SRC I and SRC II as rapidly as possible by building demonstration-scale plants that will bring the technology into use by the late 1980's. SRC I can satisfy the needs of the Southern and Southwestern utilities, permitting them to burn a clean, very low-sulfur coal without having to use complex, unreliable scrubbers. Moreover, SRC I reduces the transport needs to the utility (since it contains one-third more energy per ton than unprocessed coal) and permits meeting forthcoming nitrogen oxide standards without further environmental controls.

SRC II can satisfy the needs of the Eastern utilities now burning oil, permitting them to burn a clean liquid made from coal without major plant modifications. SRC II also produces other petroleum products.

The technologies are both needed, and sufficiently different that both need to be demonstrated.

9. Leasing of Naval Petroleum Reserve - A

Problem: Since 1977, NPR A has been administered by the U. S. Geological Survey. Government-managed exploration has occurred without significant oil and gas discoveries. In recent years, the drilling program has cost about \$200 million per year. However, the Administration has proposed phasing the program out in FY 1980. Until now, the Government has not allowed private interests to explore NPR-A. Hence, unless action is taken now, this large resource will not be explored by either the public or private sector.

Initiative I: Significantly expand the Federal Government's program to explore NPR A. A stepped-up exploration program will improve the chances for successful oil and gas finds in areas of promising geological formations.

Initiative II: Submit legislation to allow private oil companies to lease this land for purposes of exploration and development. The legislation should provide for expedited environmental reviews to minimize delay.

10. Oil and Gas Resources on Federal Lands

Problem: Major Federal land withdrawal proposals can lock-up oil and gas resources almost irrevocably. Usually, very little data are available on the energy resource potential of the lands being considered for withdrawal because they are usually remote or relatively unexplored and undeveloped. This is not necessarily a problem for resources such as coal, where the total resource base is known to be large. For oil and gas, however, the total domestic resource base is quite small relative to the national need. Hence, there is a need to ensure that the President and Congress receive better information on oil and gas reserves prior to making withdrawal decisions.

Initiative: In the recent RARE II process, the USDA Forest Service was sensitive to this problem and responsive to the DOE analysis of resource potential. This kind of cooperation should be institutionalized. The President should announce that the Administration will not support new proposals for land withdrawal unless the Secretary of Energy is satisfied that sufficient consideration has been given to their potential, if any, for oil and gas resources.

11. Accelerated OCS Leasing Schedules

Problem: The Department of the Interior has recently proposed a five year schedule for oil and gas leasing on the Outer Continental Shelf (OCS) which calls for 5 to 6 lease sales per year through 1985. In view of U.S. and world oil supply projections, this rate of sales may not be sufficient. Only two sales per year are scheduled for the Gulf of Mexico area. DOE's draft production goals analysis suggests that seven major sales per year could be held and three could be held in the Gulf of Mexico.

Initiative: The Interior Department could increase its proposed schedule to at least seven sales per year in view of the critical national need to develop domestic oil and gas resources in the 1980's.

INITIATIVES TO PROVIDE GREATER EQUITY

Problem: The impact of increased energy prices falls heavily on low-income households. Low-income families frequently live in homes that are poorly weatherized and they often must rely on older cars with poor mileage. They neither have the income to afford increased energy bills, nor the cash to refit their homes or replace their cars. Thirty percent of the income of low income households is used to meet energy costs. In regions of the country like New England, the percentage is higher and growing.

Initiative I: Refinery overcharges.

The money that DOE collects in settlement of suits against refiners who overcharged for their products during the 1973-74 embargo can be used to help low-income Americans. Some portion of this money can be added to the existing Weatherization program to improve the energy-efficiency of homes. Because of administrative limitations, this program cannot be expanded substantially in the short-term. Nevertheless, the earmarking of funds for this program now would show a commitment to solving the energy problems of low-income families.

Initiative II: Low interest loans for insulation.

The National Energy Act authorized subsidized loans to low-income individuals for insulation, but this HUD program was never funded. Authority exists for up to \$3 billion in loans. The decision not to fund this program should be reconsidered.

Initiative III: NEA Tax Credits.

Today, low income taxpayers receive very little benefit from the NEA tax credits because they do not pay any taxes. These energy tax-credits could be made refundable tax-credits, so that Americans of all income levels can take equal advantage of them.

Initiative IV: Use of Food Stamp Program.

The present food stamp program could be extended so that recipients could use food stamps for home heating oil, gasoline, natural gas, electricity, and propane. Even with no increase in the budget of the program, this initiative would allow recipients more flexibility in their household budget. Alternatively, increases could be made in the budget of the food stamp program on a regional basis according to the importance of energy as a household expense in each region. The size of food stamp allocations has historically varied regionally to reflect different food costs. Such changes would add minimal administrative costs to the present program.

This proposal could be a temporary measure, coterminous with, and financed by, a tax on gasoline--or it could be a permanent change in the food stamp program. Increases in the program might range from one to two billion dollars annually. The current food stamp program costs approximately \$5 billion annually.

Such a program would not create incentives for increasing energy use, because the stamps can always be used to purchase food. The full conservation impact of high energy prices would be preserved, and very little administrative overhead would be added because the food stamp program is already well established and staffed.

FUEL SWITCHING INITIATIVE

1. Tax on Utility Uses of Distillate Fuel Oil

Problem: Outside of gasoline, distillate oil will be the fuel in most critical demand as a result of the Iranian cutbacks. Distillate use in utility and industrial sectors is approximately 400,000 barrels per day. If some portion of this distillate could be replaced by natural gas, coal, or residual fuel oil, the potential for shortages and high prices next winter could be avoided. Over the long-term,

every effort should be made to reduce unnecessary distillate use as a means of reducing imports and reducing pressure on home heating oil costs.

Initiative: Implement a \$3 per barrel tax on industrial and utility use of distillate. The tax would not only encourage greater conservation, but would also encourage switching to other fuels. Even distillate used for peaking purposes for powerplants could be replaced by natural gas. Altogether, a \$3 distillate tax could save from 50,000 to 100,000 barrels a day, or roughly one quarter of current use.

OTHER LANGUAGE

A. Nuclear Issues

It is clear that nuclear energy makes a significant and essential contribution to our present energy economy. This technology has the potential to become an even greater contributor for the remainder of this century and well into the next. But the extent to which this potential will be realized depends upon actions which we take now. The central features of the Administration's nuclear policy are:

- o expanded use of the light water reactor;
- o effective and responsible management of nuclear waste materials;
- o continued attention to our nonproliferation goals to assure that civilian nuclear power is not the source of materials or technology for use in nuclear explosives; and
- o an effective research program aimed at assuring the availability of technology to employ breeder reactors when they are needed.

To carry out this policy, we have undertaken several significant actions. With regard to strengthening the light water reactor as an active contributor to our future energy supplies, we are introducing legislation to improve the process by which nuclear

generating stations are licensed; actively working toward more efficient fuel usage and higher powerplant productivity, thus lowering cost to the consumer; and continuing our emphasis on reactor safety and the reduction of occupational exposure to radiation. With regard to nuclear waste, we have introduced legislation to provide interim storage of spent nuclear fuel at away-from-reactor sites. This storage capability will serve as a temporary bridge between operating reactors and an ultimate mined repository. An Interagency Review Group has recently defined the strategies for development of such a repository. We are proceeding with confidence toward the necessary decisions and implementing actions.

The strategy will emphasize the need for an early waste disposal repository. The waste isolation pilot plant at Carlsbad, New Mexico is an important part of the effort to address the waste management problem in a responsible manner. The Nuclear Regulatory Commission will license new, permanent disposal facilities, provided it does not interfere with national security activities.

With regard to nuclear as an inexhaustible energy source, we have proposed a broad-based development program aimed at commercial introduction of the "breeder" around 2020. Since there is little analytic support for introduction of this technology prior to that time, we have proposed termination of the Clinch River Breeder Reactor. In its place we have proposed a larger, more modern plant upon which construction might begin as early as 1981 if conditions warrant.

Finally, and perhaps most important, I would like to emphasize personally the significance of nuclear energy to this nation's well-being. I am confident that we possess the technical capabilities and management skills to enable this technology to take a responsible and active role. This Administration looks forward to working with the nuclear industry, the electric utilities, our neighbors abroad, and all concerned citizens to meet this goal in a timely and effective manner.

B. Loan Guarantees

I shall be submitting to Congress a proposal to streamline the Department of Energy's authority to issue loan guarantees for a broad range of energy technologies.

The Department must have the flexibility to provide financial incentives, such as loan guarantees, to the private sector in a timely and efficient manner. With the authority I will request, a range of new energy technologies could be demonstrated, at little or no cost to the Federal government. The technologies eligible for loan guarantees potentially range from solar and renewable sources to demonstration of high-Btu gasification from coal.

c. Solar

The greatest source of energy comes not from minerals buried in the earth, but from the natural forces of sun, wind, and water. These renewable energy sources--called solar energy--can begin to meet an increasing share of our energy requirements without destroying the environment and without depleting stocks of remaining hydrocarbons.

Subsidies for conventional fuels have hindered the application of those solar technologies that are now commercially viable. Any comprehensive program to exploit solar energy must allow solar energy to compete fairly in the market place with other energy sources.

Last summer, I directed a Domestic Policy Review of Solar Energy be undertaken. Based on the options presented to me from the review, I will shortly submit to the Congress a detailed program to accelerate the use of solar energy.

D. Energy Facility Siting Problems

- o The Sohio Pipeline is still held up after 715 permits have been issued and the local populace voted favorably in a referendum. Now it appears that the pipeline has become uneconomic.
- o The Pittston refinery is being held up because a bald eagle's nest is nearby. After resolution of the bald eagle question, the effect on whales must be evaluated. Meanwhile, the air permit which has been issued is due to expire in September, and a new one will take 2 years to obtain.
- o The Hampton Roads refinery is being held up because of an interagency dispute between the Corps of Engineers and DOI. It's air permit is also due to expire soon.
- o The Colstrip 3 and 4 powerplants are being held up because of an intercomputer dispute. One model predicts that visibility standards will be (just barely) violated--another model predicts that they will not.
- o Delays in permitting nuclear powerplants are preventing the displacement of oil imports. But for these delays the country could have eliminated by now a substantial portion of oil used for baseload power.

E. Coal Slurry Pipelines

Uncertainty over transportation costs represents one constraint on greater use of coal by utilities and industry. Today railroads move most of the nation's coal over long distances. Coal slurry pipelines can supplement railroads in moving large quantities of coal cheaply from the mine to the users. Not only can coal slurry pipelines reduce costs, but they can also enhance competition in the movement of coal.

It is important that legislation be enacted to facilitate the construction and approval of coal slurry pipelines. Because of critical water problems in the West, it will be necessary to balance off water needs against coal transportation needs. The legislation supported by the Administration would provide a mechanism for dealing with these trade-offs and for providing the necessary rights-of-way that would allow coal slurry pipelines to be built.