THE SECRETARY OF ENERGY
WASHINGTON, D.C.

March 16, 1987

The President
The White House
Washington, DC 20500

Dear Mr. President:

I am pleased to transmit the Department of Energy review of energy-related national security concerns which you requested in response to declining domestic oil production and rising oil imports. This review, "Energy Security," covers all aspects of U.S. energy supply and demand -- and their implications for our energy security.

This report shows that, while our energy security remains strong in the short term, there is justification for national concern over the declining competitiveness of our domestic oil and gas industry. Although we have made progress toward enhancing energy security in the last six years, we can only ensure continued security with a viable domestic energy industry -- and, in particular, a vigorous petroleum industry. Even with continued conservation and efficiency and substantial contributions from other energy resources, like coal, nuclear energy and renewables, our economic and energy security is inextricably tied to the fate and fortunes of our domestic petroleum industry through this century.

It is clear that the weakening of our domestic oil infrastructure holds the potential for significant, detrimental ramifications for our energy and national security if action is not taken. Although falling domestic oil production and increasing dependence on foreign oil pose a different set of problems from those that existed at the onset of this Administration, they represent a perhaps more difficult and complex challenge. The need to address this energy challenge is no less urgent than when the Nation was confronted with two oil supply interruptions in the 1970s.

As the report documents, the suddenness and severity of the oil market collapse of 1986 has devastated significant segments of the U.S. petroleum industry. Marginal oil production has been shut in; development of high cost and enhanced oil recovery projects has been postponed; and exploration in frontier areas has been slowed. Expenditures in 1986 for exploration and development dropped by 30 percent among major oil companies and by 50 percent or more among independents.

2

Coupled with the production decline is increased consumer demand for oil, which has resulted in a rise of one million barrels per day in U.S. imports. Our projections show that continuation of present market trends will accelerate the decline in U.S. production, stimulate more consumption, and continue severe impacts in oil producing areas of the country. This turn of events could leave U.S. energy security in jeopardy. This and other scenarios and projections are described in more detail in the report.

Much has already been done during this Administration to strengthen the domestic oil industry and remove impediments to the exploration for oil and gas. With your leadership, Federal price and allocation controls on oil have been eliminated and the Economic Regulatory Administration has been sharply reduced. Needed oil and gas tax incentives like the treatment of intangible drilling costs were preserved in the tax reform bill. In the past year, we've won approval of two Federal Energy Regulatory Commission orders, Orders 436 and 451, that should move the natural gas industry much closer to a market base. The Securities and Exchange Commission, with our persuasion, retained full-cost accounting provisions that are vital to independent petroleum producers. Government regulations that would have forced the capping of stripper wells on Federal lands were lifted. Since you took office, the Strategic Petroleum Reserve has been increased five-fold to more than 516 million barrels. We have also worked with our allies to expand their strategic stocks, recognizing that energy gains by this Nation can be lost unless complementary policies are pursued overseas.

Still other steps need to be considered and more must be done. Along with our continued support of the clean coal program, nuclear licensing reform, Price-Anderson reauthorization, and increased investment in basic science, as an absolute minimum we need to continue to aggressively seek enactment of the many oil and gas initiatives proposed by the Administration last year, which are as follows:

- o Repeal of the Windfall Profit Tax, which currently produces virtually no revenue and is a counterincentive to industry investment;

- o Comprehensive natural gas reform, including wellhead price decontrol, mandatory contract carriage and demand restraint repeal, which would encourage the production of an estimated 30 trillion cubic feet of additional gas, the equivalent of 5.3 billion barrels of oil; and o Adoption of key regulatory reform provisions of the 1986 Oil and Gas Production Revitalization Act. Specifically:

-- Extending the Environmental Protection Agency deadline to report to Congress on the degree of hazard from oil and gas production wastes;

-- Clarifying the exemption for small temporary collection devices from underground storage tank regulations called for in the 1984 Hazardous and Solid Waste Amendments, where there are negligible environmental impacts;

-- Permitting land treatment and recycling of oil and gas wastes when studies have demonstrated that the practices do not threaten public health or the environment.

However, these measures alone aren't enough -- and, in many cases, they won't provide the kind of immediate incentives that are needed to counter an even greater slide in domestic capacity and provide the potential for increased domestic production. It is imperative that, in addition to pressing for the initiatives that have already been proposed, we address this need -- and the need to provide incentives to longer-term oil and gas exploration.

Based on my review of the costs and benefits of the options available, there are several principal tax incentives, along with other necessary long-term steps, that I recommend for your endorsement and which I propose to bring before the Domestic Policy Council and the Cabinet for appropriate review and evaluation:

o An increase in depletion allowances (or a floating depletion allowance) up to 27½ percent for all oil and gas producing properties and for new and enhanced recovery production. This action would encourage investment in reserve additions and lead to an increase in exploration and development of new oil and gas as well as an increase in revenue to the hard-hit oil services industry;

o Repeal of the transfer rule to allow independent producers to use percentage depletion allowances on properties bought from major oil companies. This change would encourage small independents to buy such properties and continue to operate them, thus keeping marginal wells in production;

o Increasing the net income limitation on oil and gas production to 100 percent. This increase would encourage the continued operation of some marginal oil properties whose operation would otherwise be discontinued and bring some added investment to new oil projects;

o Expensing of geological and geophysical costs in the same manner as intangible drilling costs. This initiative would directly encourage exploration activity leading to development of new reserves;

o Resolution of the impasse over oil and gas development of the Outer Continental Shelf, now tying up an estimated 2 to 5 billion barrels of oil;

o Environmentally sound oil and gas exploration and prudent energy-related development of the Arctic National Wildlife Refuge coastal plain, which may have "in place" oil of up to 30 billion barrels; and

o Maintenance of a strong Strategic Petroleum Reserve fill rate to reinforce deterrence against an oil supply interruption.

Adoption of these and previous proposals, according to our estimates, will result in approximately one million additional barrels per day in increased domestic oil production. On balance, the increased production, related economic growth and reduced reliance on foreign oil imports far outweigh the alternative of increasing imports, which primarily benefits oil-exporting nations. Furthermore, these proposals achieve these objectives in a cost-effective manner as opposed to proposals like the oil import fee which carry a sizable net economic loss to the Nation.

In my estimation, this additional domestic oil production will provide an absolutely critical margin of energy security that is essential to our economic and national security based on the conclusions and threat to energy security outlined in this report.

Respectfully,

John S. Herrington

John S. Herrington

Enclosure