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SUBJECT: MEMO: ENERY POLICY – INTERIM REPORT PAGES: C+8

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THE WHITE HOUSE
WASHINGTON

September 30, 2005

INFORMATION

MEMORANDUM TO THE PRESIDENT

THROUGH: AL HUBBARD

FROM: KEITH HENNESSEY & BRYAN HANNEGAN

SUBJECT: Energy Policy – Interim Report

Your advisors are developing options to:

1. increase refining capacity;
2. address natural gas shortages, in both the short and long term; and
3. increase oil and natural gas production.

Increasing refining capacity

While no new refineries have been built in 29 years, U.S. refining capacity has increased about 12 percent since 1993, entirely through expansions of existing refineries. Conversations with the majors and refining firms confirm that some are now making decisions about expansions. As an example, Chevron CEO Dave O'Reilly told you he plans to expand his Pascagoula refinery. He plans to add 25,000 barrels per day capacity to a 325,000 barrel per day refinery, an expansion of just under 8 percent. Incremental investments have kept domestic refining capacity growing at 1.1 percent per year, still slower than the 1.6 percent annual growth of consumption.

U.S. refining had relatively low profitability in the early to mid-1990s. A primary factor was a decrease in the price spread between light-sweet and heavy-sour crude oils. Due to misguided policy in the 1970s, the industry was also still suffering from excess capacity. These relatively low refining profits and excess capacity resulted in reduced investments in U.S. refineries and slow capacity growth.

Factors other than environmental regulations appear to have been the primary cause of lower U.S. refinery profitability and capacity growth in the mid-1990s. Nonetheless, environmental regulations do lower long-term returns and slow the growth of refining capacity.

Profits have rebounded in the past few years, due to a substantial increase in the light-heavy price spread, as well as cost reductions. As a result, there are some signs of increased interest in U.S.-based refining investment.

The first four recommendations listed below should reduce the costs to building or expanding a refinery and thus would encourage domestic expansion. Katrina and Rita demonstrated that a serious policy problem facing domestic refining capacity is the geographic concentration of refineries in an area subject to hurricane risk. Your advisors believe that we need an effective way to address this risk. We are exploring option numbers 5 and 6 listed below to address this problem.

Recommendations

1. **Consolidate and shorten the permitting process** – Hundreds of Federal, State, and local permits and approvals are required to build or expand a refinery. Many of these processes include administrative appeals, timeframes measured in months, and extensive opportunities for judicial appeal. EPA Administrator Johnson is developing a consolidated one-year permitting process. Implementation of such a plan would require legislation, and would be extremely difficult to enact, given that it would propose consolidating processes for politically sensitive laws (e.g., the Clean Air and Clean Water Acts).

2. **Federal "backstop" siting authority** – As a component of shortening the permitting process for a refinery or a pipeline, propose legislation to allow the Department of Energy to overrule State and local regulations as needed. This would be controversial with State and local officials, and with environmental activists, but would be necessary to provide regulatory speed and certainty.

3. **Harmonize EPA fuel regulations** – There are 15 environmental regulations and fuel standards that are either being implemented or are scheduled to be implemented over the next several years. Each has a different timeframe, creating complex planning processes and uncertainty for refinery operators. EPA is developing a tighter and more coordinated implementation schedule.

4. **Codify New Source Review (NSR) reforms for refineries** (codify existing policy) – The DC Circuit Court of Appeals approved some of these NSR reforms, but sent others back to EPA for more regulatory work. Your advisors recommend you ask Congress to eliminate legal uncertainty by codifying these provisions. Doing so would enable more rapid efficiency and productivity upgrades at refineries, helping to boost capacity and mitigate cost.

Options still under development

5. **Create strategic fuel reserves** – Secretary Bodman and CEA Chairman Bernanke are developing options to mandate that private firms keep a certain amount of fuel inventories as a reserve. A reserve requirement is an insurance policy. The premium is the cost of creating and carrying the reserve, and the benefit is the amelioration of shortages during crises.

The SPR and Northeast Home Heating Oil Reserves are government-owned and taxpayer-financed. The proposal being drafted would instead require refiners, terminal operators, and importers to store emergency fuel stocks to cover disruptions of a certain duration.

6. **Incentives to build outside the Gulf region** – Nearly half of the Nation's refining capacity is located in the Gulf coast area affected by the hurricanes. Commerce is drafting a proposal modeled after its existing Economic Development Assistance programs that could be provided to encourage refinery construction in other areas, such as the Midwest.

7. **Eminent domain authority for oil and product pipelines** – The Energy Policy Act gave the federal government eminent domain authority for transmission lines. Your advisors are considering similar authority for oil and product pipelines. In light of a recent and controversial Supreme Court decision on eminent domain, if we pursue this option, we would constrain it to items that are genuinely for "public use."

8. **Dedicated coal-to-liquids for military use** –We are reviewing a Department of Defense proposal to enter into long-term contracts with private industry, at a guaranteed price, to ensure a dedicated supply of liquid fuels for military use.

9. **Bio-refineries** – Fostering a domestic biorefinery industry modeled after petro-chemical refineries is a primary objective of DOE's biomass R&D programs. DOE is reviewing whether additional funding from Congress could enable loan guarantees to industry to construct demonstration biorefineries that would allow economical production of a wide range of fuels, chemical, materials, and power from biomass.

10. **Oil shale** – The U.S. has more than 2 trillion barrels in known oil shale resources. It has not been economic to produce them. In recent years, Canada has added 1 million barrels per day of new production from its Alberta tar sands. Several firms have responded to the Interior Department's offer to lease land for oil shale R&D purposes. In addition, the Energy Policy Act directs Interior to develop a commercial leasing program for oil shale.

11. **Establish voluntary agreement on fuel economy of cars and light trucks** – Administration officials could work with leaders of the auto industry to establish size-based targets for the fuel economy of cars and light trucks for model year 2015. This voluntary measure would build on the mandatory CAFE requirements now being finalized for model years 2008-2011.

Options your advisors have considered and rejected

12. **Consolidate "boutique fuels"** – Your advisors believe the legislative pressure in a boutique fuel debate would push consolidation to standardize on cleaner, more expensive fuels, eliminating most if not all of the efficiency gains from standardization. Having many different fuel standards would segment markets, but

the likely outcome of pushing this policy change (standardized but expensive fuel) is worse.

13. **Tax or other financial incentives** – Conversations with the majors and refiners suggest that financial incentives would have to be enormous to fundamentally change their investment decision-making. Reducing regulatory hurdles to increase investment is, we believe, a more productive path. Also, recommending tax relief for refiners at a time of high profits would be legislatively unproductive.

Addressing natural gas shortages

As a result of Hurricanes Katrina and Rita, approximately 80% of Outer Continental Shelf (OCS) natural gas production (13% of total U.S. supply) is "shut-in." While many production facilities are expected to restart over the next few days, damage to onshore natural-gas-processing facilities remains a critical bottleneck preventing delivery of natural gas from the Gulf Coast to U.S. markets.

The factors most likely to help the natural gas crunch this winter are, in order:

1. market signals – as the price climbs, demand will drop;
2. conservation;
3. fixing natural-gas-processing facilities and drilling rigs; and
4. potentially, accessing the "base gas" described in option 8 below.

Recommendations

1. **Expedite repair of damaged natural-gas-processing facilities** – Gas processing facilities with more than 4 billion cubic feet per day of natural gas capacity (6% of U.S. consumption) remain out of service following the two hurricanes. (A separate energy supply update memo provides the status of particular facilities.)

   UPDATE: Dynegy, which runs two of the three largest damaged natural gas processing facilities, is now looking to reroute natural gas around inoperative processing facilities. They are also exploring options to bring partial capacity online more rapidly.

2. **Consumer conservation efforts** – DOE, EPA, and other agencies have developed a campaign to promote energy efficiency and conservation which can be initiated during the first week of October. This campaign would include public events, media interviews, public service announcements, and advertising to raise consumer awareness of efficiency opportunities.

3. **Accelerate energy tax incentives** – Certain tax provisions in the Energy Policy Act take effect on January 1, 2006. Your advisors recommend asking Congress to accelerate those effective dates to mid-October. This would encourage energy-efficient home improvements and purchase of more fuel-efficient vehicles. Treasury

(and likely the tax-writing committees in Congress) argues that the extra two to three months is not worth the hassle of changing the law. Most of the benefit from this provision is in the announcement and the additional attention it would draw to the importance of conservation.

4. **Increase weatherization funding** – Similarly, a modest increase in Federal grants to states for weatherization funding used to improve low-income-housing energy efficiency could have a beneficial announcement effect. The small policy benefit would, however, not occur for at least several months.

5. **Make fuel switching easier** – The Clean Air Act requires a utility to get approval from EPA if they want to switch from one fuel source to another (e.g., from natural gas to fuel oil). Your advisors recommend asking Congress to give EPA authority to waive these Clean Air Act limits temporarily in times of natural gas shortage.

6. **Clear Skies legislation** (existing policy) – Legislative enactment of Clear Skies would provide the certainty utilities need to build new large clean-coal plants and to increase efficiency at existing units. Clear Skies would significantly reduce the projected increased use of natural gas to meet future electricity demand and is the least expensive way to ensure compliance with new air-quality requirements.

7. **Codify New Source Review (NSR) reforms for electric utilities** (codify existing policy) – The DC Circuit Court of Appeals stayed these NSR reforms, pending the outcome of protracted EPA litigation with utilities. Legislative adoption of NSR should enable more rapid investment in efficiency upgrades at utilities, reducing their demand for natural gas. These reforms are included in your proposed Clear Skies legislation.

Options still under development

8. **Allow limited withdrawal of "base gas" in storage** – More than half of all natural gas in storage fields is used as base gas to pressurize the field and is never withdrawn and sold to markets. A portion may be available (DOE estimates up to 200 bcf) out of select storage facilities and reservoirs, provided the removal will not lessen the physical integrity of storage. DOE is working to address complex regulatory, tax, and ownership issues.

9. **Coal gasification** – The energy bill you signed in August contains authorization for loan guarantees to encourage construction of new coal gasification facilities, which can generate electricity or provide synthetic natural gas resources for use as a feedstock for chemicals or manufacturing. DOE could seek additional funding for these loan guarantees, to encourage new facility construction over the next few years.

10. **Create strategic natural gas reserve** – Secretary Bodman and CEA Chairman Bernanke are developing options to mandate that private firms hold additional natural gas reserves to be used to cover disruptions of a certain duration.

Options your advisors have considered and rejected

11. **Waive restrictions on BPA/TVA hydro facility flows** – Limits placed on water flows in the Bonneville and Tennessee Valley hydroelectric systems could be waived to provide more power at the expense of fish protection or other values. We found that potential supply increases were insignificant.

12. **Give FERC authority to order dispatch of non-gas-fired generation** – Legislation could be pursued to make clear that FERC would have the authority to order preferential dispatch of non-gas-fired electric generating units. However, this approach would pre-empt the ability of State Public Utility Commissions or independent Regional Transmission Organizations to dispatch power based on a number of considerations, and is likely to face significant opposition in Congress.

Increasing oil and gas production

The options described below would have long-term effects. They would not help our short-term problems on oil and natural gas.

Recommendations

1. **Accelerate "categorical exclusions" to reduce permit backlog** – Under the National Environmental Policy Act (NEPA), certain kinds of activities with no significant environmental impact can be "categorically excluded" from analysis. This greatly accelerates leasing and permitting decisions by streamlining environmental review. Interior is expediting its use of categorical exclusions permitted in the energy bill, and several other proposals for administrative action are pending at CEQ.

2. **Provide additional funding for permitting staff** – The rate at which applications for permits to drill on existing leases is limited mainly by the manpower available to conduct the required reviews and to process these applications. Interior and OMB are reviewing options to reprogram a small amount of additional funding to boost permitting staff in areas of the Rockies where interest in natural gas production activity has dramatically increased.

3. **Modify seasonal leasing restrictions in times of shortage** – Lease stipulations to protect wildlife and ecosystems can, in some areas, reduce the amount of time each year that oil and gas production can be conducted on Federal lands. Interior is reviewing whether such stipulations are truly warranted, and whether additional production could be obtained by modifying lease restrictions in times of shortage.

4. **Streamline administrative and judicial review of lease-sale decisions** – Over the past five years, legal challenges to Federal actions enabling onshore oil and gas exploration and production have increased by more than 250%. These challenges serve to delay or discourage new production activities without having a meaningful

impact on the environment. Interior is reviewing its regulations to identify places where administrative appeals processes are outdated or no longer needed. Interior is also reviewing the possibility of Congressional legislation to limit the scope of judicial review to only the most substantive questions.

Options still under development

During Congressional consideration of the energy bill, your advisors were skeptical that private firms would choose to build an Alaskan natural gas pipeline. Senator Stevens (R, AK) prevailed and included financial incentives for building the pipeline in that law. So far, the pipeline is not moving forward. Your advisors remain skeptical about the firms' interest, and Alaska has made some demands. At the same time, we share a common interest with Senator Stevens in facilitating the development of this pipeline.

5. **Sunset energy bill financial incentives if no application** – Private firms have not yet submitted an application to build a pipeline. You could ask Congress to place a (short) end date on the financial incentives. Private firms would then either have to build the pipeline quickly or lose the incentives. We plan to seek Senator Stevens' views on this idea before making a recommendation.

6. **Shorten FERC review process of the Alaska natural gas pipeline** – Secretary Bodman is exploring whether the FERC review process can be compressed.

7. **Seek authorization for "natural gas"-only leases** – To reduce public opposition to offshore oil drilling, Congress has focused on providing Interior with the ability to offer OCS leases only for natural gas production. However, as a practical matter, Interior questions whether it is technically feasible to ensure the recovery of natural gas only from a hydrocarbon deposit (e.g., it would require reinjection of any oil found).

8. **Default drilling-permit approval if action not taken in specified time** – This option would automatically grant a drilling permit if the Interior Department failed to take action by a certain deadline. This would require a change in the law, which would be difficult to enact.

9. **Brazilian ethanol** – Brazil and the U.S. are the world's largest producers of ethanol. Brazil makes ethanol from sugar crops. After learning that over half of all vehicles in Brazil are capable of using ethanol, we explored the feasibility of sugar-based ethanol in the U.S.

Ethanol made from ...	... costs this much per gallon of ethanol
Brazilian sugar	\$0.88 (\$1.42 with 54¢ duty)
U.S. corn	\$1.00 for older plants \$1.24 for newer plants
U.S. sugar (with current price supports)	\$1.84

U.S. sugar (with worldwide free trade in sugar)	$1.10 – $1.32

Based on the above data, the U.S. could be competitive in sugar ethanol production if there was international reform of sugar supports. Current levels of domestic sugar production could not, however, support a domestic sugar ethanol industry. In a complete free trade environment for sugar, a domestic sugar ethanol industry would be possible (and opposed by corn farmers).

Options your advisors have also considered

10. **Imports from Canada** – The information you received Monday, September 26, about the Iroquois pipeline being down was incorrect. All major pipelines from Canada are operational, and we can find no market barriers to increased imports. Your advisors believe that if the U.S. price is high enough, small increments of additional natural gas will enter the U.S. from Canada.

11. **Liquefied Natural Gas (LNG) imports** – Only 11 percent of natural gas traded internationally is sold on the spot market. The rest is sold in long-term contracts. During a shortage, extraordinarily high spot prices are needed to redirect LNG internationally, because of the considerable distances and international demand for LNG cargoes. Your advisors believe additional imports will occur if the U.S. price is high enough.