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23 April 1987

MEMORANDUM FOR: Distribution

SUBJECT: Inter-Agency Meeting

TYPE OF MEETING EPC/DPC with the President

DATE ~~Friday, 24 April 1987~~ Wednesday, 29 April 87

TIME 1400 1300

PLACE Cabinet Room

CHAired BY President

ATTENDEE(S) (probable) ADCI

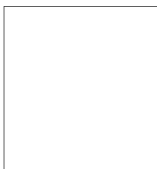
SUBJECT/AGENDA Energy Security

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*Gates attended*

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Remarks

  
 Executive Secretary  
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**THE WHITE HOUSE  
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Executive Registry

87-1706X

**CABINET AFFAIRS STAFFING MEMORANDUM**

**Date:** April 28, 1987 **Number:** 317,314 **Due By:** \_\_\_\_\_

**Subject:** Joint DPC/EPC Meeting--April 29, 1987--<sup>1:00 p.m.</sup>~~11:00 a.m.~~--Energy Security

ALL CABINET MEMBERS	Action	FYI		Action	FYI
Vice President	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>
State	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEQ	<input type="checkbox"/>	<input type="checkbox"/>
Treasury	<input checked="" type="checkbox"/>	<input type="checkbox"/>	OSTP	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Defense	<input checked="" type="checkbox"/>	<input type="checkbox"/>	NSF	<input type="checkbox"/>	<input type="checkbox"/>
Justice	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Interior	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Agriculture	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
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**REMARKS:** A joint meeting of the Domestic and Economic Policy Councils will be held on Wednesday, April 29, 1987 at <sup>1:00 p.m.</sup>~~11:00 a.m.~~ in the Cabinet Room. The President will chair the meeting. The agenda will be Energy Security. A background paper is attached for your review.

**RETURN TO:**

Nancy J. Risque  
Cabinet Secretary  
456-2823  
(Ground Floor, West Wing)

Associate Director  
Office of Cabinet Affairs  
456-2800  
(Room 235, OEGB)



THE WHITE HOUSE

WASHINGTON

April 27, 1987

MEMORANDUM FOR THE DOMESTIC AND ECONOMIC POLICY COUNCILS

FROM: RALPH C. BLEDSOE *RCB*  
Executive Secretary, DPC  
EUGENE J. MCALLISTER *EM*  
Executive Secretary, EPC

SUBJECT: Joint Meeting on April 29, 1987

A joint meeting of the Domestic and Economic Policy Councils will be held on Wednesday, April 29, 1987 at ~~11:00 a.m.~~ <sup>11:30 a.m.</sup> in the Cabinet Room. The President will chair this meeting, in which we will discuss Energy Security.

A paper outlining the issue is attached for your review.

~~SECRET ATTACHMENT~~

**THE WHITE HOUSE**  
**WASHINGTON**

**DOMESTIC POLICY COUNCIL AND ECONOMIC POLICY COUNCIL**  
**JOINT MEETING**

Wednesday, April 29, 1987

*1:00 p.m.*  
~~11:00 a.m.~~

Cabinet Room

**AGENDA**

1. Energy Security -- Secretary Herrington

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THE WHITE HOUSE

WASHINGTON

April 27, 1987

MEMORANDUM FOR THE PRESIDENT

FROM: THE DOMESTIC POLICY COUNCIL  
THE ECONOMIC POLICY COUNCIL

SUBJECT: Energy Security

Last October, you promised to conduct a review of our energy-related national security concerns. Shortly thereafter, Congress included in the Consolidated Omnibus Reconciliation Act of 1986 a provision requiring Secretary Herrington to conduct a study of domestic crude oil production and petroleum refining capacity and the effects on oil imports. The legislation also requires that within forty-five days of receiving Secretary Herrington's study, you shall report your views:

concerning the levels at which imports of crude oil and refined petroleum products become a threat to the national security and advise the Congress concerning [your] views of the legislative or administrative action, or both, that will be required to prevent imports of crude oil and refined petroleum products from exceeding those import levels that threaten our national security.

Secretary Herrington issued his report on March 17, 1987. The analysis has been very well received. Among the study's most important conclusions is that the costs of an oil import fee would clearly outweigh the benefits.

The White House Counsel advises that you are under no constitutional obligation to recommend legislative or administrative action and that you have substantial flexibility in deciding how to report your views. The Domestic and Economic Policy Councils believe it is in your interest to convey your views and policies, because energy security is a very important issue and the Administration has done much to improve that security. The Councils recommend that you convey your views in a May 1, 1987 letter, while not forwarding a specific legislative proposal.

The Councils have reviewed the Department of Energy study and have prepared several policy options for your consideration. These options reflect the tension between competing goals of: (1) improving national security; (2) preserving the principles established in tax reform; (3) maintaining a free market energy policy; and (4) reducing the Federal budget deficit.

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## NATIONAL SECURITY CONCERNS

The Department of Energy study concludes that by the mid-1990s we may be importing more than half of our oil. This prospect raises national security concerns about a potential supply interruption. The national security community believes such an interruption is a real possibility because of the the potential for political instability in the Middle East and the ever-present Soviet threat to this region.

A supply interruption (or threat thereof) might pose two dangers:

- o Disrupting our economy and economies of our allies who are also highly dependent on imported oil, more specifically Persian Gulf oil; and
- o Impairing our ability to conduct the desired foreign policy.

Although the danger of a supply interruption significantly impairing our ability to mobilize our defense establishment is small, it could cause severe distress to civilian sectors as defense needs are given priority access to available oil supplies. (A fuller description of the national security concerns is attached.)

## ADMINISTRATION GOALS

While there is disagreement about specific additional initiatives you might seek, the Councils unanimously recommend that in your letter to the Congress you establish the following broad goals for U.S. energy and oil policy:

The United States should take steps to better protect ourselves from potential oil supply interruptions and increase our energy security. These steps should include:

- increasing our domestic stockpiles, which we can draw down in the event of a supply interruption;
- maintaining a strong domestic oil industry;
- expanding the availability of domestic oil and gas resources; and
- promoting among our allies the importance of increasing their stockpiles.

An additional element of our U.S. "energy security" strategy is to promote the use of alternative economically efficient energy sources. The increased use of coal and the introduction of new types of nuclear reactors are among the most promising alternatives.



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**PREVIOUS ADMINISTRATION ACTIONS**

The Councils believe it is very important to keep the idea of energy security in perspective. You have already taken two extremely important actions to increase our energy security by: (1) fully decontrolling oil prices in 1981; and (2) filling the Strategic Petroleum Reserve (SPR) to more than 500 million barrels and committing to a 750 million barrel SPR. Some of the other major steps this Administration has taken to strengthen our energy security and maintain a strong domestic oil industry include:

- o Reestablishing the five-year Outer Continental Shelf (OCS) leasing program and reducing the minimum bid for certain offshore leases.
- o Increasing Federal spending for clean coal to \$2.5 billion over the next five years and reestablishing a Federal coal leasing program.
- o Preserving the favorable treatment of intangible drilling costs in the Tax Reform Act and retaining the full-cost accounting provisions.
- o Lifting foreign policy controls on the export of petroleum equipment and technology.
- o Encouraging our allies to build up their stockpiles, which amount to about 350 million barrels (mostly in Germany and Japan).
- o Vetoing standby petroleum price control and allocation legislation in 1982.

These actions, and their effects, should be cited in your letter to Congress. They have substantially increased our energy security and improved our capability to mitigate a future supply disruption of twice the size of historic disruptions, but would not be sufficient to completely mitigate a much larger disruption.

**CURRENT ADMINISTRATION PROPOSALS**

In addition, the Councils believe your report to the Congress is an excellent opportunity to re-emphasize the importance of a number of initiatives that you have proposed but which have not yet been adopted, including:

- o Seeking comprehensive natural gas decontrol, including wellhead price decontrol, and repeal of the Fuel Use Act.

- o Repealing the Windfall Profit Tax.
- o Continuing to improve access to OCS and Federal lands.
- o Seeking nuclear licensing reform, reauthorization of the Price Anderson Act, and developing a nuclear waste repository.
- o Continuing to push hard for higher levels of oil stockpiles among our allies, particularly at the ministerial meeting of the International Energy Agency in May and the Venice Summit.

If all these proposals that are currently on the table were enacted, they could yield additional domestic production of 375,000 barrels per day of oil equivalent by the early 1990s.

#### ADDITIONAL PROPOSALS

The Domestic and Economic Policy Councils reviewed a number of additional proposals for improving our energy security. These proposals can be divided into three general categories: (1) tax incentives; (2) Federal lands leasing policy; and (3) the SPR.

#### Tax Incentives

The Councils considered four tax proposals designed to increase U.S. oil production. The first two proposals remove restrictions on the use of percentage depletion by independents. This will reduce early well-abandonment and will stimulate additional drilling activity. The last two proposals are incentives targeted toward exploration and development of new oil and gas reserves and toward helping to maintain the domestic oil and gas exploration infrastructure.

1. Repealing the transfer rule to permit use of percentage depletion for proven properties that have changed ownership.
2. Increasing the net income limitation on the percentage depletion allowance from 50 percent to 100 percent per property.
3. Providing for faster tax-write off of geological and geophysical expenses.
4. Providing a non-refundable tax credit for oil exploration and development on new properties which would be fully creditable against the alternative minimum tax.

These proposals are arrayed below according to cost and expected additional production. The additional production would peak in 1992 and decline thereafter.

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<u>Tax Change</u>	<u>Five-Year Revenue Loss</u>	<u>Additional Production by 1992</u>
Transfer Rule	\$ 142 million	55,000 b/d
Net Income Limitation	\$ 212 million	58,000 b/d
G&G expensing with \$21-25 barrel phase out	\$ 1.9 billion	200,000 b/d
with three-year sunset	\$ 1.1 billion	125,000 b/d
Tax Credit for Exploration and Development		
with \$25 barrel sunset	\$ 2.9 billion	325,000 b/d
with three-year sunset	\$ 1.7 billion	230,000 b/d

#### Federal Lands Policy

Federal lands have tremendous potential for new significant oil and gas discoveries. Offshore has a potential of more than 11 billion barrels of recoverable oil. Onshore, the Arctic National Wildlife Refuge (ANWR) alone has a potential of up to 30 billion barrels of oil in place with a recoverable reserves potential of up to 9.2 billion barrels.

On April 20, Secretary Hodel announced that the Department of Interior would forward a report and environmental impact statement to Congress seeking authority for full leasing of ANWR in a manner reflecting wildlife values.

An additional initiative the Administration might take in lands policy that would lead to more exploration and development without any budget costs is reducing the minimum bid requirement for Federal leases from \$150 per acre to \$25 per acre.

The Administration might also eliminate the royalty requirement on new competitive leases, except in the case of ANWR.

#### Strategic Petroleum Reserve

One of the most important steps we have taken to strengthen our energy security is to commit to building up our strategic petroleum reserve to 750 million barrels. The 1988 budget calls for a SPR fill rate of 35,000 barrels a day, with a budget cost of \$233 million in 1988 and \$1.3 billion over five years. By 1995, the SPR would reach almost 640 million barrels, providing 63-83 days of import protection. The Councils have developed three proposals for accelerating the SPR fill rate.

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1. Increasing the SPR fill rate to 75,000 barrels per day, resulting in completion of 750 million barrel reserves in 1995. This would provide 18 percent more days of import protection by 1995 than does the 35,000 fill rate. Outlays would be increased by \$304 million in 1988 and \$2.1 billion over 1988-1992.
2. Increasing the SPR fill rate to 100,000 barrels per day. This would complete the 750 million barrel reserve by 1993. Outlays would be increased by \$482 million in 1988 and \$3.2 billion over 1988-1992.
3. Studying the possibility of providing a special oil-based security that would be sold to investors to finance up to 100,000 barrels per day in the SPR at lower cost than if DOE purchased the oil for SPR.

#### OPTIONS

The Councils have developed two options based on these proposals. Option 1 has been fashioned to be revenue neutral and avoid reopening basic issues considered in tax reform.

Option 2 is designed to increase U.S. oil and gas production up to 1 million barrels per day, to help make up the production lost in the 1986 oil price collapse and to stimulate drilling activity in the troubled oil service sector. The 1 million barrel increment would increase domestic production by about six percent, reduce projected imports by about ten percent, and reduce world dependence on Persian Gulf oil up to five percent. Secretary Herrington believes that a goal of 1 million barrels new production is essential to curb rising imports and preserve domestic oil industry infrastructure.

Option 1: Supplement current Administration proposals with a revenue neutral program and tax changes of a relatively technical nature. Elements included in this option are:

- opening up ANWR
- reducing the minimum bid requirement
- increasing the net income limitation
- repealing the transfer rule
- studying the possibility of private financing for a SPR fill rate of up to 100,000 barrels per day

#### Advantages

- o Does not increase the budget deficit and continues our effective policy of relying on the market.

-7-

- o Avoids a major reopening of tax reform while endorsing the changes, which though technical in nature, have nevertheless significantly discouraged marginal production.
- o Focuses pressure on Congress to take the actions that are very important for our energy security and a strong domestic oil industry: natural gas deregulation, opening up ANWR, and repealing the windfall profit tax.
- o A private SPR may have a number of attributes, including reducing Federal costs and incorporating private sector judgments about the possibility of supply interruptions.

Option 2: Supplement current Administration proposals with additional proposals that may not be revenue neutral (depending in part on the budget savings resulting from the private SPR) but which will lead to significantly more domestic oil and gas production than option 1. This option includes the elements of option 1 with the following additional possibilities:

- A. Providing for faster tax write-off of G&G expenses;
- B. Providing a tax credit for oil exploration and development;
- C. Increasing the SPR fill rate up to 75,000 barrels per day if the private SPR financing is not feasible.

#### Advantages

- o Provides substantial new U.S. oil production of up to a million barrels per day and offers a credible alternative to the oil import fee.
- o Tax proposals will help sustain the domestic oil industry infrastructure so that it will be able to respond effectively when prices rise in the 1990s.
- o Increasing the SPR fill rate to 75,000 b/d will lead to a 750 million barrel SPR by 1995 when the national security projections show we will be most vulnerable.

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## DECISION

\_\_\_\_\_ Option 1: Supplement current Administration proposals with a revenue neutral program and only technical tax changes. Elements included in this option are:

- opening up ANWR
- reducing the minimum bid requirement
- increasing the net income limitation
- repealing the transfer rule
- studying the possibility of private financing for a SPR fill rate of up to 100,000 barrels per day.

(The savings estimates for private SPR financing range from zero to \$250 million per year. OMB has concerns about the budget integrity of such a proposal.)

Option 2: Supplement current Administration proposals with additional proposals that may not be revenue neutral but which will lead to substantially more new domestic oil production than option 1. This option includes the elements of option 1 with the following additional possibilities:

A. Providing for faster tax write-off of G&G expenses. (See page 5 for additional estimated production and revenue loss.)

\_\_\_\_\_ i. with \$21 - \$25 per barrel phase-out

\_\_\_\_\_ ii. with three year sunset

B. Providing a non-refundable tax credit for oil exploration and development. (See page 5 for additional estimated production and revenue loss.)

\_\_\_\_\_ i. with \$25 per barrel sunset

\_\_\_\_\_ ii. with three year sunset

\_\_\_\_\_ C. Increasing the SPR fill rate to 75,000 barrels per day if the private SPR financing is not feasible.

Options 1 and 2 are mutually exclusive. Option 2, sub-options A, B, and C are not mutually exclusive.

*Edwin Meese III*  
EDWIN MEESE III  
Chairman Pro Tempore

*James A. Baker III*  
JAMES A. BAKER, III  
Chairman Pro Tempore

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## APPENDIX

### Is There a National Security Threat?

The national security implications of projected levels of dependence on insecure sources of oil are significant. The following discussion has been prepared by the State Department, the Department of Defense, the Central Intelligence Agency and the National Security Council.

#### Growing Reliance on Insecure Oil Affects National Security Interests

Over the next decade, the West, including the United States, will become more dependent on insecure oil supplies, particularly from the Persian Gulf. This poses a threat to U.S. national security interests. The decline in surplus production capacity will leave the West more vulnerable to supply disruptions, price manipulation, and attempts to use oil as a political weapon. (C/NF)

#### Political Instability in the Persian Gulf

Increased dependence on the Persian Gulf for oil supplies is a concern because of the continuing volatility in the region and the threat of a supply cutoff or a major supply disruption. The course of the Iran-Iraq war, an almost certain power struggle in post-Khomeini Iran, and Soviet competition for influence in the region all influence Western access to Persian Gulf oil. Furthermore, developments in the Arab-Israeli arena could again bring Middle East politics to the forefront of oil policy decisions as they did in 1973. (C/NF)

The countries in the Arabian Peninsula will face continuing and perhaps increased political, economic, and social pressures over the next decade. The political stability of these states over the past 30 years has been particularly remarkable in light of their rapid economic and social development. Changing political, economic, and social environments, however, are likely to stimulate increased political activism that could lead to periods of instability in some of these states before the end of the century. Ruling families will face more complex challenges as they try to meet the rising expectations of increasingly educated and rapidly growing populations. Thus when combined with the hostility between Iran and Iraq the risk of political instability in the Persian Gulf area will remain high. (S/NF)

Although political change on the Arabian Peninsula would not necessarily be inimical to U.S. interests, instability could be exploited by external elements hostile to the United States. Radical domestic groups probably would receive external support,

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and their antiregime activities may well include an anti-U.S. focus. (S/NF)

## U.S. Interests

Energy security policy must deal with two environments -- reducing our vulnerability to supply disruptions prior to their occurrence and preparing us to cope with supply interruptions.

National security is affected by our energy situation in several ways:

- o Economic Impacts. Strong economies are essential to Western security. Thus, national security is enhanced by the contribution lower oil prices and a market-based energy system make to economic growth and efficiency. Strategic stocks give oil-importing nations the capability to mitigate most of the economic impact of historic-sized disruptions. However, as the cushion of surplus production capacity diminishes, our ability to cope will be reduced. Under these conditions, supply disruptions or price manipulation could seriously damage the world economy and undermine our ability to pursue our security objectives. (C/NF)
- o Defense Requirements. Although defense needs are small relative to overall oil consumption, disruptions can hamper defense readiness and sustainability during periods of international crisis or during times of war. Moreover, defense needs in a major conventional conflict would include industrial mobilization. Ensuring that defense demands are met may mean that discretionary civilian consumption would yield to security requirements in an emergency. (U)
- o Foreign Policy Implications. Increasing dependence on insecure oil can hamper pursuit of U.S. security and foreign policy interests. Heavy and growing reliance on the Persian Gulf region requires that we continue to devote limited defense readiness resources to this area, stretching our global defense capabilities. Our own political willingness to pursue fundamental long-term interests could be reduced if special priority must be accorded to ensuring oil supply. Support from Allies could also be reduced if they respond to perceived vulnerabilities and rivalries for oil supplies, thus undermining Allied solidarity and complicating the management of a major crisis. Heavy reliance on the Persian Gulf may also reduce Allied willingness to provide access to military facilities essential for U.S. capabilities to respond to crises in the Middle East/Southwest Asia region. Following the U.S. bombing of Libya, for example, Tripoli pressed hard for an Arab oil embargo against the United States and Allies who supported the effort. The Arab world -- including Egypt -- strongly condemned the U.S. action,

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but did not pursue an embargo in part because of the abundance of alternative supplies. In a tight oil market, fear of unified Arab retaliation might have stiffened Allied resistance to the bombing. (S/NF)

Energy security can be achieved only on a collective basis. Measures aimed at ensuring our access to oil supplies at the expense of our allies not only will fail, but also will encourage them to pursue go-it-along strategies that are likely to be harmful to our interests. In contrast, cooperative efforts to reduce collective vulnerability give the United States greater flexibility in foreign policy and add to our national security. National security is enhanced when the U.S. and its Allies minimize, in a cost-effective way, the risks of a supply disruption (and maintain the capability to mitigate its impacts should one occur). (U)

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Remarks

Executive Secretary  
29 Apr '87  
Date

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THE WHITE HOUSE  
WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

Date: April 29, 1987 Number: 317,315 Due By: \_\_\_\_\_

Subject: Energy Security Issues

ALL CABINET MEMBERS	Action	FYI		Action	FYI
Vice President	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>
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REMARKS: The attached memorandum from Jim Miller is forwarded for your review prior to today's EPC/DPC meeting with the President.

RETURN TO:

Nancy J. Risque  
Cabinet Secretary  
456-2823  
(Ground Floor, West Wing)

Associate Director  
Office of Cabinet Affairs  
456-2800  
(Room 235, OEOB)

**THE WHITE HOUSE**

**WASHINGTON**

April 29, 1987

**NOTE FOR ECONOMIC POLICY COUNCIL  
DOMESTIC POLICY COUNCIL**

**FROM: NANCY J. RISQUE** *njr*

Jim Miller asked that I send the attached materials to you before today's EPC/DPC meeting.



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

April 28, 1987

MEMORANDUM FOR THE ECONOMIC AND DOMESTIC POLICY COUNCILS

FROM: ~~James Miller III~~  
Director

SUBJECT: Energy Security Issues

Over the past few days, I have had several conversations with Secretary Baker and Secretary Herrington regarding potential offsets for the increased budgetary costs of the two options presented in the EPC/DPC issue paper. Based on subsequent staff analysis, I have prepared the attached table summarizing the production estimates, budgetary costs, and our best estimate of the potential offsets for the two options. (This does not include the option of increasing the Strategic Petroleum Reserve (SPR) fill rate through direct Government outlays.)

The table makes three points:

- 1) The full cost of Option 2 can be fully offset in FY 1988, but not over the five-year period.
- 2) Option 1 can be more than fully offset.
- 3) Achievement of the offsets depends heavily upon Secretary Herrington's ability to sell the Great Plains facilities in FY 1988, and most importantly, upon the Administration's ability to develop a viable private financing mechanism for the SPR that will result in no net cost to the Government. This will require relinquishment of some of the current Government controls over SPR drawdown and use.

I look forward to reviewing the issues with you in our meeting with the President.

Attachment

## ENERGY SECURITY OPTIONS

Summary of Production Effects, Budgetary Costs,  
and Potential Offsets

	<u>Budget Costs (\$ in Millions)</u>		<u>Incremental CY 1992 Oil and Gas Production (B/D)</u>
	<u>FY 1988</u>	<u>FY 1988 thru FY 1992</u>	
<u>Current Administration Proposals</u> (Natural Gas Deregulation and Expanded OCS Leasing).....	(Already in the budget.)		375,000
<u>Option 1</u> (Current proposals plus repeal transfer rule and increase net income limitation).....	+65	+318	488,000
<u>Option 2</u> (Option 1 plus G&G expensing and production credit).....	+592	+5,172*	1,013,000*
<u>Potential Offsets</u>			
o Lease Arctic Wildlife Refuge (ANWR).....	--	-425	
o Private SPR Financing....	-233	-1,273	
o Sale of Great Plains Synfuels Plant.....	-360	-450	
Total	-593	-2,148	

\* This cost could be reduced by approximately \$2 billion through a three-year sunset of both items, resulting in 170,000 B/D of less production.

Note:

All estimates of budget costs are based on oil price forecasts contained in the budget, and are generally consistent with those in the House Budget Resolution and the Senate (Chiles) Resolution. Use of the higher price forecasts contained in the Energy Security Study would result in lower costs. However, higher energy prices would also increase the baseline budget deficit estimates by a larger amount, so the effect would be to increase the deficit overall.