ADMINISTRATION HISTORY APPENDIX
CHAPTER THREE: IMPROVING FINANCIAL SERVICES, AND MARKETS AND THE FEDERAL GOVERNMENT'S FINANCIAL MANAGEMENT

ELK HILLS

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INFORMATION

August 14, 1997

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS
UNDER SECRETARY HAWKE
GENERAL COUNSEL KNIGHT

FROM: Mozelle W. Thompson MWT
Principal Deputy Assistant Secretary
(Government Financial Policy)

Peter Necheles PN
Policy Advisor
(Government Financial Policy)

SUBJECT: Elk Hills Naval Petroleum Reserves

I. Overview

By statute, the "draft contract or contracts, including the terms and provisions of the sale of the interest of the United States in the [Naval Petroleum Reserve Numbered 1 ("NPR-1")], [are] subject to the review and approval by the Secretary [of Energy], the Secretary of the Treasury, and the Director of the Office of Management and Budget."

The Secretary of Energy is directed to sell the government's interest in NPR-1 (the "Assets") "in a manner consistent with commercial practices and in a manner that maximizes sale proceeds to the Government." The legislation also provides that the Secretary of Energy and the Director of OMB are to set the minimum acceptable price for the Assets. Additionally, the Secretary of Energy and the Director of OMB are provided with the authority to cancel the sale if they jointly determine that (a) the sale is proceeding in a manner inconsistent with achievement of a sale price that reflects the full value of the reserve, or (b) a course of action other than the immediate sale of the reserve is in the best interests of the United States.

To assist in the development and implementation of the sale, the Department of Energy ("Energy") retained CS First Boston and Petrie Parkman & Co (a Houston-based investment banking firm with experience in petroleum sales), as well as the law firm O'Melveny & Myers.

Over the last three months, the Office of Government Financial Policy (OGFP), in consultation with the Office of General Counsel and the Office of Tax Policy, has closely participated with OMB and the Department of Energy (Energy) in the development of the purchase and sale agreement (the "PSA").

The purpose of this memorandum is to (1) familiarize you with the nature of the Department's role, (2) summarize our work to date, and (3) identify key issues in the PSA.

II. The Elk Hills Naval Petroleum Reserves

NPR-1 is owned jointly by the U.S. government and Chevron USA, and is operated under a 1944 agreement (the U.S. government owns approximately 78% of the interest in the field). NPR-1 produced over 21 million barrels of crude oil in 1996 and ranks among the 11 largest domestic producing oil fields in the lower 48 states. It is also one of the top 10 producing gas fields in the nation, producing almost 360 million cubic feet of natural gas per day. In preparation for the sale, two reserve reports of the entire field (including Chevron's interests) were prepared: an "upside study" conducted by Energy, and a study conducted by an independent oil and gas assessor, the Ryder Scott Company. The upside report establishes a present value of the reserves (at a 10% discount rate) in excess of $6.3 billion. The Ryder Scott report establishes a present value of the reserves (also at a 10% discount rate) in excess of $3.3 billion.

III. Chronology of Key Events

- May -- Energy published a solicitation of the government's interest and has since established a process for interested parties to have access to relevant information.
- August 12 -- Energy distributed the procedures for the bidding process to interested parties, with the commitment to distribute shortly the draft PSA.
- August 15 -- Energy will distribute its report on the net present value of NPR-1 if it were to continue to be held by the federal government. (The authorizing legislation requires that Energy retain independent assessors to assist with the establishment of a minimum acceptable price that must be exceeded for the sale of NPR-1 to be consummated.)
- August 20 -- Energy would like to distribute the draft PSA to interested parties. (Treasury and OMB's approvals of the draft PSA are to be obtained before Energy may distribute to potential purchasers.)
- October 1 -- bids will be due. This date will be the effective date of the PSA. (Energy has indicated to Treasury and the OMB that it will provide buyers with an opportunity to propose changes to the draft PSA.)
- October through early-November -- negotiations will take place in Houston on the price and any proposed changes to the PSA.
- January 1998 -- the negotiated contracts will be submitted to the relevant committees of Congress for the 31-day "lie before."
- February 10, 1998 -- is the scheduled closing date. (Subject to its authority to suspend the sale, Energy must enter into one or more contracts for the sale of its entire interest in

NPR-1 by February 10.)

IV. Structure of the Sale

Energy has elected to offer the Assets in two types of interests: (1) an "operator" interest equal to 74% of the Assets (guaranteeing the purchaser an interest in over 51% of the entire NPR-1); and (2) 13-smaller interests each equal to 2% of the Assets. Bidders may bid on some or all of the undivided interests being sold by Energy. Therefore, there may be one, some or fourteen different purchasers, along with up to fourteen different PSAs.

Energy's financial advisers prepared a "white paper" that discusses the rationale for the sale structure. (Attached at Tab A.)

V. Key Elements of the Purchase and Sale Agreement

The PSA contains the following important elements that we are reviewing in consultation with the Office of General Counsel:

1. Option Agreement

Energy has structured the sale to require awarded bidders to execute the PSA in late-October or early-November, along with an Option Agreement. Energy would also sign the Option Agreement, but would not sign the PSA until February 1998, since Energy needs to complete all environmental review procedures, complete consultation with Justice on antitrust concerns, and lie the contracts before Congress for 31 days before executing them.

The Option Agreements provide the United States with the right to require each awarded bidder to purchase an undivided percentage interest in the NPR-1 assets held by the federal government (the "Assets"), provided that the option is exercised by March 10, 1998. The United States must exercise the option after the expiration of the "lie before" period unless (1) the Secretary of Energy suspends the sale, (2) Congress passes supervening legislation that prevents the sale, (3) Energy's environmental review requires additional environmental provisions in the PSA, or (4) Justice raises antitrust concerns.

Along with the Option Agreement, the prospective buyer would provide a deposit equal to 10% of the base purchase price in the form of a letter of credit. The LC must be irrevocable and immediately drawable in full upon the presentation of a sight draft.

2. Adjustments to Purchase Price

The purchase price will be based on the value of the Assets as of October 1, 1997 (the "Effective Date"), with the expected closing date of February 10, 1998. Adjustments will be required for production and operating expenses during this period. The base price will be decreased for the net proceeds from the operation of the Assets.

Unlike traditional commercial transactions, buyers will not receive a period of due diligence during the period between the Effective Date and closing. Energy, based on the recommendations of its investment bankers, has elected this structure to reduce the likelihood of substantial changes to the aggregate purchase price (Energy must have certainty that the price exceeds the minimum price established by the independent assessors).

After the Effective Date the "risk of loss" due to catastrophes generally is passed to the buyer. However, if any portion of the Assets is materially damaged or destroyed before closing as a direct result of actions by Energy or its contractor that is currently operating NPR-1, Energy may choose to (1) repair or restore the Asset at Energy's expense, (2) indemnify the buyer for reasonable repair or restoration expenses, (3) reduce the base purchase price, or (4) do nothing and permit the buyer to terminate the PSA.

3. Representations and Warranties

Energy will make the traditional representations and warranties regarding its authority, performance, the absence of material litigation, necessary approvals and the absence of broker's commissions.

The buyer will make similar representations and warranties, as well as that it has not relied on any representation or warranty other than those expressly provided in the PSA, and that the buyer is "knowledgeable" and purchasing the Assets for its own account, and not with an intent to make a distribution within the meaning of securities laws.

For both Energy and the buyer, the representations and warranties survive for a period of three years after the closing date.

4. Indemnification and Environment

Energy has proposed a range of indemnification obligations and environmental obligations to buyers that are considered, by Energy's investment bankers, to be consistent with commercial practices. One item that we understand is not the commercial norm is Energy's agreement to continue remediation activities on environmental sites that are currently being undertaken. Energy also commits to conduct remediation activities on environmental sites that were not known to buyer prior to the closing date if they are identified within three years. We understand that OMB advocates these environmental positions based on policy concerns.

Indemnifications will be provided for (1) material breaches of the representations and warranties, (2) personal injury or property damage occurring prior to the closing date, (3) contractual claims occurring prior to the closing date, and (4) damages occurring from Energy's environmental remediation efforts. For all of the items, except the remediation, claims must be raised by the buyer before the third anniversary of the closing date. The indemnification obligations are limited by a $25,000 minimum claim amount, a $10 million threshold for all claims (which is in the form of a deductible), and an overall cap for indemnification at 10% of the base purchase price.

Energy's outside counsel prepared a table that sets forth the range of indemnifications and environmental obligations. (See Tab B.)

The legislation provides that the Secretary of Energy "may extend such indemnities and warranties as the Secretary considers reasonable and necessary to protect the purchaser from claims arising from the ownership in [NPR-1] by the United States." Counsel for Treasury, OMB and Energy are working on the issue of how Energy will fund any indemnification that is called.

5. Small Refiners "Set Aside"

The existing operations at NPR-1 provide for a small refiner "set aside" of 25% of the production at the bid price for the crude oil sold at auction (the market price). While the House version of the privatization legislation required that purchasers of NPR-1 continue this set aside, neither the Administration's nor the Senate's versions included the provision. During conference, the provision was stricken. Nevertheless, Energy has recommended that a provision be included in the PSA that would require the buyer of the 74% interest in the Assets (the "Operator") to provide a call option to the small refiners for a period of three years up to 25% of the production of crude oil. Unlike the existing set aside, the small refiners would be charged an administrative fee of $0.10 per barrel.

Energy believes that this provision makes sound energy policy, allowing for the small refiners on the West Coast to continue to have access to light crude oil, necessary for their operations. Additionally, Energy believes that the inclusion of the set aside would preempt antitrust issues at the State of California level. Energy's financial advisers have informed Energy that the inclusion of the provision would not result in more than an "insignificant" change in the purchase price.

VI. Implications of Treasury Approval of the PSA

In conveying the draft PSA and requesting Treasury approval, Energy suggested that the Treasury may wish to authorize Energy to negotiate purchase and sales agreements that differ from the draft approved by Treasury and OMB, provided that Energy consults with Treasury in the event that the modified agreements have terms "less favorable economically to the Government than those included in the draft of the agreement provided" to the Treasury.

After consultations with the Office of General Counsel, it is our recommendation that the Treasury approval of any draft PSA be conditioned upon further consultation if terms or conditions of the PSA are materially changed during the negotiations.

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August 8, 1997

Ms. Patricia F. Godley
Assistant Secretary for Fossil Energy
U.S. Department of Energy
Naval Petroleum and Oil Shale Reserves
1000 Independence Avenue SW
Washington, DC 20585

HERBERT C. WILLIAMSON III
Director

Dear Ms. Godley:

As requested, please find attached a summary description of the considerations attendant to the final formulation of the divestiture strategy recommended by Credit Suisse First Boston and Petrie Parkman & Co. This should permit a review of the process and rationale used to arrive at the recommended structure. Please let me know should there be questions or if additional information would be helpful.

Very truly,

Herb Williamson

Herbert C. Williamson III
Director

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Divestiture Strategy Formulation

The strategy selected for the monetization of the Naval Petroleum Reserve Numbered 1 ("Elk Hills") was that determined to have the greatest likelihood of achieving two stated and two perceived or assumed objectives. The first two of these objectives were, as stated in the 1996 Defense Authorization Act;

- to achieve the maximum value for the United States and;
- to complete the transaction, or transactions, within the time frame mandated by the enabling legislation, (before March 1998).

Furthermore, these stated objectives were evaluated within the context, as mandated by the enabling legislation, that the United States must divest of all right, title and interest ~~in~~ Elk Hills. This condition as a given eliminated any rationale for evaluating or considering any form of continuing interest including any of the several forms of actual, contingent or future options, royalty or net profits interests (to include any form of continuing mineral or economic ownership, interest or right) as generally utilized in the extractive industries. Obviously this premise also eliminated from consideration a continuing interest in the form of a government corporation, agency or other partially privatized entity and direct investment vehicles (traded or not) including master limited partnerships, true royalty trusts and net profits interests (often called "royalty trusts").

The two perceived and assumed objectives were:

- to conduct an open or transparent process that would reflect positively on the DOE and generally, thereby, on the United States Government by being able to bear the intense scrutiny of Congressional oversight, oil and gas industry observation and comment as well as the examination by any special interest group that might be opposed to the monetization of Elk Hills or disposed to be critical of the anticipated process and outcome;
- to conduct a process that would provide a wide range of credible interested private parties an equal opportunity to gain an economic interest Elk Hills through the divestment process.

It should be noted that the advisors included the added and presumed objectives due to their judgment at ~~the time of strategy~~ formulation that there was no significant potential for conflict ~~between the~~ presumed objectives and the stated objectives or between the two presumed objectives.

Within the context of satisfying the four general objectives described above, the financial advisors examined a universe of all practical options and alternatives for effecting a divestiture or privatization. Acknowledging that any divestiture must be complete and without continuing interest, structural alternatives ranged between two general types;

I. securitization through the sale of financial instruments as either a public offering of common equity (traded and reporting), as a private placement (non-trading but reporting) or as a combination of such trading and non-trading instruments;

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II. monetization through the sale of Elk Hills to oil and gas industry buyers and, potentially, to financial buyers.

I. **Securitization**

A. Common Equity

The first method considered within the context of securitization was a corporate initial public offering of common stock representing all of the United States' Interest. The value of Elk Hills (assumed to be $2.5-3.0 billion for evaluative purposes), its significant development and exploration potential, strong cash flow and ability to be capitalized with a modest or quite acceptable level of leverage would all be viewed as decided attributes by potential public equity buyers. However, there were other factors that would constitute decidedly negative limitations in any attempt to effect a divestiture through an initial public offering of common equity. These limitations were evaluated to include:

1. A complete lack of generally recognized and respected senior management upon which a public equity Investor could readily depend with confidence for future investment and escalating economic return would be a defining problem. The quality of management is critical in determining the market valuation of any oil and gas company. The valuation of a prospective company relative to its peer group and existing proven reserve base is a function of management's ability, as demonstrated by record, to create or destroy value through its investment decisions.

2. Allied with the lack of recognized management was the lack of a verifiable track record in escalating net reserves and production through the reinvestment of cash flow from operations. While this fact may have been due to chronic underfunding relative to actual net cash flows from operations because of the Federal Budget process, it was a negative factor that had to be considered.

3. In addition there was, for understandable reasons, no record of administrative or field management cost structures within appropriate and expected private sector levels. Without a proven record of acceptable private sector efficiency levels, the market would be unaccepting of any forecast presuming such and, as with the first two factors, would demand a significant discount to acceptable value, defined as a mean of comparable market valuation levels.

4. The fact that any newly public entity would consist of only the Elk Hills field would be considered by the market to have a relatively high degree of asset concentration. This concentration is termed by analysts as "single field risk" and is a negative factor in arriving at a market equity valuation. Most oil companies have a portfolio of properties which fact is generally held to diversify asset concentration and thereby to reduce specific risk.

Of the negative factors cited above, the most limiting were those of (i) no recognized management team with a verifiable record of value creation and (ii) the issue of no record of operations or administration with the efficiency level expected by the investment community for a private enterprise. Based on the negative factors discussed above, the financial advisors concluded to not recommend divestment through a public offering of common equity.

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There were also two additional but exogenous factors that contributed to not advocating a public equity offering. The first was that the sheer size of an offering sufficient to achieve a complete divestiture of Elk Hills ($2.5 to $3.0 billion) would likely necessitate a material discount in excess of the standard 15% discount to mean market valuations of comparable companies that is usually required for an initial public offering. The second was the fact of equity market risk given the long lead time to prepare for an initial public offering of Elk Hills. At times the equity markets are simply closed to new entrants regardless of price or issuer. Insofar as divestiture needed to be achieved prior to March 1998, the fact of market dependency would have added significant risk to achieving the objective through this method.

B. Alternative Securities

In addition to an initial public common equity, three other types of securities to achieve divestiture were also considered. Most of the negative factors with an initial public offering of common stock were also found to apply, although to different degrees, to privately placed equity, traded partnerships and royalty trusts. There were, however, specific additional negative factors that added to the reasons for also rejecting securities other than common stock. The three categories of alternate securities all represent much smaller markets than the market for public common stock. Consequently any one of them would simply be too small to efficiently absorb the alternate equity securities of a $2.5 to $3.0 billion independent oil and gas company. The discount to comparable mean firm valuations that would be required to attempt any of these methods would be more adverse than for public common equity.

1. In the case of traded partnerships (or MLPs, etc.) there were particular negative factors inherent in this structure. The first was that traded partnerships and other direct investments (unlike common stock and other indirect securities) generate taxable business income for investment entities that are otherwise tax exempt (pension management entities). Consequently, very few financial institutions, which form the vast majority of domestic capital market liquidity, will invest in this type of security thereby relegating direct investments of this type to almost exclusively the retail securities market. Not only is this market comparatively small and insufficient in size for an efficient securitization of Elk Hills, but it is also driven by a need to make cash distributions to provide individual investor a current cash yield as a "fixed income alternative." An income stream is also needed to provide liquidity for tax payments to cover the taxable income allocated to investors from partnerships or direct investment structures. As a result of these factors, the fully developed potential and consequent optimal valuation of Elk Hills would not be realized because a high level (or all) of net operating cash flow would not be available for reinvestment in the field. In essence, the historic problem at Elk Hills of insufficient investment in new drilling and infrastructure would be exacerbated by this type of structure.

   The specific problems reviewed above have largely eliminated the traded partnership as a vehicle for the securitization of oil and gas assets. The extensive issuance of traded oil and gas partnerships in the mid 1980s generally resulted in illiquidity, poor cash returns, poor market valuations and in most cases they have been replaced through an exchange offer and conversion to corporate form or through asset sales attendant to liquidation. Accordingly this type of security was eliminated from consideration.

2. Royalty trusts and net profits interests (burdened and unburdened direct economic participations) do, at times, provide market valuations comparable to common equity

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and are still viable as a security for oil and gas asset securitization. However they are not viable for the divestiture of an asset such as Elk Hills for two primary reasons. The first is that, as with a partnership, there is no ability to provide for extensive cash flow reinvestment for full value realization in that market valuations are highly dependent on current cash distributions. Were Elk Hills a fully developed, efficient and liquidating asset, this issue would not be a deciding consideration. The second reason is that the market for securities of this type is simply not of sufficient size to accommodate the entirety of Elk Hills. Notwithstanding these facts, a royalty trust was considered as a potentially viable vehicle for a portion ($250 million to $400 million) of the proved developed producing reserves that could be separated from other oil and gas reserve asset categories to potentially optimize valuation within the context of other securitization or monetization methods used to realize complete divestiture.

In summary, none of the methods available under the general category of securitization were judged viable to satisfy the two stated objectives.

II. Direct Sale

The second category of monetization considered was that of a direct sale to oil and gas industry buyers. Within this category there were four general types of potential structures possible:

A. a single comprehensive sale of all of Elk Hills to a single purchaser;

B. separate sales of discreet sub-divisions delineated by defined surface topographical demarcation such that multiple well groupings could constitute multiple operating and non-operating working interest segments or in effect multiple fields potentially joined by a development alliance;

C. sales of interests by separate producing formations resulting in lateral sub surface divisions with discreet operating and non-operating segments for each horizontal geological producing horizon;

D. a economic segmentation of the field between an operatorship portion and multiple undivided non-operating portions - essentially creating multiple individual but undivided working interests in the field similar in structure to the economic division of most oil and gas fields, whether unitized or not.

The evaluation of the four general types of asset sale structures was considered within the context of seeking to facilitate bidding tension by appealing to, all else being equal, the widest and largest group of responsible bidders in order to aid in maximizing value and to aid in satisfying the two assumed objectives regarding the character of the process. A larger and more diversified bidding group was sought to provide the fact and atmosphere of a very competitive process with a high level of general industry interest to urge bid maximization by establishing scarcity and desirability. A larger and more diverse universe would also discourage attempts to "signal" between bidders to limit the range of possible outcomes and to make competitive analysis quite difficult by having diverse parties not well known to each other to introduce the possibility of upside irrationality.

The first structure considered (A. Above) was the simplest and most direct consisting of a complete sale of all of Elk Hills to a single industry buyer. The advantages of this process were found to consist of:

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1. Simplicity of process in that due to the absolute large value of Elk Hills there would be a relatively small universe of potential buyers due to limited financial capacity and resulting asset concentration
2. Speed of process in that facilitating the required dissemination of initial sales information, exchange of evaluative information, due diligence process and negotiations would involve a relatively small group.
3. Assurance of closing would be enhanced due to dealing with only a single sophisticated and eminently well financed buyer.

Disadvantages of this structure were concluded to include:

4. A high potential of having only a few valid and very similar bidders which fact could prevent the realization of maximum value by having less than the most available competitive process
5. Neither of the presumed objectives would be satisfied in that the universe of actual bidders would be relatively limited and narrow in scope.
6. The dissemination of information supporting an open process would be limited if only very large integrated "major" oil companies were to constitute the potential universe.

The available universe of capable industry buyers with a potential interest in Elk Hills (domestic, onshore California production) was judged to consist of the following members:

Amerada Hess
Amoco
Arco
British Petroleum
Chevron
Exxon
Mobil
Unocal
Occidental Petroleum
Shell (Cal Resources)
Texaco

Of this group a high degree of interest was quite probable from only four companies: Arco, Chevron, Occidental and Shell. This conclusion was formulated through a review of each of these "major" company's current upstream producing property base, indications of core areas for future concentration and expansion as well as those areas being de-emphasized or divested. This information was discerned from public indications or as was known through investment banking and equity research contacts with these various companies. With the distinct possibility of having only four (or fewer) very similar bidders the risk of only modest competition and a rather closed process was considered quite high.

As a result of the serious disadvantages deemed attendant to the single buyer process, it was determined that if a segmented approach was possible it would be a preferable structure. Consequently structures providing for an economic or property segmentation of the asset were examined.

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The first of the segmented structures considered were those potentially possible with a property division as outlined in structures (B. and C., above). These two forms of segmentation would produce similar benefits, but would also prove to have similar problems and will therefore be described together. The obvious benefit to either method of property segmentation with multiple operatorships would be the material expansion in the number of potential bidders. Simply reducing the size of any given transaction to the $300 to $500 million per segment range would expand the universe of possible buyers to include the larger and intermediate size "independent" oil and gas companies. Indicative of the added class of potential buyers were the following companies:

Anadarko
Apache
Burlington Resources (Meridian)
Cabot Oil & Gas
Devon Energy
Enron
Enserch Exploration
Gulf Canada Resources
Lomak / Snyder
Louis Dreyfus Oil & Gas
Marathon
Noble Affiliates
Nuevo / Torch Energy
Parker & Parsley Petroleum
Pennzoil
Phillips Petroleum
Santa Fe Energy (Monterey Resources)
Seagull
Union Pacific Resources
United Meridian

With smaller value packages, there would also be a greater probability of attracting international bidders possibly including:

BHP
CNOC
ELF
ENI
Enterprise
Repsol
Santos
Total
Western Mining
YPF

Smaller segments would significantly increase the number of companies that could potentially participate in the sales process and thus increase competition. The fact of a much wider bidding group would make "signaling" almost impossible and a gathering of market intelligence as to others' valuation methods and strategies very difficult. A larger number of prospective

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buyers would help to deflect potential claims that the sale process favored any particular buyer or that the process and dissemination of information was limited or in some way restricted.

While a physically segmented process would provide benefits compared to offering the fields as a single unit, it would also provide serious operational and analytical difficulties that would prevent maximum value from being realized and might place at risk the entire divestiture process. As can be readily recognized, the maximization of operating efficiency and therefore the highest net present value are dependent on Elk Hills and its various reservoirs being produced and managed on a unified basis. Issues arising from the prospect of properties (surface or vertical division) or formations (sub-surface or horizontal division) being managed by competing companies with divided ownership interests would include some of the following items:

- The shallow oil zone formation overlays two of the three major Stevens formation geologic structures (29R and 31A) making a vertical division determined by surface area very difficult. A division by surface area would attempt to create discreet partial ownership positions of several producing or prospective zones without being able to delineate with precision either the corresponding relationship of geologic zone to surface area or the quantity of recoverable hydrocarbon by formation segment. To attempt this could result in a drilling frenzy to capture production before depletion by other owners that would reduce economic total value. This problem is in part the reason for the practice of unitization, forced pooling and spacing limits by regulation.
- Horizontal division would also be difficult due to stacked pay zones being present in existing and prospective wellbores with existing and potential commingled and dual completed production to enhance economic returns. Consequently, a vertical or horizontal division could dramatically increase the number of new wells required to drain these stacked pay zones with a corresponding reduction in a buyer's expected return.
- High pressure, low pressure and vacuum gathering systems tied to producing formation interval depths, additional overlap of gathering lines, multizone gas reinjection programs and unified processing facilities with conflicting economic effect if divided, water disposal systems and unified usage facilities such as LACT (Lease Automated Custody Transfer) units would all require extensive and redundant surface facility modification. It would also require a myriad of negotiated interdependent agreements to provide the ability to determine production ownership and value through setting the economic relationship between portions of an entire production system designed to be operated as a unified whole. Attendant to an extensive modification and expansion of surface facilities to accommodate a field or formation division would be a negative environmental impact due to an expanded surface "footprint."

Other problems with either a B or C division were reviewed and could be discussed here at length, however, it was readily apparent that this structural type would result in an inability for all prospective owners to achieve maximum operational efficiencies and production. There would be a complete lack of coherent, unified reservoir and field management. Elk Hills would eventually have to be reunitized with a high probability of litigation in light of, among other reasons, no clear unitization or pooling guidelines in California. From an economic geological or operational basis there is no method to efficiently divide Elk Hills into multiple discrete operating (and non operating) packages without a significant loss of value. Either of these

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methods of division would prevent value maximization by any evaluation parameter including unit operating costs, achievement of maximum production, future capital investment with new reserve development and ultimate reclamation costs. Consequently, these divided structures would preclude the realization of maximum value.

The final structure considered (D., above) was a configuration whereby the United States' interest in the integrated operation that is Elk Hills (reserves, acreage, gathering and processing facilities, power generation, etc.) would be parsed into multiple undivided segments each of which would represent a percentage of the entire U.S. ownership position. It was determined that the optimal structure would include one large segment which would confer operatorship of Elk Hills and multiple non-operating segments. It was determined that to ensure the maximum valuation of the operatorship segment, such segment had to be large enough that potential buyers were highly confident that if they acquired such interests, their position as operator would be secure. The determination was made that transferring a majority interest (at least 50%) in each unitized zone as part of the operatorship segment would meet this criteria. Simple arithmetic then dictated that an operatorship segment of 74% of the United States' interest would include at least 51% of each producing zone. It would also level the playing field with the other existing working interest owner in that, in order to operate, Chevron would need to secure the same operatorship segment "control block" as any other bidder rather than to simply add to its existing position (approximately 22%) to achieve a majority interest.

It was further determined that in order to afford companies too small to acquire the operatorship segment a valid opportunity to acquire an interest in Elk Hills, several much smaller interests would be offered. The size (and thus number) of such interests was determined based on consideration of multiple factors including (i) the likely market (breadth and composition) for non-operated interests in a California oil field, (ii) the concern of the acquirer of the partners would constrain maximum efficient development of the field, and (iii) the desirability of allowing for companies to acquire significant non-operated positions (10% or 20%) without artificially designating the specific size of such larger non-operating blocks. It was determined that 13. 2% segments would be optimal. The undivided non-operating working interest segments would expand the potential universe of bidders to potentially include non-oil and gas industry (financial) buyers that might desire a direct interest but would not be in a position to operate a producing field of substantial complexity. For smaller industry independents there would also be an opportunity to participate through the relatively smaller (2%) undivided working interests thereby further expanding the universe of potential bidders to include entities similar to the following list;

- Belco Petroleum
- Bellweather Oil & Gas
- Berry Petroleum
- Cross Timbers Oil & Gas
- Chesapeake Energy
- Comstock Resources
- Har-Cor Energy
- McFarland Energy
- Vintage Petroleum
- other CIPA members as well

financial or trading buyers:

- Beacon Group
- Blackstone Group
- Contour Investments

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Encap Investments
First Reserve Corp.
Fidelity Management & Research
Natural Gas Partners
NGC Corp.
Pan Energy
Prudential
Red Diamond Energy
Tejas Gas

The opportunity to acquire both operating and non-operating interests was judged to be quite familiar and acceptable to the oil and gas industry in that participation in almost every producing field in the world is similarly structured. The operating segment would be large enough to maintain the interest of the major companies (approximately $1.85 to $2.22 billion) while also permitting the participation of the larger independents. Assuming a total value for the United Sates' interest of between $2.5 and $3.0 billion, each 2% segment would represent a value of approximately $50 to $60 million. Increments of this relatively modest size would permit all of the intermediate and many smaller independents to participate. It was also decided that entities would be permitted to form consortia or alliances to effect participation through joint ventures and that prospective purchases would be allowed to bid on one, some, or all of the various segments. The advantages of this structure were considered to be:

1. An operationally sound and optimally economic structure for segmentation that would permit the full value potential of Elk Hills to be realized through a comprehensive and unified production and development program. By securing the operatorship segment the field operator would be assured that its plan for efficiency improvements and accelerated exploration and development would be secure for unfettered implementation. Insofar as the realization of economic potential will provide the highest increment of value, this fact would aid in receiving a maximum price. Furthermore, with only an entity of substantial size and capability able to acquire the operatorship segment, the smaller non-operating participants could be confident in an aggressive and capable management and development program to effect the economic maximization of their undivided interest.

2. By reducing the size of the control position, relative to offering Elk Hills as a single unit, the universe of potential buyers was at least trebled given the ability of the larger independent companies to participate in bidding for the most valuable segment.

3. Permitting conventional undivided working interests as small as 2.0% would produce the potential for at least one hundred identified entities to participate. The smaller operating segment combined with relatively modest multiple non-operating segments were together found to produce the largest number of potential bidders within the constraint of maximizing economic value through unified field management.

4. This structure also provided for flexibility through permitting bids for all of the field, the operating segment and from one to all of the 2% non-operating segments, individually or in any combination.

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5. The wider universe of potential buyers aids in achieving the two assumed objectives of a broader dissemination of information and a more open process.

In summary, the sale of individual undivided interests was recommended as the best viable alternative for monetization. This method preserved the compelling economic imperative of a potential for full valuation through unified management and development. At the same time, the largest and widest potential universe of buyers could be sought through having segments small enough to encourage the participation of all but the least substantial industry participants.

Limitations on Seller's Indemnification of Buyer				
Description of Indemnified obligation	**Notice of Claim in 3 yrs**	**Subject to $25K**	**Subject to $10MM deductible**	**Subject to overall limit of 10% of all Base Purchase Prices**
Material breach of Seller's representations or warranties (§12.1(a)(i))	Yes	Yes	Yes	Yes
Personal injury or property damage arising prior to the Closing Date (§12.1(a)(ii)(A))	Yes	Yes	Yes	Yes
Breach or default under Assumed Contracts prior to the Closing (§12.1(a)(ii)(B))	Yes	Yes	Yes	Yes
Third Party Claim other than by a Governmental Authority because of Seller's failure to perform Remediation	No	Yes	Yes	Yes
Remediation required by Governmental Authority of for (i) On-going Remediation Sites, (ii) New Sites and (iii) Federal Sites (§12.1(a)(iv))	No	Yes	Yes	Yes
Third Party Claims arising from Seller's disposal of Environmental Contamination (§12.1(a)(v))	No	Yes	Yes	Yes
Personal injury to or death of any employees of Seller or its contractors while conducting post-closing Remediation	No.	No	No	Yes

Limitations on Seller's Liability for Environmental Matters for which Seller is Responsible			
Description	**Subject to $25K**	**Subject to $10MM deductible**	**Subject to overall limit of 10% of all Base Purchase Prices**
On-going Remediation Sites (§12.7(a)(i)(1))	No	No	No
New Sites (§12.7(a)(i)(2) and (3)) (i.e., either (A) Unknown Environmental Site identified within 3 years or (B) Known Environmental Site, On-Going Remediation Sites or Unknown Environmental Sites where Seller previously achieved Completion that needs additional Remediation because of certain events)	Yes	Yes	Yes
Federal Sites	No	No	No

<table>
<tr><th colspan="6">SUMMARY OF ENVIRONMENTAL RESPONSIBILITY UNDER PURCHASE AGREEMENT
(Assuming no Reopening of Closed Sites)</th></tr>
<tr><th colspan="3"></th><th>CLOSURE RESP.</th><th>LIABILITY UNTIL CLOSURE COMPLETE</th><th>LIABILITY AFTER CLOSURE COMPLETE</th></tr>
<tr><td>ON-GOING REMEDIATION SITES</td><td colspan="2">ANY NPR-1 LANDS</td><td>SELLER</td><td>SELLER</td><td>BUYER</td></tr>
<tr><td>KNOWN ENVIRONMENTAL SITES (already closed)</td><td colspan="2">ANY NPR-1 LANDS</td><td>N/A</td><td>N/A</td><td>BUYER</td></tr>
<tr><td rowspan="2">UNKNOWN ENVIRONMENTAL SITES</td><td>I.D. WITHIN 3 YEARS</td><td>ANY NPR-1 LANDS</td><td>SELLER</td><td>SELLER</td><td>BUYER</td></tr>
<tr><td>I.D. AFTER 3 YEARS</td><td>ANY NPR-1 LANDS</td><td>BUYER</td><td>BUYER</td><td>BUYER</td></tr>
<tr><td>FEDERAL SITES</td><td colspan="2">U.S. LANDS ONLY</td><td>SELLER</td><td>SELLER</td><td>SELLER</td></tr>
</table>

Notes:

1. It is assumed that Chevron will contribute to closure and liability costs paid by Seller and/or Buyer for contamination that arose from UPC operations.
2. If any Known Environmental Site or On-going Remediation Site is reopened within 3 years after closing, Seller would have "Closure Responsibility" and "Liability Until Closure Complete" until site is reclosed.
3. As between Buyer and Seller, Buyer is responsible for contamination arising after Closing.
4. Neither Buyer nor Seller assume responsibility for any contamination on Chevron Lands caused by persons other than Seller or its agents (e.g., during Unit operations under the UPC).
5. At present, the Purchase Agreement does not directly cover contamination off NPR-1.
6. THIS TABLE DOES NOT DEPICT ALL SITUATIONS UNDER PURCHASE AGREEMENT.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

BRIEFING

August 14, 1997

MEMORANDUM FOR **SECRETARY RUBIN**
DEPUTY SECRETARY SUMMERS
UNDER SECRETARY HAWKE
GENERAL COUNSEL KNIGHT

FROM: Mozelle W. Thompson MWT
Principal Deputy Assistant Secretary
(Government Financial Policy)

Peter Necheles PN
Policy Advisor
(Government Financial Policy)

SUBJECT: Elk Hills Naval Petroleum Reserves

I. Overview

By statute, the "draft contract or contracts, including the terms and provisions of the sale of the interest of the United States in the [Naval Petroleum Reserve Numbered 1 ("NPR-1")], [are] subject to the review and approval by the Secretary [of Energy], the Secretary of the Treasury, and the Director of the Office of Management and Budget."

The Secretary of Energy is directed to sell the government's interest in NPR-1 (the "Assets") "in a manner consistent with commercial practices and in a manner that maximizes sale proceeds to the Government." The legislation also provides that the Secretary of Energy and the Director of OMB are to set the minimum acceptable price for the Assets. Additionally, the Secretary of Energy and the Director of OMB are provided with the authority to cancel the sale if they jointly determine that (a) the sale is proceeding in a manner inconsistent with achievement of a sale price that reflects the full value of the reserve, or (b) a course of action other than the immediate sale of the reserve is in the best interests of the United States.

To assist in the development and implementation of the sale, the Department of Energy ("Energy") retained CS First Boston and Petrie Parkman & Co (a Houston-based investment banking firm with experience in petroleum sales), as well as the law firm O'Melveny & Myers.

Over the last three months, the Office of Government Financial Policy (OGFP), in consultation with the Office of General Counsel and the Office of Tax Policy, has closely participated with OMB and the Department of Energy (Energy) in the development of the purchase and sale agreement (the "PSA").

The purpose of this memorandum is to (1) familiarize you with the nature of the Department's role, (2) summarize our work to date, and (3) identify key issues in the PSA.

II. The Elk Hills Naval Petroleum Reserves

NPR-1 is owned jointly by the U.S. government and Chevron USA, and is operated under a 1944 agreement (the U.S. government owns approximately 78% of the interest in the field). NPR-1 produced over 21 million barrels of crude oil in 1996 and ranks among the 11 largest domestic producing oil fields in the lower 48 states. It is also one of the top 10 producing gas fields in the nation, producing almost 360 million cubic feet of natural gas per day. In preparation for the sale, two reserve reports of the entire field (including Chevron's interests) were prepared: an "upside study" conducted by Energy, and a study conducted by an independent oil and gas assessor, the Ryder Scott Company. The upside report establishes a present value of the reserves (at a 10% discount rate) in excess of $6.3 billion. The Ryder Scott report establishes a present value of the reserves (also at a 10% discount rate) in excess of $3.3 billion.

III. Chronology of Key Events

- o May -- Energy published a solicitation of the government's interest and has since established a process for interested parties to have access to relevant information.

- o August 12 -- Energy distributed the procedures for the bidding process to interested parties, with the commitment to distribute shortly the draft PSA.

- o August 15 -- Energy will distribute its report on the net present value of NPR-1 if it were to continue to be held by the federal government. (The authorizing legislation requires that Energy retain independent assessors to assist with the establishment of a minimum acceptable price that must be exceeded for the sale of NPR-1 to be consummated.)

- o August 20 -- Energy would like to distribute the draft PSA to interested parties. (Treasury and OMB's approvals of the draft PSA are to be obtained before Energy may distribute to potential purchasers.)

- o October 1 -- bids will be due. This date will be the effective date of the PSA. (Energy has indicated to Treasury and the OMB that it will provide buyers with an opportunity to propose changes to the draft PSA.)

- o October through early-November -- negotiations will take place in Houston on the price and any proposed changes to the PSA.

- o January 1998 -- the negotiated contracts will be submitted to the relevant committees of Congress for the 31-day "lie before."

- o February 10, 1998 -- is the scheduled closing date. (Subject to its authority to suspend the sale, Energy must enter into one or more contracts for the sale of its entire interest in

NPR-1 by February 10.)

IV. Structure of the Sale

Energy has elected to offer the Assets in two types of interests: (1) an "operator" interest equal to 74% of the Assets (guaranteeing the purchaser an interest in over 51% of the entire NPR-1); and (2) 13-smaller interests each equal to 2% of the Assets. Bidders may bid on some or all of the undivided interests being sold by Energy. Therefore, there may be one, some or fourteen different purchasers, along with up to fourteen different PSAs.

Energy's financial advisers prepared a "white paper" that discusses the rationale for the sale structure. (Attached at Tab A.)

V. Key Elements of the Purchase and Sale Agreement

The PSA contains the following important elements that we are reviewing in consultation with the Office of General Counsel:

1. Option Agreement

Energy has structured the sale to require awarded bidders to execute the PSA in late-October or early-November, along with an Option Agreement. Energy would also sign the Option Agreement, but would not sign the PSA until February 1998, since Energy needs to complete all environmental review procedures, complete consultation with Justice on antitrust concerns, and lie the contracts before Congress for 31 days before executing them.

The Option Agreements provide the United States with the right to require each awarded bidder to purchase an undivided percentage interest in the NPR-1 assets held by the federal government (the "Assets"), provided that the option is exercised by March 10, 1998. The United States must exercise the option after the expiration of the "lie before" period unless (1) the Secretary of Energy suspends the sale, (2) Congress passes supervening legislation that prevents the sale, (3) Energy's environmental review requires additional environmental provisions in the PSA, or (4) Justice raises antitrust concerns.

Along with the Option Agreement, the prospective buyer would provide a deposit equal to 10% of the base purchase price in the form of a letter of credit. The LC must be irrevocable and immediately drawable in full upon the presentation of a sight draft.

2. Adjustments to Purchase Price

The purchase price will be based on the value of the Assets as of October 1, 1997 (the "Effective Date"), with the expected closing date of February 10, 1998. Adjustments will be required for production and operating expenses during this period. The base price will be decreased for the net proceeds from the operation of the Assets.

Unlike traditional commercial transactions, buyers will not receive a period of due diligence during the period between the Effective Date and closing. Energy, based on the recommendations of its investment bankers, has elected this structure to reduce the likelihood of substantial changes to the aggregate purchase price (Energy must have certainty that the price exceeds the minimum price established by the independent assessors).

After the Effective Date the "risk of loss" due to catastrophes generally is passed to the buyer. However, if any portion of the Assets is materially damaged or destroyed before closing as a direct result of actions by Energy or its contractor that is currently operating NPR-1, Energy may choose to (1) repair or restore the Asset at Energy's expense, (2) indemnify the buyer for reasonable repair or restoration expenses, (3) reduce the base purchase price, or (4) do nothing and permit the buyer to terminate the PSA.

3. Representations and Warranties

Energy will make the traditional representations and warranties regarding its authority, performance, the absence of material litigation, necessary approvals and the absence of broker's commissions.

The buyer will make similar representations and warranties, as well as that it has not relied on any representation or warranty other than those expressly provided in the PSA, and that the buyer is "knowledgeable" and purchasing the Assets for its own account, and not with an intent to make a distribution within the meaning of securities laws.

For both Energy and the buyer, the representations and warranties survive for a period of three years after the closing date.

4. Indemnification and Environment

Energy has proposed a range of indemnification obligations and environmental obligations to buyers that are considered, by Energy's investment bankers, to be consistent with commercial practices. One item that we understand is not the commercial norm is Energy's agreement to continue remediation activities on environmental sites that are currently being undertaken. Energy also commits to conduct remediation activities on environmental sites that were not known to buyer prior to the closing date if they are identified within three years. We understand that OMB advocates these environmental positions based on policy concerns.

Indemnifications will be provided for (1) material breaches of the representations and warranties, (2) personal injury or property damage occurring prior to the closing date, (3) contractual claims occurring prior to the closing date, and (4) damages occurring from Energy's environmental remediation efforts. For all of the items, except the remediation, claims must be raised by the buyer before the third anniversary of the closing date. The indemnification obligations are limited by a \$25,000 minimum claim amount, a \$10 million threshold for all claims (which is in the form of a deductible), and an overall cap for indemnification at 10% of the base purchase price.

Energy's outside counsel prepared a table that sets forth the range of indemnifications and environmental obligations. (See Tab B.)

The legislation provides that the Secretary of Energy "may extend such indemnities and warranties as the Secretary considers reasonable and necessary to protect the purchaser from claims arising from the ownership in [NPR-1] by the United States." Counsel for Treasury, OMB and Energy are working on the issue of how Energy will fund any indemnification that is called.

5. Small Refiners "Set Aside"

The existing operations at NPR-1 provide for a small refiner "set aside" of 25% of the production at the bid price for the crude oil sold at auction (the market price). While the House version of the privatization legislation required that purchasers of NPR-1 continue this set aside, neither the Administration's nor the Senate's versions included the provision. During conference, the provision was stricken. Nevertheless, Energy has recommended that a provision be included in the PSA that would require the buyer of the 74% interest in the Assets (the "Operator") to provide a call option to the small refiners for a period of three years up to 25% of the production of crude oil. Unlike the existing set aside, the small refiners would be charged an administrative fee of $0.10 per barrel.

Energy believes that this provision makes sound energy policy, allowing for the small refiners on the West Coast to continue to have access to light crude oil, necessary for their operations. Additionally, Energy believes that the inclusion of the set aside would preempt antitrust issues at the State of California level. Energy's financial advisers have informed Energy that the inclusion of the provision would not result in more than an "insignificant" change in the purchase price.

VI. Implications of Treasury Approval of the PSA

In conveying the draft PSA and requesting Treasury approval, Energy suggested that the Treasury may wish to authorize Energy to negotiate purchase and sales agreements that differ from the draft approved by Treasury and OMB, provided that Energy consults with Treasury in the event that the modified agreements have terms "less favorable economically to the Government than those included in the draft of the agreement provided" to the Treasury.

After consultations with the Office of General Counsel, it is our recommendation that the Treasury approval of any draft PSA be conditioned upon further consultation if terms or conditions of the PSA are materially changed during the negotiations.

A

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

BRIEFING

August 15, 1997

MEMORANDUM FOR SECRETARY RUBIN

FROM: Mozelle W. Thompson MT
Principal Deputy Assistant Secretary
(Government Financial Policy)

Peter C. Necheles for PN
Policy Advisor
(Government Financial Policy)

SUBJECT: Elk Hills Naval Petroleum Reserves

After reviewing our August 14 memorandum on the sale of the Government's interests (the "Assets") in the Elk Hills Naval Petroleum Reserves (the "NPR-1"), you raised several questions. This note addresses your inquiries.

1. How is a actual sales price (not base price), determined? I gather a auction of some sort?

Energy is required to establish a minimum acceptable price for the Assets, which must exceed the net present value calculated by five independent assessors for a continued ownership in the Assets by the federal government. There are two types of interests in the Assets being offered by Energy: (1) an "ownership" interest that will assure the holder at least 51% interest in NPR-1; and (2) 13 smaller investment units. Offers may be made for **one, some or all** of the offered interests in any combination.

Energy expects to conduct further negotiations with bidders that meet the minimum acceptable price and the essential terms and conditions set forth in the Purchase and Sale Agreement. We are in discussions with Energy concerning the extent of Treasury and OMB involvement in the negotiation process.

2. (Re: Structure of Sale) Is there a bidding process?

As set forth above, there will be a combination minimum bid and negotiation process. Over the last three months, interested parties (the "bidders") have been provided with access to the production records, oil and gas reserve reports, and the operating history for the NPR-1. As a condition for participation, however, bidders are required to execute non-collusion agreements.

On August 13, the bidders were provided with the bidding procedures, and Energy hopes to provide bidders with a copy of the draft purchase and sale agreement (the "PSA") within the next week.

Energy has established a deadline of October 1, 1997, for the submission of bids along with the form of PSA, as modified by the bidders. Upon receipt of the bids, Energy has reserved the right to further negotiate with bidders. Energy has directed bidders to indicate whether their offer is for all of the interests, or parts thereof. The investment bankers will advise Energy on which offers will maximize proceeds to the federal government.

Energy will thereafter negotiate will individual bidders to clarify terms and conditions, as well as to maximize price.

The Secretary of the Treasury

August 14, 1997

NOTE FOR MOZELLE THOMPSON
PETER NECHELES

FROM: BOB RUBIN

How is actual sales price (not base price), determined. I gather an auction of some sort?

<u>Page 3 -- Structure of Sale</u>
Is this a bidding process?

<u>Page 5 -- Implications of Treasury Approval of the PSA</u>
Agreed.

Attachment

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

BRIEFING

August 14, 1997

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DEPUTY SECRETARY SUMMERS
UNDER SECRETARY HAWKE
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Peter Necheles PN
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I. Overview

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The Secretary of Energy is directed to sell the government's interest in NPR-1 (the "Assets") "in a manner consistent with commercial practices and in a manner that maximizes sale proceeds to the Government." The legislation also provides that the Secretary of Energy and the Director of OMB are to set the minimum acceptable price for the Assets. Additionally, the Secretary of Energy and the Director of OMB are provided with the authority to cancel the sale if they jointly determine that (a) the sale is proceeding in a manner inconsistent with achievement of a sale price that reflects the full value of the reserve, or (b) a course of action other than the immediate sale of the reserve is in the best interests of the United States.

To assist in the development and implementation of the sale, the Department of Energy ("Energy") retained CS First Boston and Petrie Parkman & Co (a Houston-based investment banking firm with experience in petroleum sales), as well as the law firm O'Melveny & Myers.

Over the last three months, the Office of Government Financial Policy (OGFP), in consultation with the Office of General Counsel and the Office of Tax Policy, has closely participated with OMB and the Department of Energy (Energy) in the development of the purchase and sale agreement (the "PSA").

The purpose of this memorandum is to (1) familiarize you with the ~~nature of the~~ Department's role, (2) summarize our work to date, and (3) identify key issues in the PSA.

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Is this a bidding process

NPR-1 by February 10.)

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Energy believes that this provision makes sound energy policy, allowing for the small refiners on the West Coast to continue to have access to light crude oil, necessary for their operations. Additionally, Energy believes that the inclusion of the set aside would preempt antitrust issues at the State of California level. Energy's financial advisers have informed Energy that the inclusion of the provision would not result in more than an "insignificant" change in the purchase price.

VI. Implications of Treasury Approval of the PSA

In conveying the draft PSA and requesting Treasury approval, Energy suggested that the Treasury may wish to authorize Energy to negotiate purchase and sales agreements that differ from the draft approved by Treasury and OMB, provided that Energy consults with Treasury in the event that the modified agreements have terms "less favorable economically to the Government than those included in the draft of the agreement provided" to the Treasury.

After consultations with the Office of General Counsel, it is our recommendation that the Treasury approval of any draft PSA be conditioned upon further consultation if terms or conditions of the PSA are materially changed during the negotiations.

1997-SE-009442

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

BRIEFING

August 15, 1997

MEMORANDUM FOR SECRETARY RUBIN

FROM: Mozelle W. Thompson
Principal Deputy Assistant Secretary
(Government Financial Policy)

Peter C. Necheles for PN
Policy Advisor
(Government Financial Policy)

SUBJECT: Elk Hills Naval Petroleum Reserves

After reviewing our August 14 memorandum on the sale of the Government's interests (the "Assets") in the Elk Hills Naval Petroleum Reserves (the "NPR-1"), you raised several questions. This note addresses your inquiries.

1. How is a actual sales price (not base price), determined? I gather a auction of some sort?

Energy is required to establish a minimum acceptable price for the Assets, which must exceed the net present value calculated by five independent assessors for a continued ownership in the Assets by the federal government. There are two types of interests in the Assets being offered by Energy: (1) an "ownership" interest that will assure the holder at least 51% interest in NPR-1; and (2) 13 smaller investment units. Offers may be made for **one, some or all** of the offered interests in any combination.

Energy expects to conduct further negotiations with bidders that meet the minimum acceptable price and the essential terms and conditions set forth in the Purchase and Sale Agreement. We are in discussions with Energy concerning the extent of Treasury and OMB involvement in the negotiation process.

2. (Re: Structure of Sale) Is there a bidding process?

As set forth above, there will be a combination minimum bid and negotiation process. Over the last three months, interested parties (the "bidders") have been provided with access to the production records, oil and gas reserve reports, and the operating history for the NPR-1. As a condition for participation, however, bidders are required to execute non-collusion agreements.

On August 13, the bidders were provided with the bidding procedures, and Energy hopes to provide bidders with a copy of the draft purchase and sale agreement (the "PSA") within the next week.

EXECUTIVE SECRETARIAT

Energy has established a deadline of October 1, 1997, for the submission of bids along with the form of PSA, as modified by the bidders. Upon receipt of the bids, Energy has reserved the right to further negotiate with bidders. Energy has directed bidders to indicate whether their offer is for all of the interests, or parts thereof. The investment bankers will advise Energy on which offers will maximize proceeds to the federal government.

Energy will thereafter negotiate will individual bidders to clarify terms and conditions, as well as to maximize price.

The Secretary of the Treasury

August 14, 1997

NOTE FOR MOZELLE THOMPSON
PETER NECHELES

FROM: BOB RUBIN

How is actual sales price (not base price), determined. I gather an auction of some sort?

Page 3 -- Structure of Sale
Is this a bidding process?

Page 5 -- Implications of Treasury Approval of the PSA
Agreed.

Attachment

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

BRIEFING

August 14, 1997

MEMORANDUM FOR **SECRETARY RUBIN**
DEPUTY SECRETARY SUMMERS
UNDER SECRETARY HAWKE
GENERAL COUNSEL KNIGHT

FROM: Mozelle W. Thompson MWT
Principal Deputy Assistant Secretary
(Government Financial Policy)

Peter Necheles PN
Policy Advisor
(Government Financial Policy)

Thx Mozelle T & Peter N

How is actual sales price (not base price), determined. I gather is thru an auction of some sort.

SUBJECT: Elk Hills Naval Petroleum Reserves

I. Overview

By statute, the "draft contract or contracts, including the terms and provisions of the sale of the interest of the United States in the [Naval Petroleum Reserve Numbered 1 ("NPR-1")], [are] subject to the review and approval by the Secretary [of Energy], the Secretary of the Treasury, and the Director of the Office of Management and Budget."

The Secretary of Energy is directed to sell the government's interest in NPR-1 (the "Assets") "in a manner consistent with commercial practices and in a manner that maximizes sale proceeds to the Government." The legislation also provides that the Secretary of Energy and the Director of OMB are to set the minimum acceptable price for the Assets. Additionally, the Secretary of Energy and the Director of OMB are provided with the authority to cancel the sale if they jointly determine that (a) the sale is proceeding in a manner inconsistent with achievement of a sale price that reflects the full value of the reserve, or (b) a course of action other than the immediate sale of the reserve is in the best interests of the United States.

To assist in the development and implementation of the sale, the Department of Energy ("Energy") retained CS First Boston and Petrie Parkman & Co (a Houston-based investment banking firm with experience in petroleum sales), as well as the law firm O'Melveny & Myers.

Over the last three months, the Office of Government Financial Policy (OGFP), in consultation with the Office of General Counsel and the Office of Tax Policy, has closely participated with OMB and the Department of Energy (Energy) in the development of the purchase and sale agreement (the "PSA").

The purpose of this memorandum is to (1) familiarize you with the ~~nature of the~~ Department's role, (2) summarize our work to date, and (3) identify key issues in the PSA.

II. The Elk Hills Naval Petroleum Reserves

NPR-1 is owned jointly by the U.S. government and Chevron USA, and is operated under a 1944 agreement (the U.S. government owns approximately 78% of the interest in the field). NPR-1 produced over 21 million barrels of crude oil in 1996 and ranks among the 11 largest domestic producing oil fields in the lower 48 states. It is also one of the top 10 producing gas fields in the nation, producing almost 360 million cubic feet of natural gas per day. In preparation for the sale, two reserve reports of the entire field (including Chevron's interests) were prepared: an "upside study" conducted by Energy, and a study conducted by an independent oil and gas assessor, the Ryder Scott Company. The upside report establishes a present value of the reserves (at a 10% discount rate) in excess of $6.3 billion. The Ryder Scott report establishes a present value of the reserves (also at a 10% discount rate) in excess of $3.3 billion.

III. Chronology of Key Events

- May -- Energy published a solicitation of the government's interest and has since established a process for interested parties to have access to relevant information.

- August 12 -- Energy distributed the procedures for the bidding process to interested parties, with the commitment to distribute shortly the draft PSA.

- August 15 -- Energy will distribute its report on the net present value of NPR-1 if it were to continue to be held by the federal government. (The authorizing legislation requires that Energy retain independent assessors to assist with the establishment of a minimum acceptable price that must be exceeded for the sale of NPR-1 to be consummated.)

- August 20 -- Energy would like to distribute the draft PSA to interested parties. (Treasury and OMB's approvals of the draft PSA are to be obtained before Energy may distribute to potential purchasers.)

- October 1 -- bids will be due. This date will be the effective date of the PSA. (Energy has indicated to Treasury and the OMB that it will provide buyers with an opportunity to propose changes to the draft PSA.)

- October through early-November -- negotiations will take place in Houston on the price and any proposed changes to the PSA.

- January 1998 -- the negotiated contracts will be submitted to the relevant committees of Congress for the 31-day "lie before."

- February 10, 1998 -- is the scheduled closing date. (Subject to its authority to suspend the sale, Energy must enter into one or more contracts for the sale of its entire interest in

Is this a bidding process

NPR-1 by February 10.)

IV. Structure of the Sale

Energy has elected to offer the Assets in two types of interests: (1) an "operator" interest equal to 74% of the Assets (guaranteeing the purchaser an interest in over 51% of the entire NPR-1); and (2) 13 smaller interests each equal to 2% of the Assets. Bidders may bid on some or all of the undivided interests being sold by Energy. Therefore, there may be one, some or fourteen different purchasers, along with up to fourteen different PSAs.

Energy's financial advisers prepared a "white paper" that discusses the rationale for the sale structure. (Attached at Tab A.)

V. Key Elements of the Purchase and Sale Agreement

The PSA contains the following important elements that we are reviewing in consultation with the Office of General Counsel:

1. Option Agreement

Energy has structured the sale to require awarded bidders to execute the PSA in late-October or early-November, along with an Option Agreement. Energy would also sign the Option Agreement, but would not sign the PSA until February 1998, since Energy needs to complete all environmental review procedures, complete consultation with Justice on antitrust concerns, and lie the contracts before Congress for 31 days before executing them.

The Option Agreements provide the United States with the right to require each awarded bidder to purchase an undivided percentage interest in the NPR-1 assets held by the federal government (the "Assets"), provided that the option is exercised by March 10, 1998. The United States must exercise the option after the expiration of the "lie before" period unless (1) the Secretary of Energy suspends the sale, (2) Congress passes supervening legislation that prevents the sale, (3) Energy's environmental review requires additional environmental provisions in the PSA, or (4) Justice raises antitrust concerns.

Along with the Option Agreement, the prospective buyer would provide a deposit equal to 10% of the base purchase price in the form of a letter of credit. The LC must be irrevocable and immediately drawable in full upon the presentation of a sight draft.

2. Adjustments to Purchase Price

The purchase price will be based on the value of the Assets as of October 1, 1997 (the "Effective Date"), with the expected closing date of February 10, 1998. Adjustments will be required for production and operating expenses during this period. The base price will be decreased for the net proceeds from the operation of the Assets.

?

Unlike traditional commercial transactions, buyers will not receive a period of due diligence during the period between the Effective Date and closing. Energy, based on the recommendations of its investment bankers, has elected this structure to reduce the likelihood of substantial changes to the aggregate purchase price (Energy must have certainty that the price exceeds the minimum price established by the independent assessors).

After the Effective Date the "risk of loss" due to catastrophes generally is passed to the buyer. However, if any portion of the Assets is materially damaged or destroyed before closing as a direct result of actions by Energy or its contractor that is currently operating NPR-1, Energy may choose to (1) repair or restore the Asset at Energy's expense, (2) indemnify the buyer for reasonable repair or restoration expenses, (3) reduce the base purchase price, or (4) do nothing and permit the buyer to terminate the PSA.

3. Representations and Warranties

Energy will make the traditional representations and warranties regarding its authority, performance, the absence of material litigation, necessary approvals and the absence of broker's commissions.

The buyer will make similar representations and warranties, as well as that it has not relied on any representation or warranty other than those expressly provided in the PSA, and that the buyer is "knowledgeable" and purchasing the Assets for its own account, and not with an intent to make a distribution within the meaning of securities laws.

For both Energy and the buyer, the representations and warranties survive for a period of three years after the closing date.

4. Indemnification and Environment

Energy has proposed a range of indemnification obligations and environmental obligations to buyers that are considered, by Energy's investment bankers, to be consistent with commercial practices. One item that we understand is not the commercial norm is Energy's agreement to continue remediation activities on environmental sites that are currently being undertaken. Energy also commits to conduct remediation activities on environmental sites that were not known to buyer prior to the closing date if they are identified within three years. We understand that OMB advocates these environmental positions based on policy concerns.

Indemnifications will be provided for (1) material breaches of the representations and warranties, (2) personal injury or property damage occurring prior to the closing date, (3) contractual claims occurring prior to the closing date, and (4) damages occurring from Energy's environmental remediation efforts. For all of the items, except the remediation, claims must be raised by the buyer before the third anniversary of the closing date. The indemnification obligations are limited by a $25,000 minimum claim amount, a $10 million threshold for all claims (which is in the form of a deductible), and an overall cap for indemnification at 10% of the base purchase price.

Energy's outside counsel prepared a table that sets forth the range of indemnifications and environmental obligations. (See Tab B.)

The legislation provides that the Secretary of Energy "may extend such indemnities and warranties as the Secretary considers reasonable and necessary to protect the purchaser from claims arising from the ownership in [NPR-1] by the United States." Counsel for Treasury, OMB and Energy are working on the issue of how Energy will fund any indemnification that is called.

5. Small Refiners "Set Aside"

The existing operations at NPR-1 provide for a small refiner "set aside" of 25% of the production at the bid price for the crude oil sold at auction (the market price). While the House version of the privatization legislation required that purchasers of NPR-1 continue this set aside, neither the Administration's nor the Senate's versions included the provision. During conference, the provision was stricken. Nevertheless, Energy has recommended that a provision be included in the PSA that would require the buyer of the 74% interest in the Assets (the "Operator") to provide a call option to the small refiners for a period of three years up to 25% of the production of crude oil. Unlike the existing set aside, the small refiners would be charged an administrative fee of $0.10 per barrel.

Energy believes that this provision makes sound energy policy, allowing for the small refiners on the West Coast to continue to have access to light crude oil, necessary for their operations. Additionally, Energy believes that the inclusion of the set aside would preempt antitrust issues at the State of California level. Energy's financial advisers have informed Energy that the inclusion of the provision would not result in more than an "insignificant" change in the purchase price.

VI. Implications of Treasury Approval of the PSA

In conveying the draft PSA and requesting Treasury approval, Energy suggested that the Treasury may wish to authorize Energy to negotiate purchase and sales agreements that differ from the draft approved by Treasury and OMB, provided that Energy consults with Treasury in the event that the modified agreements have terms "less favorable economically to the Government than those included in the draft of the agreement provided" to the Treasury.

After consultations with the Office of General Counsel, it is our recommendation that the Treasury approval of any draft PSA be conditioned upon further consultation if terms or conditions of the PSA are materially changed during the negotiations. K g Creek

FEDERAL HOME LOAN BANK (FHLB)

DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

June 10, 1994

MEMORANDUM FOR SECRETARY BENTSEN

FROM: Frank N. Newman RE FOR FNN
Under Secretary of the Treasury
Domestic Finance

SUBJECT: Senate Banking Committee Hearing on the Federal Home Loan Bank System

ISSUE:

I am scheduled to testify before the Senate Committee on Banking, Housing, and Urban Affairs on June 15 to discuss Federal Home Loan Bank (FHLBank) System reform. We expect Nicolas Retsinas, Assistant Secretary of Housing - Federal Housing Commissioner, will also testify on behalf of the Department of Housing and Urban Development (HUD). Mr. Retsinas, in addition to his responsibilities at HUD, is Secretary Cisneros' designee to serve on the Federal Housing Finance Board, the FHLBank System's regulator. Since the Finance Board currently lacks a chairman and a quorum, Mr. Retsinas, as a practical matter, is running the agency.

BACKGROUND:

The attachment to this memo provides a brief background on the FHLBank System and on the recent events that have led to this hearing. The System currently has $187 billion in assets, of which $101 billion is in loans (advances) to members. We have been developing the Administration's policy goals for needed FHLBank restructuring and reform through interagency discussions, and expect the process to continue into next year. Treasury's principal concern is the safety and soundness of a system that has been low-risk in the past, but has been rapidly incurring additional risk.

OUTLINE OF TESTIMONY:

My statement will cover three main topics.

1. <u>Study Recommendations</u>: We will review the major recommendations of the five congressionally mandated studies that have recently been completed, with particular emphasis on the changing mission of the FHLBank System.

• The FHLBank System's traditional mission of providing liquidity to home lenders--through collateralized loans known as advances--should be maintained. Because of the Administration's interest in community development, the mission statement has been expanded to include community development lending. We believe, for reasons of safety and soundness, that collateral rules should not be relaxed to reflect this expansion in the mission statement. HUD supports us on this point.

- Membership in the System should be offered to commercial banks and savings associations on an equal basis. Thus all members will become voluntary (currently savings and loans are mandatory members), all members would have equal access to advances (presently, commercial banks must pay more for advances), and all members would share the System's obligations equally.

- With voluntary membership it becomes important to provide for permanence in the System's capital base, as well as maintain a meaningful requirement linking System membership with an ongoing commitment to a public purpose.

- The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 gave the System an ongoing obligation to pay $300 million per year towards the interest payments on REFCorp bonds, and an obligation to fund, at approximately $100 million annually, an affordable housing program for the System (AHP). (Should the System fail to meet its REFCorp obligation, that obligation would be absorbed by taxpayers.) The fixed nature of these obligations has been problematic for the System because of the variability of System income. The System has responded to recent declines in its traditional source of income by arbitraging its GSE status in the mortgage-backed securities market. We strongly believe that these investments are inappropriate. The lack of equity in how the FHLBanks share the REFCorp and AHP obligations is also an issue. We would prefer a different allocation formula for the distribution of these obligations. Attempts to "fix" this problem have failed because of pay-as-you-go budgetary considerations. Still, we continue to look for a way to overcome these problems.

2. <u>Capital and Regulatory Structure</u>: We will review proposals for establishing a regulatory capital requirement and offer an outline of Treasury's recommended approach. We will also discuss system regulation.

- The capital currently in the System is redeemable by members and is not risk-based. The five reports agree that the System needs permanent capital and needs capital rules that are risk-based, but they disagree on how best to accomplish these ends. We agree with these principles but disagree with the approaches put forth. Approaches proffered include publicly tradeable stock and increased retained earnings. We will make a strong case in our statement that issuing publicly traded stock would weaken or eliminate the cooperative nature of the System and increase the incentives of the System for risk-taking, thus increasing risk to the Treasury, if financial problems ever lead to a potential bail-out by the government.

• We believe modifications to the System's existing capital structure rather than a complete overhaul is the best approach. We are developing a proposal which strengthens the conditions under which a member could leave the System and redeem its capital stock. The proposal will also provide for risk-based rules for establishing minimum capital levels for each FHLBank.

• The reports recommend that the System's three responsibilities -- program regulator, safety and soundness regulator and manger -- be separated. HUD recommended that it be the System's program regulator and that the Office of Federal Housing Enterprise Oversight (OFHEO), which was created in 1992 as an independent office within HUD to oversee Fannie Mae and Freddie Mac, be the safety and soundness regulator. We do not support the latter recommendation. (We see a conflict between OFHEO as the safety and soundness regulator of the System and HUD's responsibility to promote housing. You should know that, as a result of our letter to Mr. Panetta during the interagency clearance process for the HUD report, the location of the System's safety and soundness regulator was left unresolved in the HUD study.)

3. <u>Comprehensive Legislation</u>: We call for comprehensive legislation to modernize the System.

• We believe that the inter-relationships between the issues involved in System reform require comprehensive legislative action, and plan to draft legislation later this year. (We expect that process to involve considerable collaboration with HUD, OMB, and NEC.)

• We believe it would be unwise to legislate piecemeal changes to the System.

INTERAGENCY ISSUES

A couple of issues may receive particular attention during the clearance process. HUD, OMB and NEC supported the expansion of the System's mission to include community development lending. We feel that a broadly defined expansion of community development is unwarranted and have tried to provide a focus for this expansion in our testimony. HUD may disagree with our opposition to tradeable stock as a solution to the shortcomings with the current capital structure. HUD, OMB and NEC all support merging the System's safety and soundness responsibilities into OFHEO. We have serious concerns about that approach for the reasons stated above. We think this will be a particularly difficult issue, but we are concerned that it would be difficult for OFHEO to be a strong, independent safety and soundness regulator as long as it is located within HUD - the same agency that has responsibility for promoting housing programs.

We will keep you apprised, as appropriate, on these issues.

Attachment

cc: Deputy Secretary Altman
General Counsel Hanson
Assistant Secretary Levy
Assistant Secretary Munnell

ATTACHMENT ATTACHMENT

Background on the FHLBank System

Since its inception in 1932, the Federal Home Loan Bank System has been an important source of mortgage credit for home buyers. Federal Home Loan Banks sell bonds in the securities market at near Treasury rates and loan the proceeds (in the form of advances) to their thrift and bank institution owner-members, who in turn are able to lend this money on to home buyers. While the housing finance market has changed dramatically since 1932, the Bank System continues to operate largely as it was initially structured. Historically, the FHLBank System has been the safest of the seven government-sponsored enterprises (GSEs). In over 60 years of making collateralized advances to savings and loans, it has never lost a dollar from a loan default.

Incredible!

FIRREA opened System membership to commercial banks and credit unions that have at least 10 percent of their assets in mortgage related assets. It also created the Federal Housing Finance Board as the System's regulator, and gave the Board certain managerial responsibilities for the System. This has created a conflict of interest at the Finance Board that is essentially inherited from the one that existed with the Federal Home Loan Bank Board's oversight of the Bank System in the 1980s.

As of April 30, 1994, the Bank System had about $187 billion in assets, of which $101 billion was advances outstanding and $83 billion was investment securities. the national average loan amount on conventional home mortgages currently is about $111,000. Thus, $101 billion in advances is equivalent to over 912,000 mortgage loans, or 3 percent of all outstanding single-family loans.

The Bank System is an active user of derivatives. FHLBanks use derivatives to (1) lower funding costs, (2) diversify funding sources, and (3) hedge risks. Much of the FHLBanks' derivative activities involves the use of bond/swap combinations to obtain structured financing that lowers FHLBanks' overall cost of funds. As of December 31, 1993, the FHLBanks had $89 billion in notional principal of interest rate swaps and interest rate caps and floors. The associated maximum credit risk is estimated to be $1.2 billion. System use of derivatives is restricted by the Financial Management Policy issued by the Finance Board.

The Housing and Community Development Act of 1992 required five studies of the Federal Home Loan Bank System. Studies were prepared by HUD, CBO, GAO, the Federal Housing Finance Board, and a committee of FHLBank shareholders. In April, the last of these studies was issued. The purpose of this hearing is to consider the results of the studies and to discuss the Administration's legislative agenda with respect to FHLBank System reform. The Treasury Department, in conjunction with HUD, will develop a comprehensive legislative proposal by the end of the year.

TREASURY CLEARANCE SHEET NO. ______________

Date: 6/09/94

MEMORANDUM FOR: SECRETARY DEPUTY SECRETARY EXECUTIVE SECRETARY

ACTION BRIEFING INFORMATION

LEGISLATION

PRESS RELEASE PUBLICATION REGULATION SPEECH

TESTIMONY OTHER

FROM: Fé Morales Marks

THROUGH:

SUBJECT: Memo on the Senate Banking Committee Hearing

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Domestic Finance
  - ☐ Financial Institutions Policy
  - ☐ OCC
  - ☐ OTS
  - ☐ Fiscal
    - ☐ FMS
    - ☐ Public Debt
- ☐ Under Secretary for International Affairs
  - ☐ International Affairs
- ☐ Enforcement
  - ☐ ATF
  - ☐ Customs
  - ☐ FLETC
  - ☐ FinCEN
  - ☐ FAC
  - ☐ Secret Service
- ☐ Legislative Affairs
- ☐ General Counsel
- ☐ Economic Affairs
- ☐ Chief of Staff
- ☐ Management
  - ☐ Treasurer
    - ☐ Mint
    - ☐ Engraving & Printing
    - ☐ Savings Bonds
- ☐ Public Affairs
- ☐ Tax Policy
- ☐ Inspector General
- ☐ IRS
  - ☐ Public Liaison
- ☐ Other

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
DeMarco			Thrift Institutions Policy	622-2792
REVIEWERS				
Affleck-Smith			Thrift Institutions Policy	622-0191
Levy			Legislative Affairs	622-1900
Hanson	JH	6/9/94	General Counsel	622-0287

SPECIAL INSTRUCTIONS: Please provide your comments/clearance to Ed DeMarco (622-2792 or room 3202) by 4:00 p.m. on Thursday, June 6.

TREASURY CLEARANCE SHEET NO. ________________

Date: 6/09/94

MEMORANDUM FOR: SECRETARY DEPUTY SECRETARY EXECUTIVE SECRETARY

ACTION BRIEFING INFORMATION

LEGISLATION

PRESS RELEASE PUBLICATION REGULATION SPEECH

TESTIMONY OTHER

FROM: Fé Morales Marks
THROUGH:
SUBJECT: Memo on the Senate Banking Committee Hearing

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INITIATOR(S)				
DeMarco	EJD	6-10-94	Thrift Institutions Policy	622-2792
REVIEWERS				
Affleck-Smith	JA-S	6/10/94	Thrift Institutions Policy	622-0191
Levy/Rojas	VAR	6/10/94	Legislative Affairs	622-1900
Hanson			General Counsel	622-0287
Marks	FMM	6/9/94	Financial Inst. Policy	622-2610
Carnell	RSC	6-10-94	Financial Insts.	622-2600

SPECIAL INSTRUCTIONS: Please provide your comments/clearance to Ed DeMarco (622-2792 or room 3202) by 4:00 p.m. on Thursday, June 6.

2

DEPARTMENT OF THE TREASURY
WASHINGTON

November 14, 1994

MEMORANDUM FOR DEPUTY SECRETARY NEWMAN

FROM: Fé Morales Marks
Acting Assistant Secretary for
Financial Institutions

SUBJECT: Key open issues on FHLBank reform

ISSUE:

You asked Assistant Secretary Richard Carnell to provide you, by the close of business today, with a summary of the key open issues remaining to be resolved with HUD regarding FHLBank reform. The following is a brief summary of those key issues, along with a notation of Treasury's tentative position on each.

REFCorp

a. Should the internal allocation of the REFCorp obligation be altered? *(We support phasing out the existing shortfall allocation, so that each FHLBank shares the same proportionate REFCorp burden.)*

b. Should there be statutory restrictions on the amount of MBS held by the System, instead of the current regulatory limits? *(MBS restrictions should be left to the System's regulator.)*

Governance and Regulation

a. How should the current regulatory and governance authorities of the FHFB be divided? Where should safety and soundness oversight responsibility be assigned and where should programmatic oversight be assigned? *(We recommend a five-member board responsible for the current regulatory responsibilities of FHFB and OFHEO -- the safety and soundness regulation of the three housing GSEs and program regulation of the FHLBank System.)*

b. What should be the role of the System's fiscal agent? Should it be established in statute and, if so, how? *(The fiscal agent should be established in statute as part of the System. We are awaiting analysis by FHFB and by our General Counsel's Office on the precise role and responsibilities of the fiscal agent and/or any other System-wide governing structure.)*

	INITIATOR	REVIEWER	REVIEWER	REVIEWER	REVIEWER	SECRETARIA
OFFICE CODE SURNAME	DeMarco	Affleck-Smith				
INITIALS/DATE	EJD 11/14/94	JAS 11/14/94	/	/	/	/

TD F 80-02.1 (11-85)

Capital Standards and Structure

a. Should the System's new capital structure be a one-tier structure of redeemable common stock that has more "permanence" than the current stock? Or, should a two-tier structure of nonredeemable common and redeemable preferred be adopted? *(Although we continue to await the System's final recommendation on capital structure, our position remains that the existing one-tier structure should be improved to add more "permanence" to the existing capital.)*

b. Under either structure, how should required capital levels be established? *(The formula for required capital should be based on, but not limited to, the present value of REFCorp, a credit/management risk component, and an interest rate risk component.)*

Community Support Regulations

a. Should access to advances be predicated on a member's satisfactory record in community lending, perhaps even beyond a satisfactory CRA rating? *(The program regulator should not be allowed to limit a member's access to advances based on community support requirements established by the program regulator.)*

to: ~~Secretary Rubin~~

room: date: 5/17/95

Department of the Treasury

Office of the Assistant Secretary for Financial Institutions

Attached is an outline of our proposal to reform the Federal Home Loan Bank System.

The issue of the REFCorp payment formula, which engendered considerable controversy at today's hearing, is discussed on page 5.

Attachment

Richard S. Carnell RC

room 2326
phone 622-2600

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

Highlights of the Administration's Federal Home Loan Bank System Modernization Proposal

- **The Federal Home Loan Bank (FHLBank) System's housing finance mission will be reinforced through a statutorily-defined statement of purpose and a new mortgage portfolio requirement.** The FHLBanks will have an explicit statement of purpose that affirms the System's important role in supporting housing and community development finance, particularly through portfolio lending. Members will be required to demonstrate an ongoing commitment to housing finance by maintaining 10 percent of their assets in whole residential mortgages.

- **System membership will carry the same rights and responsibilities for all member institutions.** The System will be voluntary for all eligible members and membership rules will apply equally to all System members.

- **The Federal Housing Finance Board's (FHFB) conflicting roles as System manager and regulator will be separated.** The FHLBanks will manage and coordinate their own activities, while a restructured FHFB will continue to provide safety and soundness and program oversight. FHFB's safety and soundness focus will be reinforced by adding the Secretary of the Treasury to the Board.

- **The System's capital structure will be strengthened and required capital will be based on the risks undertaken by each FHLBank.** The proposal will:

  - specify the rules governing stock redemption;
  - require FHFB to establish risk-based and leverage capital requirements for each FHLBank, as well as prompt corrective action rules that require remedial actions by FHFB and the FHLBank when a FHLBank fails to meet its capital requirements; and
  - require each FHLBank to meet its capital requirements by having its members purchase sufficient stock in their FHLBank. Each member will be required to purchase stock in proportion to its total assets.

- **The System's obligation to pay $300 million annually to help cover interest on REFCorp bonds (*i.e.*, the System's REFCorp obligation) will be more equitably distributed, thereby making the System more stable. System-wide capital requirements will provide greater protection for taxpayers.** The REFCorp allocation formula will be changed to a percentage of each FHLBank's required capital. An opportunity will be provided for the FHLBanks to develop an acceptable alternative allocation formula. System capital requirements will protect taxpayers from the cost of the System's REFCorp obligation and from any risk from financial losses in the System.

Benefits of the Administration's FHLBank System Modernization Proposal

1. Mission, Activities, and Collateral

The Administration proposes to adopt the following explicit mission statement for the FHLBank System:

> *The Federal Home Loan Bank System is a profit making enterprise whose purpose is to support residential mortgage lending (including mortgages on housing for low- and moderate-income families), as well as community development lending, throughout the Nation, safely and soundly, primarily through a program of collateralized advances to System members. The System facilitates such lending by increasing the liquidity and improving the distribution of investment capital available through its member institutions.*

The Administration's proposal will:

Affirm the important role played by the FHLBank System in making mortgage credit available both for residential lending and community development lending by including mortgages on housing for low- and moderate-income families in the scope of residential mortgage lending and including community development lending in the statement.

Recognize the need for the System to operate safely, soundly, and profitably.

Minimize credit risk in making advances by retaining existing restrictions governing acceptable collateral.

Preserve the link between advances and mortgage lending, which is central to the System's public purpose, by continuing to require mortgage-related collateral and by requiring members to maintain at least 10 percent of their assets in whole residential mortgages.

2. Membership and Terms of Advances

The Administration proposes to offer FHLBank System membership on the same terms to all eligible members (currently, federal saving associations are mandatory members, while commercial banks, state-chartered savings associations, and credit unions are voluntary members). All members will have equal access to advances (presently, banks and credit unions face greater restrictions on their access to advances), and all FHLBanks will share the System's REFCorp and Affordable Housing Program (AHP) obligations equitably. The Administration's proposal will:

Strengthen FHLBank managers' incentives to operate their FHLBanks efficiently and be responsive to their members by allowing all members to vote with their feet by voluntarily withdrawing from the System.

Give all members the same incentives to ensure their FHLBank is prudently managed by equalizing the relative risk exposure of all its members.

Strengthen commercial bank and credit union members' stake in the System by equalizing their membership rights, improving their access to advances, and equalizing the cost of advances to all members.

3. Management and Regulation

The Administration proposes to separate the FHFB's conflicting roles as program and safety and soundness regulator from its role as System manager and coordinator. The Administration's proposal will:

Remove the inherent conflicts between FHFB's regulatory and managerial responsibilities, while strengthening all members' stake in the System, by devolving FHFB's managerial responsibilities to the FHLBanks while retaining safety and soundness and program oversight responsibilities for FHFB.

Have the System's debt obligation issued through a central office of the FHLBanks, instead of by its regulator, by replacing the Office of Finance with a central office of the FHLBanks that will act as the System's fiscal agent.

Ensure that the System remains safe, sound, and true to its public purpose by having the Secretaries of Treasury and HUD on the Board.

Make two of the appointed board members part-time, instead of full-time, since the Board's revised oversight responsibilities will be less time-consuming.

4. Capital

The Administration proposes to strengthen the capacity of FHLBank capital to absorb losses by establishing stricter stock redemption rules and risk-based and minimum capital requirements. Additionally, prompt corrective action rules will specify remedial actions should a FHLBank fail to meet its capital requirements. The Administration's proposal will:

Establish risk-based and leverage capital rules for the FHLBanks by directing FHFB to develop a risk-based capital requirement consisting of 3 components: (1) capital for credit risk, (2) an interest rate risk stress test, and (3) additional capital sufficient for the FHLBank to generate the earnings needed to meet its System obligations. Regulatory capital requirements will also include a leverage requirement and a retained earnings requirement. Prompt corrective action rules will ensure ongoing enforcement of these requirements.

Make all members share proportionally in capitalizing their FHLBank by requiring each member to purchase stock in proportion to its total assets. Each FHLBank will determine its own capital level, provided it satisfies its regulatory capital requirements.

Specify the rules governing redemption of FHLBank stock by defining the relevant capital tests and time frames for redeeming (partially or entirely) a member's stock investment in its FHLBank.

- A member will normally receive payment for its stock in two equal installments, one after six months, the second six months after that.

- If the FHLBank is experiencing large capital outflows, the redemption period will extend to 3 payments over 18 months.

- If the FHLBank is undercapitalized, FHFB will reduce (*i.e.*, haircut) any redemption by the member's *pro rata* share of the FHLBank's capital deficiency.

- FHFB will measure a FHLBank's capital net of all pending stock redemptions.

- As under current law, a member that withdraws from the System may not rejoin for ten years.

- A member that files a redemption notice but then cancels the notice would pay a fee. The fee would discourage members from attempting to defeat the waiting period or other safeguards on redemption by continually filing withdrawal notices -- notices filed not because the member actually intends to leave but because it wants to keep its options open.

5. REFCorp

The Administration proposes to eliminate the perverse incentives created by the current formula for allocating the System's REFCorp obligation among the FHLBanks. Each FHLBank will contribute to the System's annual REFCorp obligation on a pro rata basis, based on its required capital. The Administration's proposal will:

Eliminate the current penalty on making advances to SAIF-insured members by dropping the shortfall allocation formula.

Enhance the FHLBanks' ability to work cooperatively in dealing with the broad array of new responsibilities being delegated to them by making the FHLBanks share proportionately in the System's REFCorp obligation.

Mitigate the incentive to increase risk in order to generate earnings for REFCorp by relating a FHLBank's share of the obligation to its risk-taking. Since risk-based capital rules will be applied the same way in setting each FHLBank's required capital, each FHLBank's REFCorp payment will be in proportion to the size and risk of its operations.

Give the FHLBanks an opportunity to develop an acceptable alternative to the Administration's proposed allocation formula within 60 days after enactment.

The Administration proposes a System-wide set of capital requirements that would help protect taxpayers from the risk of absorbing the System's REFCorp obligation. Since any failure by the System to meet this obligation would directly increase taxpayer costs, we propose some early warning signals and capital conservation steps to protect taxpayers. The Administration's proposal would establish the following System-wide capital safeguards:

- If System capital falls below $7 billion (currently, it is nearly $14 billion), the System must submit a System-wide capital restoration plan to the FHFB. This capital plan would describe how the FHLBanks, individually and collectively, will deal with the declining System-wide capital base.

- If System capital falls below $6 billion, no FHLBanks could distribute retained earnings. This restriction represents a modest first step toward conserving capital to prevent a dissipation of retained earnings before, or in connection with, withdrawals from the System.

- If System capital falls below $5 billion, no FHLBank could pay dividends. At $5 billion, the fixed REFCorp obligation will likely be considerably burdensome to all the FHLBanks.

Questions and Answers on the Administration's FHLBank System Modernization Proposal

Modernizing the FHLBank System

The System has undergone considerable study over the past few years. What did the Administration conclude from these studies?

There have been five studies of the System completed over the past two years. The studies were mandated by the Housing and Community Development Act of 1992 and were written by the Federal Housing Finance Board, HUD, CBO, GAO, and the Federal Home Loan Banks Stockholders Study Committee. In addition, the Treasury Department formally commented on the five studies in testimony before the Senate Banking Committee last June. The studies concluded that the System:

- **continues to have an important public purpose** as a source of liquidity, both short-term and long-term, to institutions specializing in housing finance; and

- **has weaknesses in its membership rules, regulatory structure, and capital structure, as well as perverse incentives created by the REFCorp allocation formula** that need to be dealt with in order to ensure the System's safety and soundness in the future.

How has the System's membership changed since the 1989 FIRREA legislation, which first permitted commercial banks to join the System?

- **Membership composition has changed dramatically.** After nearly 60 years of serving just thrifts, most of which were required to be System members, FIRREA opened the System to commercial banks and credit unions.

  - As of March 31, 1995, there were 5,442 System members, of which 2,040 were thrifts and 3,285 were commercial banks.

- Beginning last month, state-chartered savings associations were no longer required to be System members. This effectively made membership voluntary for all eligible institutions, since federal savings associations (which are required by law to be System members) may leave the System after first changing their charters.

Why is the Administration proposing this legislation? Is there a problem today with the System?

Current weaknesses put the System's future at risk. After Fannie Mae, the System is the largest private issuer of debt securities in the country. Yet its unequal membership rules, its conflicted regulatory structure, its non-risk-based capital structure, and the perverse incentives arising from the formula allocating its fixed REFCorp obligation necessitate comprehensive reform.

- **Membership rules differ based on a member's charter.** Such differences treat members unequally and arbitrarily, and create perverse incentives to take risks.

- **The regulatory structure has built-in conflicts of interest.** A fundamental conflict exists between the Federal Housing Finance Board's roles as the System's manager and regulator. The Board is, in effect, managing the very enterprises it is responsible for regulating.

- **The System's capital stock lacks resiliency and the regulatory capital rules are not based on FHLBanks' risk-taking.** The FHLBanks must redeem a withdrawing member's capital stock at par so long as the FHLBank's capital is not impaired. Ninety-eight percent of FHLBank capital consists of stock, none of which would have sufficient permanence to qualify as capital as the term is generally used. This lack of permanence, combined with a lack of regulatory capital requirements that take account of the FHLBanks' particular structure and risks, underscores the need to strengthen the System's capital structure.

- **The Resolution Funding Corporation (REFCorp) allocation formula disproportionately burdens certain FHLBanks and creates a perverse incentive to not make advances to savings associations.** The disproportionate financial burden weakens the System's financial integrity, and the penalty on making advances to savings associations runs counter to the System's purpose.

What are the Administration's goals in its modernization legislation?

- **Promote housing finance** through portfolio lending. In that context, the Administration seeks to encourage mortgage-lending on housing for low- and moderate-income families, as well as community development lending, through the System's Affordable Housing and Community Investment Programs and its traditional advances products.

- **Make membership voluntary,** with equal rights and responsibilities, for all members;

- **Improve the government's oversight of the System** by giving the FHLBanks full management responsibility for running the System while focusing FHFB's oversight on FHLBanks' safety and soundness and their compliance with the System's public purpose.

- **Strengthen the System's safety and soundness** through risk-based capital requirements and associated prompt corrective action rules.

- **Protect taxpayers by ensuring payment of the REFCorp obligation** so long as the System remains a going concern, while removing the perverse incentives created by the current allocation formula.

Benefits to Eligible Member Institutions

What are the benefits of the Administration's proposal for institutions that are voluntary members today?

- **Removes limit on advances to non-QTL members.** All restrictions on advances to members based on whether they comply with the qualified thrift lender (QTL) test will be removed. The limit on total System advances to non-QTL members will also be removed.

- **Increases their ability to leverage their capital.** While most thrifts can borrow advances up to twenty times their FHLBank stock, some voluntary members may borrow advances only up to twice their FHLBank stock. All institutions may leverage their FHLBank stock to the same extent under the Administration's proposal.

- **Reduces risk by putting each FHLBank on the same financial footing.** The FHLBanks are jointly and severally liable for System debt obligations. While they have the same cost of funds and offer similar products and services, the disproportionate allocation of the REFCorp obligation creates economic differences among the FHLBanks that increase the earnings pressures in certain FHLBanks and, through the joint and several liability, overall System risk as well.

- **Strengthens their ownership claim on the System.** Through equalizing their membership rights and removing FHFB's role in managing the System, voluntary members will gain greater say in the operations of their FHLBank and of the System.

- **Continues the benefits from:**

  - immediate access to credit, both for short-term liquidity needs and longer-term financing;

  - structured financing such as variable rate repayment and other structured financing that may improve a member's interest rate risk management;

  - correspondent services;

  - advisory services for interest rate risk management and affordable housing;

  - CIP and AHP programs.

What are the benefits of the Administration's proposal for institutions that are mandatory members today?

- **Become voluntary members.** After a brief transition period, all federal savings associations will become voluntary System members. At that point, they may continue to be System members, or they may withdraw from the System under the terms and conditions specified in the proposal. The Administration expects the vast majority of mandatory members to remain in the System because of the benefits of System membership, which will be enhanced by this proposal.

- **Reduces their FHLBank stock purchase requirement.** The new risk-based capital requirements should generally require thrifts to hold less capital than under the present rules. Provided System membership remains stable, the new capital requirements should permit mandatory members to gradually reduce their holdings of FHLBank stock.

- **Strengthens their ownership claim on the System.**

- **Continues the benefits of System membership** that thrifts have enjoyed for over sixty years.

What are the "equal responsibilities" of System membership that go along with these benefits?

- **Maintaining at least ten percent of assets in whole residential first mortgages.**

- **Directing FHLBank management** through selection of boards of directors;

- **Ensuring the member's FHLBank has sufficient capital** to satisfy its risk-based and leverage capital requirements;

- **Underwriting the risks taken by a FHLBank** on a pro rata basis through a capital stock investment based on a member's assets;

- **Absorbing the cost of the REFCorp and AHP obligations** through reduced FHLBank earnings.

What are the public benefits of this proposal?

- **Protects taxpayers.** Removing the perverse incentives inherent in the current REFCorp allocation formula will eliminate the penalty on making advances to SAIF-insured members while enhancing the ability of the FHLBanks to work together. These improvements will make the System more stable. At the same time, prompt corrective action and System-wide capital requirements will provide additional taxpayer protection.

- **Continues the System's important role in increasing the liquidity of mortgage loans held by portfolio lenders.** While the secondary mortgage market is a vital and growing part of our housing finance system, many home buyers' access to mortgage credit depends upon community-based portfolio lenders that make mortgage loans on terms different than those of the secondary markets.

- **Increases mortgage lending.** FHLBank membership reduces the need for a member to carry liquid assets on its balance sheet. This allows the member to hold more mortgages, which are relatively illiquid. Expanded access to advances by non-QTL members and a strengthened nexus between membership, advances, and home financing will work together to increase the availability of mortgage credit.

- **Encourages members to become more involved in community development lending, especially community development lending oriented toward housing.** For example, the AHP and CIP programs, while still relatively new, show great promise. The proposed mission statement takes this development one step further to encourage System members to become active community lenders.

- **Improves the ability of depository institutions to manage their interest rate risk.** Expanded access to advances for non-QTL institutions, risk-based capital requirements for FHLBanks, advances structured to the asset/liability management needs of members, and advisory services offered by the FHLBanks all enhance the interest rate risk management abilities of members.

Establishing a New Capital Structure

How will FHFB determine a FHLBank's regulatory capital requirement?

FHFB will establish a risk-based capital requirement and a leverage capital requirement for the FHLBanks. The risk-based requirement will be the sum of three components:

- **Credit risk:** Capital required for credit risk will be no less than the tier 1 risk-based capital required for well-capitalized banks and savings associations. This component will cover both on- and off-balance sheet risk exposure.

- **Interest rate risk:** Capital required for interest rate risk will be based on an interest rate risk stress test developed by FHFB. Such a test will rigorously test a FHLBank's ability to withstand large changes in interest rates, as well as severe rate volatility and changes in the shape of the yield curve.

- **REFCorp and AHP Obligations:** FHFB will establish as a third component of each FHLBank's risk-based capital requirement an amount sufficient to generate the earnings needed to meet the FHLBank's ongoing obligations, including its payments for REFCorp and the Affordable Housing Program.

FHFB will also establish a leverage capital requirement for the FHLBanks of no less than 4 percent capital-to-assets.

A FHLBank's effective capital requirement will be the greater of the risk-based or leverage capital requirements.

To ensure there is some non-redeemable capital in the System, given the voluntary membership structure being proposed, FHFB will also establish a retained earnings requirement for the FHLBanks.

What will be the role of retained earnings in the regulatory capital requirements?

FHFB will establish a retained earnings requirement for each FHLBank. This requirement should be:

- based on an interest rate risk stress test or some other standard as FHFB deems appropriate to ensuring the FHLBank's safety and soundness; and

- built directly into the risk-based capital requirement or may be a separate requirement.

How will a member's stock purchase requirement be set, given these regulatory capital requirements?

Each FHLBank will determine its own desired capital level, given its regulatory requirements. Each FHLBank will also determine its own desired mix of member-owned capital stock and retained earnings, given its regulatory requirements.

Once a FHLBank determines its desired level of capital stock, it will issue this stock to its members on a *pro rata* basis, based on each member's total assets.

How long will be the transition from the current capital requirements to these new capital requirements?

FHFB must make the new capital requirements effective within one year from the date of enactment, although final completion of the interest rate risk stress test may take longer. FHFB will determine the appropriate phase-in of the retained earnings requirement.

Once FHFB issues the new capital rules (and thereby informs each FHLBank of its minimum regulatory capital requirement under these rules), each FHLBank's board of directors must establish a capital target for the FHLBank, and a transition plan to get there. **Within two years after the new capital rules are effective, all FHLBanks should be in full compliance with the new capital rules.**