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United States Government

Department of Energy

memorandum

DATE: February 14, 1997

REPLY TO
ATTN OF: IG-30

SUBJECT: U.S. Department of Energy Naval Petroleum and Oil Shale Reserves 1996 Financial Statement Audit - (WR-FC-97-01)

TO: Deputy Assistant Secretary for Naval Petroleum and Oil Shale Reserves, FE-60

The attached report presents the results of the independent certified public accountants' audit of the Department of Energy's (Department) Naval Petroleum and Oil Shale Reserves (NPOSR) financial statements as of September 30, 1996. The auditors have expressed an unqualified opinion on the 1996 statement of financial position and the related statements of operations and changes in net position.

The 1996 financial statement audit was performed under the provisions of the Inspector General Act (5 U.S.C. App.) as amended, Government Management Reform Act (31 U.S.C. 3515), and Office of Management and Budget implementing guidance. The auditors' work was conducted in accordance with generally accepted government auditing standards. To fulfill our audit responsibilities, we contracted with the independent public accounting firm of KPMG Peat Marwick LLP (KPMG) to conduct the audit for us, subject to our review.

The auditors' report on the NPOSR internal control structure disclosed three new reportable conditions and discussed the status of an unresolved reportable condition from prior years' findings. None of these reportable conditions are considered to be material weaknesses. NPOSR management concurred with the recommendations regarding the reportable conditions and stated that corrective actions would be implemented by September 30, 1997. The auditors also considered the overview and performance measurement data for completeness and material consistency with the basic financial statements. The auditors' report on compliance with laws and regulations disclosed no instances of material noncompliance.

During the course of the audit, KPMG also identified other matters which, although not material to the financial statements, nevertheless, warrant management's attention. These items are fully discussed in a separate letter to management.

We believe that the financial statements, together with KPMG's opinion and our review of that work, provide NPOSR management and the Department's Chief Financial Officer with a basis for evaluating NPOSR's financial position and results of operations for the period audited.

In accordance with Department Order 2320.2B, "Establishment of Departmental Position on Inspector General Reports," as amended by the October 11, 1994, memorandum on "Implementing Guidelines For Streamlining Pilot," management concurred with the recommendations and initiated corrective action plans. Accordingly, a Departmental position is not required.

We appreciate the cooperation of your staff during the review.

Greg Friedman

Gregory H. Friedman
Deputy Inspector General
for Audit Services

Attachment

cc: Director, Audit Liaison Division, CR-33
Program Audit Liaison, FE-63
Manager, Western Regional Audit Office, IG-35

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IG Report No. WR-FC-97-01

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KPMG

The Global Leader

U.S. Department of Energy

NAVAL PETROLEUM AND OIL SHALE RESERVES

Combined Financial Statements

September 30, 1996 and 1995

NAVAL PETROLEUM AND OIL SHALE RESERVES

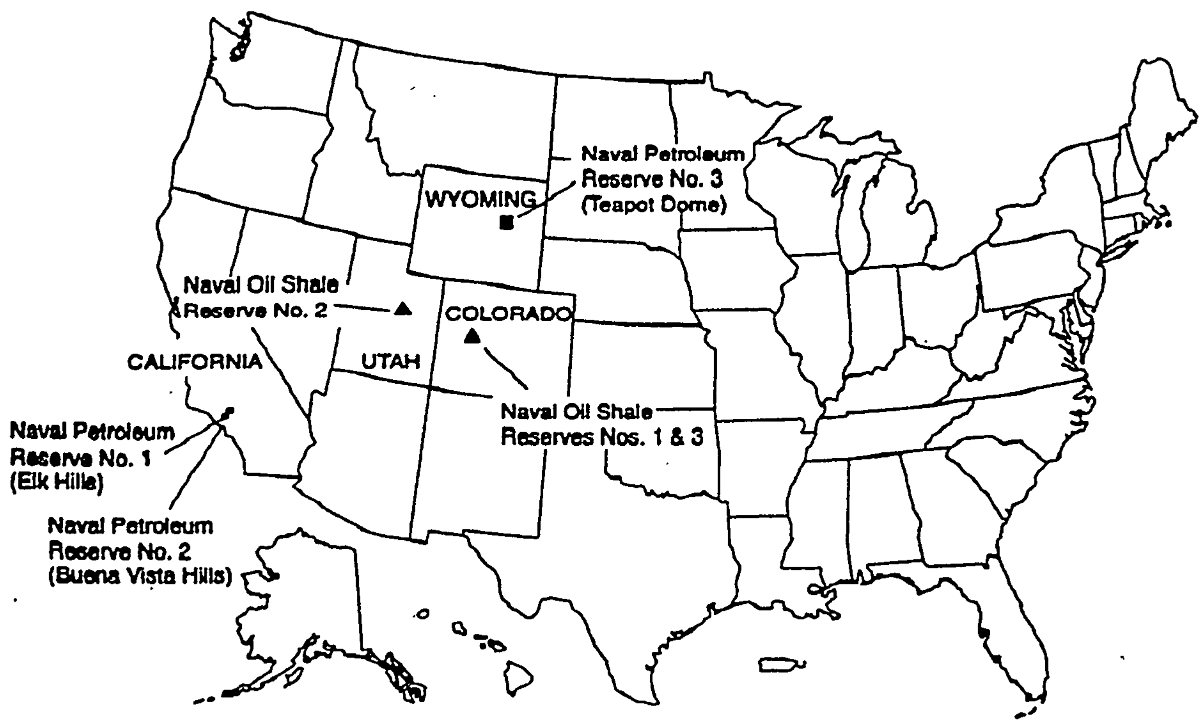
Table of Contents

OVERVIEW

Purpose and History

The Naval Petroleum and Oil Shale Reserves (NPOSR) produces crude oil and associated hydrocarbons from the Naval Petroleum Reserves (NPR) numbered 1, 2, and 3, and the Naval Oil Shale Reserves (NOSR) numbered 1, 2, and 3 in a manner to achieve the greatest value and benefits to the United States taxpayer.

NPOSR consists of the Naval Petroleum Reserve in California (NPRC or Elk Hills), which is responsible for operations of NPR-1 and NPR-2; the Naval Petroleum Oil Shale Reserve in Colorado, Utah, and Wyoming (NPOSR-CUW), which is responsible for operations of NPR-3, NOSR-1, 2, and 3 and the Rocky Mountain Oilfield Testing Center (RMOTC); and NPOSR Headquarters in Washington, D.C., which is responsible for overall program direction.



NPOSR was established by a series of Executive Orders in the early 1900s as a future source of liquid fuels for the military. NPOSR remained largely inactive until Congress, responding to the Arab oil embargo of 1973-74, passed the Naval Petroleum Reserves Production Act of 1976. The law authorized production for six years. Thereafter, NPOSR production could be reauthorized by the President in three-year increments. Since enactment of the law, every President has determined that continuing NPOSR production is in the nation's best interest. NPOSR currently is authorized to continue production through April 5, 2000.

NPRC, located in Kern County, California, about 35 miles west of Bakersfield, consists of a Management and Operating (M&O) contractor responsible for daily operations of NPR-1 and a Department of Energy (DOE) field office responsible for overseeing operations of NPR-1 and NPR-2. NPR-2 is operated by various leaseholders who pay royalty revenues to NPRC. NPR-1 is jointly owned by the United States Government (about 78 percent) and Chevron USA, Inc. (Chevron) (about 22 percent) and is operated according to the provisions of a Unit Plan Contract (UPC) executed in 1944 and last amended May 25, 1976. Under the UPC, each participant shares in the unit costs and production of hydrocarbons in proportion to the weighted acre-feet of commercially productive oil and gas formations (zones) underlying the respective surface lands as of 1942. The participating shares of NPR-1 as of September 30, 1996 are:

Zone	U.S. Government	Chevron
Dry Gas	83.8726%*	16.1274%*
Shallow Oil	70.0119%	29.9881%
Stevens	79.6357%	20.3643%
Carneros	100.0000%	0.0000%
Asphaltos	100.0000%	0.0000%

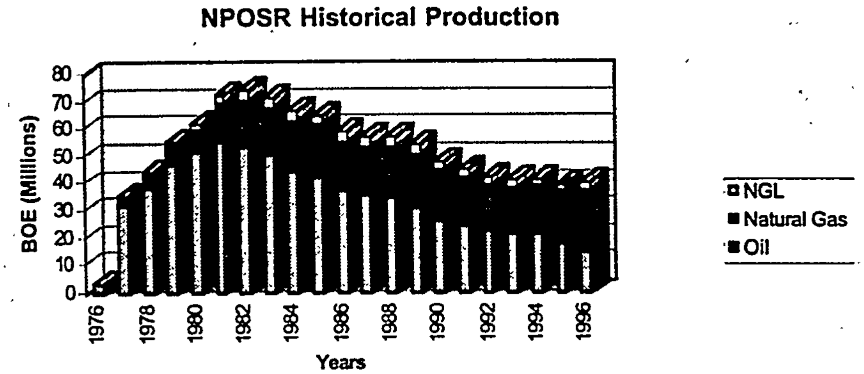
* Based on November 1994 redetermination

Under the terms of the UPC, either participant may request a redetermination of their participating share of a producing zone (redeterminations of participating shares are retroactive to 1942). In November 1994, a redetermination of the Dry Gas Zone (DGZ) was completed, which resulted in an increase in the Government's percentage for the DGZ from 77.0492 percent to 83.8726 percent. Subsequently, Chevron requested a redetermination of the Shallow Oil Zone (SOZ) and requested that a settlement agreement on the DGZ be postponed until a final SOZ determination is made. Therefore, for purposes of calculating shares of DGZ production and costs, DOE's share is considered to be 77.0492 percent during this intermediate period. Chevron and NPOSR have since presented their cases on the SOZ to the Assistant Secretary of Fossil Energy who has been delegated responsibility for making final equity determinations. All participating percentages are being finalized for divestment as required by the 1996 Defense Authorization Act.

NPOSR-CUW consists of a M&O contractor responsible for daily operations of NPR-3 and RMOTC and a DOE field office responsible for overseeing operations of NPR-3 and RMOTC. The DOE field office has assumed most of the daily operations of the NOSR properties. NPR-3 and RMOTC are located in Natrona County, Wyoming; NOSR-1 and NOSR-3 in Garfield County, Colorado; and NOSR-2 in Uintah County, Utah.

NPOSR Production, Revenues, and Expenses

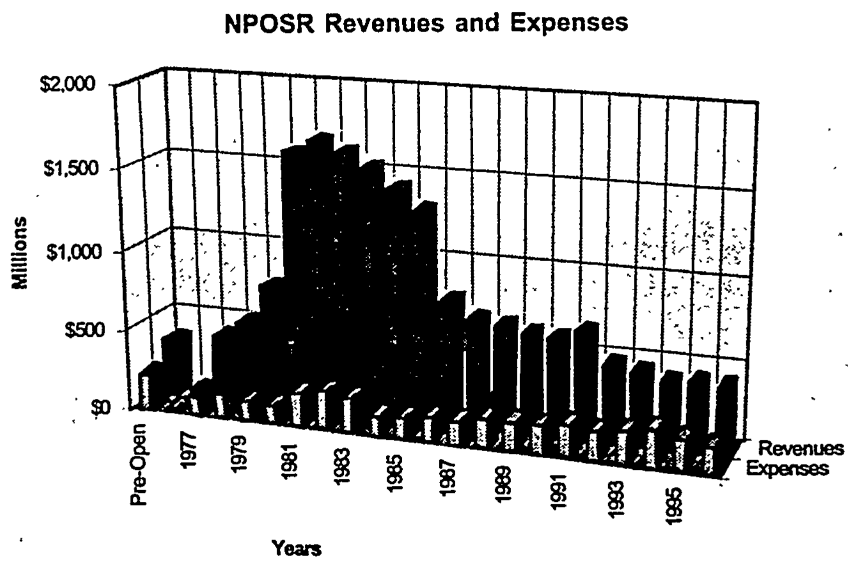
NPOSR's share of total Fiscal Year (FY) 1996 production was 40 million barrels of oil equivalent (BOE), an increase of one million BOE over FY 1995 production. (A BOE is a unit of measure in which quantities of natural gas and natural gas liquids (NGL) are converted into equivalent barrels of oil.) Production which is not reinjected into the field is sold by sealed bidding. Royalties are collected for the leased properties within NPR-2. Unlike NPR-1, 2, and 3, development of NOSR properties is restricted to protecting the government's assets from drainage. Thus primary NOSR production comes from NOSR-3 to mitigate drainage from offsite operators who have drilled near the borders of the property. The FY 1996 reserve report, less fourth quarter production, indicates DOE's share of NOSR-3 potential reserves is 29,911 billion cubic feet in the existing communitized areas alone which would yield substantial production and increased revenues if full development, rather than protective drilling, were approved by Congress.



One of the most significant accomplishments during FY 1996 was, despite an 8 percent reduction in the drilling budget, production increased by one million BOE and net income increased approximately 23 percent from FY 1995. The implementation of an NPOSR marketing effort, together with higher prices for crude oil and other petroleum products, and reduced expenses due to downsizing efforts have resulted in significantly higher profits for the program.

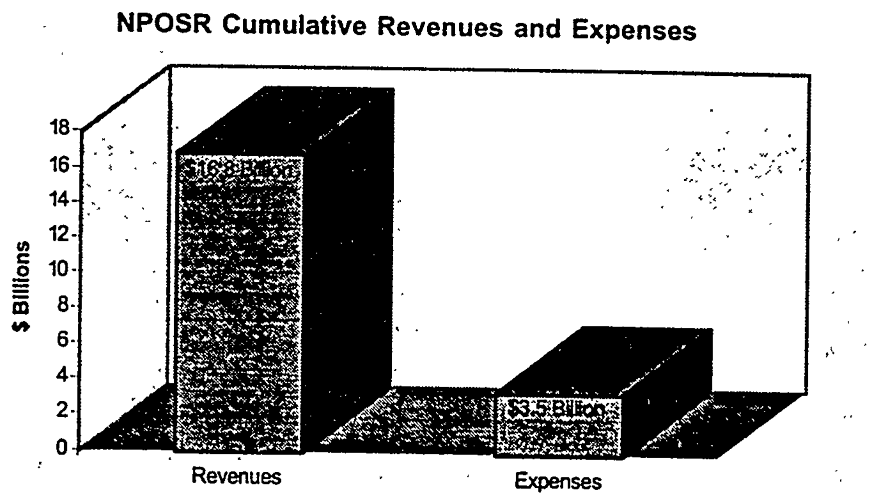
The formation of a marketing group, which includes both DOE and support services personnel from throughout NPOSR, was instrumental in developing a sales program for all of NPOSR to maximize sales revenues. Adopting standard industry practices used within private energy sectors, the marketing group incorporated several major changes into the sales programs at both NPRC and NPOSR-CUW just prior to the start of FY 1996. Some of these changes included new pricing indices, new contract terms and documents, new payment terms, better customer communications, and a streamlining of the entire sales process.

FY 1995 revenues were up $21.6 million over FY 1994, and FY 1996 revenue gains were $29.1 million over FY 1995 revenues. The projections for FY 1997 look even better, with the first two months of FY 1997 already experiencing gains exceeding $25 million over the same period in FY 1996.



NPOSR headquarters costs were about $5.9 million in FY 1996, up significantly from approximately $2.3 million in FY 1995. Headquarters costs have increased dramatically due to divestment activities associated with selling NPR-1, and the evaluation of alternatives regarding the future of the remaining NPOSR properties. Under consideration are continued operations by NPOSR, transfer to another government agency for leasing, or outright sale.

From 1976 through 1996, NPOSR generated $16.8 billion in revenues while expenses during that time amounted to only $3.5 billion. During FY 1996, NPOSR generated $412.2 million in revenues and totaled $161.2 million in expenses, resulting in net income of $251.0 million, compared with net income before cumulative effect of change in accounting principle of $195.5 million in FY 1995. At the 1996 level, the Government would accrue about $1 billion in profits from NPOSR in just five years.



Naval Petroleum Reserves in California

The cogeneration plant, which provides NPR-1 with its own source of electricity by using natural gas produced on site, completed its second year of operation. Revenues from the sale of excess electricity amounted to $2.4 million for FY 1996, up from $1.9 million in FY 1995. Not only does the cogeneration plant produce a revenue stream, but it allows NPRC to avoid approximately $12 million in annual costs if it were to purchase electricity instead of producing it. Construction of new control buildings at both of NPR-1's Low Temperature Separation gas processing plants was completed in FY 1996. The plants now feature state-of-the-art computer process controls and safety enhancements that meet or exceed safety codes and standards. Another facilities project completed at NPR-1 in FY 1996, involved the modification of three tank settings to allow for increased oil production from the Stevens Zone. The $885,000 project cost has a payout of less than six months and more than a 1,000 percent rate of return.

NPRC received a significant honor from the oil and gas industry in FY 1996. *Hart's Oil and Gas World*, one of the industry's leading publications, named NPRC the winner of its "Best Advanced Recovery Project" in its Best of the Pacific contest. NPRC was recognized for using the first large-hole horizontal wells for improved recovery from the 26R pool at Elk Hills. In FY 1996, the successful and highly profitable horizontal drilling program at Elk Hills was expanded to include the SOZ and the 7R pool. Production from all horizontal wells rose to 11,600 barrels of oil per day in FY 1996, an increase of 36 percent over FY 1995.

One of the most significant accomplishments in FY 1996 in terms of production was in the SOZ, the oldest producing zone at NPRC. Completion of a successful gas-injection project, along with profitable liner replacement and infill drilling programs, boosted production in the SOZ to more than 16,000 barrels per day--the highest production level from that zone since 1988 and a 7.6 percent increase over FY 1995.

The FY 1996 drilling and remedial programs at NPRC yielded more than 8,600 barrels of oil per day in additional production. The $46 million cost for these programs was recouped in only 10 months, and tens of millions of dollars will be generated in new net revenues in the future.

With total revenues of $396.6 million and net income to the Government of $258.2 million in FY 1996, Elk Hills is a highly profitable asset. The Elk Hills field is the 11th largest oil field and the 10th largest operating gas field in the lower 48 states. The field produced its billionth barrel of oil in 1992, making Elk Hills only the 13th field in the nation to reach this significant milestone. Even with production already topping a billion barrels, a great deal of oil and gas still remains to be produced. In its annual ranking of U.S. oil fields for 1996, the *Oil & Gas Journal* placed Elk Hills fourth in the nation in terms of remaining reserves.

Naval Petroleum and Oil Shales Reserves--Colorado, Utah, and Wyoming

The NPOSR-CUW staff have taken significant steps during FY 1996 to improve the efficiency, productivity, and profitability of NPR-3 and the NOSRs. The DOE staff in Casper have assumed responsibility for the daily operations of the NOSR programs. The M&O contractor now provides only minimal support, thereby eliminating the need for two management teams (contractor and DOE) and reducing the performance fees being paid. The costs associated with operating and maintenance of the NOSR properties was reduced by $1 million from the previous fiscal year.

A new gas gathering system for NOSR-3 was completed by the Battlement Mesa Gas Gathering Company in September 1996. Under the terms of the gas gathering contract, the costs associated with transporting NOSR-3 gas to a market center will be reduced by almost $500,000. Further, the terms of the gathering contract allow NOSR to adopt sales practices which are seen as customer friendly and will contribute to higher gas prices for the foreseeable future.

A twenty-six well NPR-3 drilling program was completed during FY 1996 and resulted in one of Wyoming's most successful producing Tensleep wells this year. Production from the 63-TPX-10 peaked in March 1996 with a first-day rate of 699 barrels of oil per day and achieved simple payout of its capital expenditures within 2 1/2 months. NPR-3 increased proved sour crude reserves by 72 percent.

Rocky Mountain Oilfield Testing Center

The Rocky Mountain Oilfield Testing Center, now in its third year of operation, has seen growing interest from equipment companies, service companies, and independent operators as a laboratory for testing their inventions--so much so that work is now scheduled six to nine months in advance. RMOTC has helped industry test 58 projects at NPR-3 since the center opened its doors in 1994, with 20 tests being completed in FY 1996.

The number of testing agreements and project work has tripled since the end of FY 1995, with projects totaling approximately $3 million being carried into FY 1997. The technologies tested at RMOTC have a great potential for helping the oil and gas industry reduce operating costs or increase production. These projects are either fully funded by the participating partner, funded by DOE programs, or the partners participate in a cost sharing arrangement with DOE. Many small companies and independent operators are marketing their technology as a result of RMOTC's testing ability.

Seventeen students, representing five universities and colleges, participated in the FY 1996 Summer Intern Program, doubling the participation from the previous year. Six of these interns were from DOE's Historically Black Colleges and Universities Program.

Divestment of Naval Petroleum Reserve No. 1

The future may hold many changes for NPOSR with the passage of the Defense Authorization Act (Act) during FY 1996. The Act, signed by President Clinton on February 10, 1996, establishes a process and schedule for conducting the sale of NPR-1 within two years from enactment, and authorizes DOE to determine what should be done with the remaining NPOSR properties.

The process for selling NPR-1 includes contracting for the services of an investment banker to independently administer the sale; five independent experts in the valuation of the oil and gas fields to separately assess the value of the Government's interest in NPR-1 to be used as the basis for establishing a minimum acceptable price; one independent petroleum engineer to finalize equity with Chevron as required by the Act; and one independent petroleum engineer to prepare a reserve report. To date, firms have been hired to provide investment banking services, equity finalization, a reserve report, legal services, environmental technical support, and support for the Department's Divestment Administration Team (which has responsibility for management and oversight of the sale process).

DOE recently announced its strategy to sell the Government's portion of the Elk Hills field in segments rather than as a single asset in order to increase competition and ensure the highest value to taxpayers. Bids will be solicited for an "operating working interest", where the buyer will become the field's operator, and for multiple "nonoperating working interests", where purchasers will bid for smaller interests in the field. Five independent evaluators will be given the task of assessing the value of the field. Although an official assessment of the field's value is not yet complete, initial estimates have placed the value of Elk Hills somewhere between $1.5 and $4 billion, clearly an exceptionally valuable resource. DOE expects to issue a solicitation of offers in April 1997, with purchase proposals due in September 1997. The sale of the Elk Hills field could be the largest U.S. Government privatization since Conrail in 1987.

Program Performance Measures

The program performance measures for NPOSR disclose program results in relation to program mission, goals, and objectives. The performance measures consider production factors such as production rates, lifting costs, downtime per well and manpower costs per well. The performance measures for each site office, as well as more detailed explanations, are found later in this document. Certain revisions have been made to FY 1995 performance measures in order to conform to the 1996 performance measures format.

1. PRODUCTION RATES measure the degree of success in achieving production targets for the fiscal year.

ANNUAL PRODUCTION	TARGET PRODUCTION FY 1996	ACTUAL PRODUCTION FY 1996	PERCENT OF TARGET FY 1996	TARGET PRODUCTION FY 1995	ACTUAL PRODUCTION FY 1995	PERCENT OF TARGET FY 1995
Crude Oil (Barrels)	17,749,504	17,483,253	98.50%	19,630,331	18,567,790	94.59%
Natural Gas (MCF)	104,583,670	110,357,510	105.52%	109,052,367	100,116,273	91.81%
Propane (Gallons)	65,389,984	47,632,520	72.84%	44,959,005	48,751,133	108.43%
Butane & Butane Plus (Gallons)	37,339,627	31,580,830	84.58%	29,474,271	29,085,128	98.68%
Natural Gasoline (Gallons)	57,195,957	45,356,551	79.30%	42,284,925	42,778,287	101.17%
Isobutane (Gallons)	11,712,000	8,741,673	74.64%	8,869,500	8,738,868	98.53%

Comments: At NPR-1, crude oil and natural gas production were very close to the target levels, however, production of the liquid products (propane, butane, isobutane, and natural gasoline) fell below target levels. NPR-3 production far exceeded their target levels due to the success of the FY 1996 drilling program.

2. LIFTING COSTS are costs incurred to produce a BOE after completion of drilling and before removal for sale or transportation. In other words, it is the cost to bring one BOE to the surface. It is computed by dividing direct costs by the quantity produced.

	FY 1996	FY 1995
Lifting cost per BOE	$1.35	$1.85

Comments: Lifting costs were significantly reduced in large measure due to a work force decrease of approximately 25 percent and a slight increase in production. An NPRC staff reduction near the end of FY 1995 reduced salaries and benefits by $13,000,000. At NPR-3, direct costs were reduced from $5,439,000 down to $4,273,000. A voluntary reduction-in-force in November 1995 resulted in 14 fewer personnel at NPR-3. Additionally, some personnel were transferred to assist with RMOTC activities. Costs were also reduced through strict control at every operating level. Every maintenance project or workover was planned and implemented with cost savings in mind. Salvage equipment and less expensive services were considered for every work order.

3. DOWNTIME PER WELL is the average number of days that producible wells are shut-down for maintenance, remedials, etc., and is computed by dividing the total number of days producible wells are down by the total number of producible wells.

	FY 1996	FY 1995
Downtime per well (days)	12.67	13.15

COMMENT: Producible wells are economically feasible wells and exclude all injection wells, water wells, uneconomic oil and gas wells, and abandoned wells. The downtime per well in FY 1996 is fairly consistent with FY 1995, and is relatively low when compared to industry accepted standards of 15 to 20 days.

4. MANPOWER COSTS PER WELL measures the direct labor costs per active well. Active wells include all wells (producing, injection, and water wells) multiplied by DOE's equity share (by zone at NPR-1 and working interest at NOSR-3).

	FY 1996	FY 1995
Manpower costs per well	$22,089	$27,600

COMMENT: Subcontractor labor is estimated by sampling some of the largest subcontracts and calculating the percentage of those costs that is labor. The percentage is then applied to all subcontractor costs to estimate total subcontractor costs. Manpower costs per well continue to decrease due to successful efforts to reduce labor costs and staffing. During FY 1996, we are beginning to see the benefits of the downsizing effort undertaken during FY 1995.

5. OPERATING COSTS include Federal staffing and support service costs as well as costs usually considered "overhead." Capital investments for drilling, completions, and facilities are excluded from this measure as well as certain nonrecurring expenses.

	FY 1996	FY 1995
Operating costs per BOE	$2.79	$3.45

Comments: Operating costs have been reduced through various cost cutting measures, among them a reduction in the number of employees due to early retirement incentives, a reduction in office expenditures such as rent, telephone, and other miscellaneous items, and a reduction of costs paid to the M&O contractor at NPR-3 due to the DOE field office assuming the daily operations of the NOSRs.

6. NET PROFIT MARGIN PER BOE is computed by subtracting operating costs and depreciation from gross revenues and dividing by BOE produced.

	FY 1996	FY 1995
Net profit per BOE	$6.38	$5.18

COMMENT: NPOSR considers this the most important performance measure. Net profit per BOE increased during FY 1996 largely due to a rise in oil prices and a concerted effort to reduce operating costs.

7. RETURN ON PROPERTY, PLANT, AND EQUIPMENT measures the relationship of net revenues to the net value of capital assets.

	FY 1996	FY 1995
Net revenue/net asset value	$0.49	$0.39

COMMENTS: The return on capital assets is approximately 49¢ for each dollar--up 10¢ from the past year and reflects the increased profitability of the program.

Estimated NPR-1 Reserves

The NPR-1 estimated DOE share of proved oil and gas reserves and changes thereto for FY 1996 and FY 1995 are shown in the following table. These quantities were estimated in FY 1995 by DOE reservoir engineers at the site location, assisted by the M&O contractor and other subcontractors. Current year estimates are made by subtracting FY 1996 production from last years estimates. "Proved Developed and Undeveloped" reserves are estimated to be 383.3 million barrels of oil equivalent (MMBOE) and "Proved Developed" reserves are estimated at 323.4 MMBOE, respectively. As part of the divestiture effort, DOE has contracted with an independent petroleum engineering firm to prepare an updated reserve report which DOE anticipates issuing in April 1997.

ESTIMATED NPR-1 PROVED DEVELOPED
AND UNDEVELOPED RESERVES
(GOVERNMENT SHARE)

	1996	1995
Proved Developed and Undeveloped Reserves (MMBOE)*:		
Beginning of year	408.3	358.3
Revisions of previous estimates	-	75.4
Production**	(25.0)	(25.4)
End of year	383.3	408.3
Proved Developed Reserves (MMBOE)*:		
Beginning of year	348.4	341.0
Revisions of previous estimates	-	32.8
Production**	(25.0)	(25.4)
End of year	323.4	348.4

* MMBOE = Million Barrels of Oil Equivalent and is converted as follows:
- 6 Million British thermal units (MMBtu) = 1 BOE
- 1 MCF of wet gas produced = 1.240 MMBtu
- 1 MCF of residue gas reinjected or sold = 1.107 MMBtu

** Production numbers are net of injected gas in the amount of 13.5 MMBOE and 11.8 MMBOE for 1996 and 1995, respectively.

The proved liquid and gas reserves reported are consistent with current knowledge of the characteristics and production history of the reserves. They include only such reserves as can be classified as proved. FY 1995 estimates of reserve quantities are based on sound geological and engineering principles; but, by their very nature, are still estimates that are subject to substantial upward or downward revision as additional information regarding producing fields and technology becomes available. Proved reserves do not include additional quantities that may result from extensions of currently proved areas, or from application of secondary or tertiary recovery processes not yet tested and/or determined to be economical. Proved developed reserves are the quantities expected to be recovered through existing wells with existing equipment and operating methods. Proved undeveloped reserves are the quantities expected to be recovered through additional development cost and new wells with existing equipment and operating methods.

NPR-1 Discounted Future Net Cash Flows

The standardized measure of discounted future net cash flows related to the above proved oil and gas reserves for NPR-1 is calculated in accordance with the requirements of Statement of Financial Accounting Standards No. 69. Estimated future cash inflows from production are computed by applying estimated annual prices for oil, gas, and natural gas liquids (propane, normal butane, isobutane, and natural gasoline) to average annual quantities of estimated DOE net proved developed and undeveloped reserves to be produced and sold. Such estimates are taken from the *FY 1995 Long Range Plan--Naval Petroleum Reserves in California Vol. II* (LRP).

The FY 1995 LRP includes forecasted future cash inflows using the then-current FY 1995 prices for all products, the trends in the actual prices, and the local (California) market conditions (supply vs. demand relationship). For FY 1996 and beyond, prices were escalated at an assumed annual inflation rate of 3 percent. Similarly, future operating costs were forecasted using past operating cost rates (per reservoir, per kind of the cost rates), and the expected operating cost changes and operating strategies for FY 1995. For FY 1996 and beyond, the operating cost rates were escalated at the assumed annual inflation rate of 3 percent. Drilling, facilities, and other costs were based on actual costs for similar items and the anticipated activities in the future, incorporating appropriate modifications, as required. For FY 1996 and beyond, these costs are escalated at the assumed annual inflation of 3 percent per year. Discounted future net cash flows are calculated using a 10 percent mid-period discount factor.

STANDARDIZED MEASURE OF
NPR-1 FUTURE NET CASH FLOWS
AS OF SEPTEMBER 30, 1996
(in thousands)

Future cash inflows	$ 8,574,244
Future costs	(2,894,329)
Future net cash flows	5,679,914
10% annual discount for estimated timing of cash flows	(3,780,942)
Standardized measure of discounted future net cash flows relating to proved oil and gas reserves	$ 1,898,972

Limitations of the Combined Financial Statements

The combined financial statements have been prepared to report the financial position and results of operations of the entity.

While the statements have been prepared from the books and records of the entity in accordance with the formats prescribed by OMB, the statements are different from the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

These statements should be read with the realization that they are for a sovereign entity, that unfunded liabilities reported in the combined financial statements cannot be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the Government, acting in its sovereign capacity.

KPMG Peat Marwick LLP

60 East South Temple
Suite 900
Salt Lake City, UT 84111

Independent Auditors' Report on Combined Financial Statements

Deputy Assistant Secretary
Naval Petroleum and Oil Shale Reserves
United States Department of Energy:

We have audited the accompanying combined statements of financial position of the U.S. Department of Energy (DOE) Naval Petroleum and Oil Shale Reserves (NPOSR) as of September 30, 1996 and 1995, and the related combined statements of operations and changes in net position, cash flows, and budgetary resources and actual expenses for the years then ended. These combined financial statements are the responsibility of NPOSR management. Our responsibility is to express an opinion on these combined financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in note 1, the combined financial statements were prepared in conformity with the hierarchy of accounting principles and standards recommended by the Federal Accounting Standards Advisory Board. This hierarchy is a comprehensive basis of accounting other than generally accepted accounting principles. Primary differences include the presentation of combined statements of budgetary resources and actual expenses, certain form and content changes to the combined financial statements and cash flows, and certain other disclosures.

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the combined financial position of NPOSR at September 30, 1996 and 1995, and the combined results of its operations and changes in net position, cash flows, and budgetary resources and actual expenses for the years then ended in conformity with the accounting policies described above.

In accordance with *Government Auditing Standards*, we also issued reports dated November 15, 1996, on our consideration of NPOSR's internal control structure and on its compliance with laws and regulations.

U.S. Department of Energy
Washington, D.C.

Our audits were made for the purpose of forming an opinion on the combined financial statements taken as a whole. The accompanying combining information is presented for purposes of additional analysis of the combined financial statements rather than to present the financial position, result of operations and changes in net position, cash flows, and budgetary resources and actual expenses of the individual locations. The combining information has been subjected to the auditing procedures applied in the audits of the combined financial statements and, in our opinion, is fairly stated in all material respects in relation to the 1996 combined financial statements taken as a whole.

As discussed in notes 1 and 17 to the combined financial statements, NPOSR adopted Financial Accounting Standards Board's Statement of Financial Accounting Standards (SFAS) No. 121 *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of*, effective September 30, 1995.

The information presented in management's Overview is not a required part of the combined financial statements, but is supplementary information required by OMB Bulletin 94-01, *Form and Content of Agency Financial Statements*. We have considered whether this information is materially inconsistent with the combined financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the combined financial statements and, accordingly, we do not express an opinion on it. The performance information included in management's Overview is addressed in our auditors' report on the internal control structure in accordance with OMB Bulletin 93-06.

This report is intended for the information of the management of NPOSR and DOE. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

KPMG Peat Marwick LLP

Salt Lake City, Utah
November 15, 1996

U.S. DEPARTMENT OF ENERGY

NAVAL PETROLEUM AND OIL SHALE RESERVES

Combined Statements of Financial Position

September 30, 1996 and 1995

	1996	1995
Assets		
Entity assets:		
Intragovernmental:		
Fund balance with U.S. Treasury (note 2)	$ 122,260,921	143,082,228
Accounts receivable, net	9,982	9,982
Advances and prepayments	6,000	-
Governmental:		
Accounts receivable, net (note 3)	41,249,838	20,722,925
Advances and prepayments	111,556	126,546
Cash	4,500	4,500
Inventories held for sale, net (note 4)	1,997,041	2,740,100
Operating materials and supplies, net (note 4)	4,352,151	5,002,342
Property and equipment, net (note 5)	519,597,695	526,171,865
Nonentity assets:		
Intragovernmental:		
Fund balance with U.S. Treasury - restricted (note 2)	424,593,078	424,664,028
Total assets	$ 1,114,182,762	1,122,524,516
Liabilities		
Liabilities covered by budgetary resources:		
Intragovernmental:		
Other funded liabilities (note 6)	$ 44,548,197	-
Governmental:		
Accounts payable	25,474,110	27,493,071
Accrued payroll, benefits, and vacation pay	4,237,622	5,047,993
Other funded liabilities (note 6)	810,000	1,004,887
Total liabilities covered by budgetary resources	75,069,929	33,545,951
Liabilities not covered by budgetary resources:		
Governmental:		
Accrued annual leave	488,264	457,548
Pension and other retirement benefits (note 10)	14,927,711	13,140,314
Environmental restoration liabilities (note 11 (b))	49,738,360	38,360,360
Total liabilities not covered by budgetary resources	65,154,335	51,958,222
Total liabilities	140,224,264	85,504,173
Net Position		
Balances:		
Unexpended appropriations	516,628,256	534,261,909
Invested capital	523,949,846	531,174,207
Cumulative results of operations	(1,465,269)	23,542,449
Less future funding requirements	65,154,335	51,958,222
Net position (note 12)	973,958,498	1,037,020,343
Total liabilities and net position	$ 1,114,182,762	1,122,524,516

The accompanying notes are an integral part of these combined financial statements.

U.S. DEPARTMENT OF ENERGY

NAVAL PETROLEUM AND OIL SHALE RESERVES

Combined Statements of Operations and Changes in Net Position

Years ended September 30, 1996 and 1995

	1996	1995
Appropriations	$ 148,433,000	186,993,054
Program revenues and expenses:		
Revenues (note 13):		
Sales of product	409,302,785	381,093,096
Other income	2,876,247	1,989,127
Total revenues	412,179,032	383,082,223
Expenses:		
Program and operating expenses (note 14):		
Personal services and benefits	45,032,985	61,467,625
Contractual services	42,334,928	44,613,879
Utilities, rent, and communications	4,306,540	6,378,747
Supplies and materials	11,030,263	13,008,500
Equipment not capitalized	5,138,781	4,650,706
Travel and transportation	4,254,145	5,340,704
Printing and reproduction	193,777	173,360
Other (note 15)	13,771,125	20,843,646
Depreciation	44,556,463	45,303,714
Environmental restoration (note 11 (b))	11,378,000	14,260,360
Less joint interest reimbursement (excluding capital additions reimbursements of $7,583,198 and $7,733,433)	20,804,286	28,462,700
Net expenses	161,192,721	187,578,541
Net income before cumulative effect of change in accounting principle	250,986,311	195,503,682
Cumulative effect of change in accounting principle (note 17)	-	(16,003,699)
Net income	250,986,311	179,499,983
Transferred to U.S. Treasury	439,158,793	412,144,044
Shortage of appropriations and net income under transfers	$ (39,739,482)	(45,651,007)
Net position:		
Net position, beginning balance, as previously stated	$ 1,037,020,343	1,082,671,350
Adjustment (note 18)	(23,322,363)	-
Net position, beginning, balance as restated	1,013,697,980	1,082,671,350
Shortage of appropriations and net income over transfers	(39,739,482)	(45,651,007)
Net position, ending balance	$ 973,958,498	1,037,020,343

The accompanying notes are an integral part of these combined financial statements.

U.S. DEPARTMENT OF ENERGY

NAVAL PETROLEUM AND OIL SHALE RESERVES

Combined Statements of Cash Flows

Years ended September 30, 1996 and 1995

	1996	1995
Cash flows from operating activities:		
Net income	$ 250,986,311	179,499,983
Adjustments affecting cash flow:		
Depreciation	44,556,463	45,303,714
Provision for inventory obsolescence	21,195	4,432,628
Provision for asset impairment	-	16,003,699
Increase in unfunded environmental restoration liabilities	11,378,000	14,260,360
Increase in unfunded pension, other retirement benefits, and accrued annual leave	1,818,113	(1,943,310)
Increase in accounts receivable	(20,526,913)	(3,340,674)
Decrease in inventories	1,372,055	338,509
Decrease in advances and prepayments	8,990	11,149
Decrease in accounts payable	(2,018,961)	(6,737,930)
Increase (decrease) in other funded liabilities and accrued payroll, benefits and vacation pay	43,542,939	(341,507)
Net cash provided by operating activities	331,138,192	247,486,621
Cash flows from investing activities - purchases of property, plant, and equipment	(37,982,293)	(38,066,101)
Cash flows from financing activities:		
Appropriations	148,433,000	186,993,054
Adjustment (note 18)	(23,322,363)	-
Transferred to U.S. Treasury	(439,158,793)	(412,144,044)
Net cash used in financing activities	(314,048,156)	(225,150,990)
Net cash used in operating, investing, and financing activities	(20,892,257)	(15,730,470)
Fund balance with U.S. Treasury and cash, beginning of year	567,750,756	583,481,226
Fund balance with U.S. Treasury and cash, end of year	$ 546,858,499	567,750,756

The accompanying notes are an integral part of these combined financial statements.

U.S. DEPARTMENT OF ENERGY

NAVAL PETROLEUM AND OIL SHALE RESERVES

Combined Statements of Budgetary Resources and Actual Expenses

Years ended September 30, 1996 and 1995

	Budget			Actual
		Obligations		
	Resources	Direct	Reimbursed	Net expenses
1996	$ 590,250,452	152,253,053	-	161,192,721
1995	$ 637,111,376	198,026,671	-	187,578,541

Budget Reconciliation

	1996	1995
A Net expenses	$ 161,192,721	187,578,541
B Add:		
Capital acquisitions	37,982,293	38,066,101
Changes in inventories	644,981	(6,558,065)
Joint interest reimbursements	28,387,484	36,196,133
C Less:		
Depreciation	44,556,463	45,303,714
Unfunded environmental restoration	11,378,000	14,260,360
Other unfunded expenses	1,818,113	(1,943,310)
Other	1,825,503	(1,220,645)
D Accrued expenditures	168,629,400	198,882,591
E Less reimbursements	2,562,748	1,929,824
F Accrued expenditures	$ 166,066,652	196,952,767

The accompanying notes are an integral part of these combined financial statements.

(1) Summary of Significant Accounting Policies

(a) Basis of Presentation

These combined financial statements have been prepared to report the financial position and results of operations of the Naval Petroleum and Oil Shale Reserves (NPOSR). They have been prepared from the books and records of NPOSR based on a comprehensive basis of accounting other than generally accepted accounting principles. The hierarchy of accounting principles consist of standards published by the Joint Financial Management Improvement Program, Office of Management and Budget (OMB) in OMB Bulletin 94-01 *Form and Content of Agency Financial Statements*, Department of Energy (DOE) accounting guidance, and accounting principles published by authoritative standard setting bodies. Primary differences include the presentation of combined statements of budgetary resources and actual expenses, certain form and content changes to the combined financial statements and cash flows, and certain other disclosures.

(b) Description of Reporting Entity

NPOSR consists of petroleum reserves in California and Wyoming, oil shale reserves in Colorado and Utah, and the Rocky Mountain Oilfield Testing Center (RMOTC) in Wyoming. The federal Government's interests in NPOSR are managed by the DOE through DOE's headquarters office in Washington, D.C. In addition to the DOE headquarters office, DOE has site offices in both California and Wyoming that are responsible for contractor oversight functions. Day-to-day operations are conducted under contract by two management and operating contractors. NPOSR also contracts for certain services with other DOE field offices.

The accompanying combined financial statements of NPOSR include the accounts of all funds under NPOSR control.

(i) NPOSR - Headquarters (NPOSR-HQ)

The Secretary of DOE has delegated the overall responsibility for achieving the mission and goals of NPOSR to the Assistant Secretary for Fossil Energy. Under the Assistant Secretary's direction, the Deputy Assistant Secretary for NPOSR is responsible for programmatic and operational management of NPOSR. NPOSR-HQ office provides staff support to the Assistant Secretary and Deputy Assistant Secretary. Consequently, NPOSR incurs certain headquarters expenses including payroll, travel, office equipment purchases, and other administrative services and supplies expense.

(ii) DOE - Site Offices

DOE site offices are responsible for monitoring day-to-day operations, and performing contractor oversight functions. The site offices report directly to NPOSR-HQ. Expenses incurred primarily include payroll, certain subcontract costs, travel, and other administrative costs. A summary of specific locations for which oversight functions are performed is provided below.

(iia) Naval Petroleum Reserves in California

The Naval Petroleum Reserves in California (NPRC) consists of the interests of DOE in both the unit and nonunit operations of Naval Petroleum Reserve No. 1 (NPR-1) and in Naval Petroleum Reserve No. 2 (NPR-2). The principal interests are minerals under the surface lands in Kern County, California. DOE's site office is in Elk Hills, California.

Except for certain limited acreage, NPR-1 is operated as a unit in accordance with a Unit Plan Contract (UPC) executed June 19, 1944, and amended December 22, 1948, by the United States of America and Standard Oil Company of California (Standard). Standard transferred its interest in the UPC to its wholly owned subsidiary, Chevron USA, Inc. (Chevron), effective January 1, 1977. The UPC enables the unit participants to develop the field on a reservoir basis rather than a parcel-by-parcel basis. Under the UPC, each participant shares in the unit costs and production of petroleum in proportion to the acre-feet of commercially productive oil and gas formations (zones) underlying their respective surface lands as of November 20, 1942.

Based on the most recent equity determination studies agreed upon by the two parties, it is estimated that approximately 22 percent of the commercially productive formations within the unit is owned by Chevron. Chevron's share of NPR-1 production is delivered in kind. In addition, Chevron may purchase crude oil and natural gas via a competitive bid process open to the public.

(iib) Naval Petroleum Oil Shale Reserves, Colorado, Utah, and Wyoming

The Naval Petroleum Oil Shale Reserves, Colorado, Utah, and Wyoming (NPOSR-CUW) consists of interests of DOE in the Naval Petroleum Reserve No. 3 (NPR-3) in Natrona County, Wyoming; Naval Oil Shale Reserves (NOSR) Nos. 1 and 3 in Garfield County, Colorado; NOSR No. 2 in Uintah County, Utah; and the Rocky Mountain Oil field Testing Center (RMOTC) co-located with NPR-3. DOE's site office is in Casper, Wyoming.

(iib) Naval Petroleum Oil Shale Reserves, Colorado, Utah, and Wyoming (continued)

At present, DOE is not authorized by law to develop the oil shale resources at the NOSR. However, the oil shale reserves in Colorado are situated close to natural gas producing fields and some portion of these gas resources underlie NOSR Nos. 1 and 3. DOE has the responsibility for protecting the Government's interest in these resources. Therefore, under the gas protection program, DOE either drills offset wells or communitizes wells whose drainage areas overlap private and Federal land where private development is taking place. Development costs of new wells and production are based on percentage ownership of the surface acreage. Cash advances are received from joint interest owners for their share of the communitized well operating costs.

(iii) Management and Operating Contractors

Bechtel Petroleum Operations, Inc. (Bechtel) and Fluor Daniel (NPOSR), Inc. (Fluor Daniel) are management and operating contractors (contractors) performing operations, maintenance, logistics support, engineering, technical, and administrative services. In return, DOE reimburses all allowable costs under the contracts, pays award fees, and provides the property, plant, and equipment necessary for the operations of NPOSR. Bechtel has served as the management and operating unit contractor for NPR-1 in accordance with DOE contract (No. DE-ACO1-85FE60520) since July 31, 1985. As authorized by the Defense Authorization Act (Public Law 104-106), the Bechtel contract has been extended through July 30, 1997. Fluor Daniel was awarded the DOE management and operating contract (No. DE-AC01-92FE62316) for NPR-3 effective October 1, 1992. Fluor Daniel's contract expires September 30, 1997.

The contractors integrate their accounting systems with DOE through the use of reciprocal accounts. The contractors are required under provisions of their respective contracts to maintain a separate set of accounts and records for recording and reporting all financial related transactions in accordance with DOE accounting practices and procedures.

(c) Basis of Accounting

Transactions are recorded on an accrual accounting basis and a budgetary basis. Under the accrual method, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds.

The statements of financial position exclude Chevron's interests in NPR-1 for the respective asset and liability amounts. Joint interest reimbursements billed to Chevron for its respective share of the costs incurred to operate NPR-1 are presented in the accompanying statements of operations and changes in net position; however, such reimbursements are not a component of net income.

(c) Basis of Accounting (continued)

NPR-1 includes primarily lands withdrawn from public sale initially in 1912, with additional withdrawals in 1942. NPR-3 includes lands withdrawn from public sale in 1915. The Secretary of the Navy was granted authority to take possession of all properties within NPR-1 and NPR-3 for the sole control and use of the United States. Therefore, no value is shown for crude oil and gas reserves underlying these lands.

(d) Appropriations and Revenues

With the exception of NOSR-3, Congress annually adopts a budget appropriation providing NPOSR with funding to meet operating and capital expense requirements. NOSR-3 is the only NPOSR operation funded by the proceeds it generates.

Crude oil, natural gas, and liquid gas products are sold under contracts to public customers at bid prices. Gross revenue is recorded at the time the product is delivered to the customer at the pipeline or truck terminal. In addition, royalties are recorded as revenues when the product is delivered by the operator of leased acreage in which DOE has a royalty interest. NPR-2 royalty income is paid directly to DOE by the leaseholder. Proceeds from sales at NPR-1 and NPOSR-CUW and royalties from NPR-2 are deposited into the U.S. Treasury as required by the Production Act of 1976.

(e) Funds with the U.S. Treasury and Cash

NPOSR does not maintain cash in commercial bank accounts. Cash receipts and disbursements are processed by the U.S. Treasury. Funds with the U.S. Treasury represent appropriated funds that are available to pay current liabilities and finance authorized purchase commitments. Cash balances held outside the U.S. Treasury represent imprest cash amounts.

Revenues from the sale of petroleum products are deposited in the U.S. Treasury's Miscellaneous Receipts account and, except for revenue generated from the sale of natural gas from wells drilled or communitized in 1990 and thereafter at NOSR-3, are not available for expenditure by NPOSR.

(f) Inventories Held for Sale and Operating Materials and Supplies

NPOSR inventories held for sale primarily consist of crude oil in the pipeline that is valued at the current market price. NPOSR operating materials and supplies consist of inventories that will be consumed in future operations. The consumable inventory is stated at the lower of cost, using the weighted-average method; or estimated realizable value. Recorded values for consumable inventory are adjusted for the results of physical inventories taken periodically in accordance with a cyclical counting plan.

(g) Property, Plant, and Equipment

Costs for real property with an expected life in excess of two years, and costs for personal property with an expected life in excess of two years and an initial cost of at least $5,000, are capitalized. Costs of major additions, improvements, and replacement of equipment are capitalized. Costs of maintenance and repairs are charged to expense as incurred. Costs and accumulated depreciation of equipment retired, abandoned, or otherwise disposed of are removed from the accounts upon disposal, and any resulting gain or loss is included in operations in the year of disposition.

Exploration and development operations are accounted for by the successful-efforts method, in accordance with Statement of Financial Accounting Standards (SFAS) No. 19 of the Financial Accounting Standards Board (FASB). Tangible and intangible costs of drilling and equipping development wells and development-type stratigraphic test wells are capitalized, whether or not the wells are productive. Costs of drilling exploratory wells are initially capitalized pending determination of whether or not such wells have found proven reserves. If such wells do not find proven reserves, the costs, net of any salvage value, are charged to exploratory expenses.

Depreciation is computed on DOE's interest in drilling and development costs, well equipment, gas plant (NPR-3), and production facilities based on the units-of-production method. Depreciation of gas plant (NPR-1), buildings, structures, office, and other equipment is computed on the straight-line method over the estimated useful lives, which range from 6 to 30 years. Depreciation on used plant, consisting of plant and equipment temporarily out of service, is computed on the straight-line method over the estimated useful lives, which range from 5 to 50 years.

Effective September 30, 1995, NPOSR adopted SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of,* which set forth circumstances under which an entity must review long lived assets for impairment. The cumulative effect of the change in method for accounting for impaired long-lived assets is reported in the 1995 combined statement of operations and changes in net position.

(h) Advances and Prepayments

Payments in advance of the receipt of goods and services are recorded as prepaid charges at the time of prepayment and recognized as expenditures/expenses when the related goods or services are received.

(i) Liabilities

Liabilities represent the amount of monies or other resources that are likely to be paid by NPOSR as the result of a transaction or event that has already occurred. However, no liability can be paid by NPOSR absent an appropriation. Liabilities for which an appropriation has not been enacted are, therefore, classified as unfunded liabilities, and there is no certainty that the appropriations will be enacted. Also, liabilities of NPOSR arising from other than contracts can be abrogated by the Government, acting in its sovereign capacity.

(j) Accrued Annual Leave

Accrued annual leave is accrued as it is earned, and the accrual is reduced as leave is taken. Each year, the accrued annual leave balance is adjusted to reflect current pay rates. To the extent that current or prior year appropriations are not available to fund annual leave earned but not taken, funding will be obtained from future financing sources. Sick leave and other types of nonvested leave are expended as leave is taken.

(k) Retirement Plans

NPOSR personnel, as employees of either DOE or of the management and operating contractors, may be participants in certain benefit plans. Bechtel sponsors a defined-benefit pension plan and a defined-benefit health care plan for certain retirees and employees. The provisions of these plans are discussed in note 10. DOE does not report plan assets, accumulated plan benefits, or unfunded liabilities, if any, applicable to its employees. Reporting such amounts is the responsibility of the Office of Personnel Management and the Federal Employees Retirement System.

Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, directs the full cost reporting of employment benefits by employing entity. Under this concept, NPOSR will be required to accrue the costs to the Federal government of providing pension, life, health, and other post-employment benefits (severance payments, counseling and training, workers' compensation benefits, etc.); "regardless of whether the benefits are funded by the reporting entity or by direct appropriations to the trust funds." SFFAS No. 4 will be effective for fiscal years beginning after September 30, 1996.

(l) Reclassifications

Certain reclassifications have been made in order to conform 1995 financial information with the 1996 financial information format. These reclassifications do not impact the combined financial position or results of operations of NPOSR.

(m) Use of Estimates

NPOSR's management has made certain estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these combined financial statements. Actual results could differ from these estimates.

(2) Fund Balances with U.S. Treasury and Cash

Fund balances (appropriated) with the U.S. Treasury include the following as of September 30, 1996 and 1995:

	1996	1995
Unexpended allotments	$ 122,000,921	143,082,228
Unapportioned revenues	424,593;078	424,664,028
Suspense	260,000	-
Total	$ 546,853,999	567,746,256

Cash includes imprest funds of $4,500 as of September 30, 1996 and 1995.

(3) Governmental Accounts Receivable

Governmental accounts receivable includes the following as of September 30, 1996 and 1995:

	1996	1995
Sales of products and earned royalties	$ 35,988,965	12,256,871
Chevron's share of billed operating costs	2,792,348	6,563,092
Chevron's share of unbilled operating costs	1,799,974	1,393,658
Other	668,551	606,626
Less allowance for doubtful accounts	-	97,322
Total	$ 41,249,838	20,722,925

(4) Inventories Held for Sale and Operating Materials and Supplies

Inventories include the following as of September 30, 1996 and 1995:

	1996	1995
Operating materials and supplies	$ 12,799,081	13,730,145
Less allowance for obsolescence and overstocking	7,608,783	7,629,275
Less Chevron's ownership	838,147	1,098,528
Subtotal	4,352,151	5,002,342
Inventories held for sale--product	1,997,041	2,740,100
Total	$ 6,349,192	7,742,442

(5) Property, Plant, and Equipment

Property, plant, and equipment includes the following as of September 30, 1996 and 1995:

	1996	1995
Buildings, structures, and improvements	$ 30,836,547	29,800,556
Gas and electric production, transmission, and distribution systems	396,865,769	389,809,620
Crude oil extraction, water supply pumping, treatment, and distribution systems	1,054,995,157	1,017,884,616
Office, transportation, security, ADP, and other equipment	21,535,621	21,102,448
Less Chevron's ownership	280,156,692	273,237,036
	1,224,076,402	1,185,360,204
Less NPOSR accumulated depreciation	711,832,557	672,309,095
	512,243,845	513,051,109
Construction work-in-progress (net of Chevron ownership of $2,048,832 and $2,801,306, for 1996 and 1995, respectively)	7,353,850	13,120,756
Total	$ 519,597,695	526,171,865

(6) Other Funded Liabilities

Other funded liabilities covered by budgetary resources include the following as of September 30, 1996 and 1995:

	1996	1995
(a) Intragovernmental:		
Uncollected product receivables due the U.S. Treasury	$ 41,160,354	-
Unsold product inventories due the U.S. Treasury	1,997,041	-
Due to U.S. Treasury for payment of legal claims	1,390,802	-
Total intragovernmental	$ 44,548,197	-
(b) Governmental:		
Funded pension expenses	$ 550,000	977,660
Customer deposit	260,000	-
Deferred revenue	-	27,227
Total governmental	$ 810,000	1,004,887

(7) Operating Leases

Bechtel has entered into an operating lease for a telephone communication system. The lease required payments of approximately $226,600 annually and expires in December 1996. DOE site office in Casper, Wyoming, entered into an operating lease for an office building. The lease required annual rental payments of $134,126 and expired in September 1996. A three-year agreement has been signed, requiring annual rental payments of $111,084 through September 1999.

The contractors also enter into various rental agreements for equipment used in NPOSR operations on a day-to-day and/or month-to-month basis. Rent expense amounted to approximately $2,067,422, and $2,934,900 for 1996 and 1995, respectively.

(8) Related Party Transactions

Vehicles are leased on a month-to-month basis to the contractors through an interagency agreement between DOE and General Services Administration (GSA). Monthly rent charges are determined based on the number and type of vehicles in service and are submitted to GSA. DOE receives a reimbursement from GSA for operating expenses incurred, including gas and oil, repairs, etc. These transactions are summarized as follows for 1996 and 1995:

	1996	1995
Rent expense	$ 1,240,601	1,365,047
Reimbursement of operating expenses	(389,748)	(417,213)

Certain management, construction, and supporting services are provided to the contractors by their respective general and central staff organizations, or by affiliated companies. Cost of services provided amounted to $78,982 and $473,799 for 1996 and 1995, respectively. These costs were reviewed and approved by the respective DOE site offices.

NPOSR-CUW has contracted with the Bureau of Land Management (BLM) to administer the surface resources management of the NOSR lands in a manner consistent with the surrounding public lands. Specific activities performed by BLM include road maintenance, prevention of erosion damage to the range and streams, monitoring of cattle grazing on NOSR lands, and the prevention of illegal hunting activities. BLM monitors NOSR lands from three different offices (Vernal, UT; Grand Junction, CO; and Moab, UT.) Cost of services provided amounted to $25,000 and $104,509 for 1996 and 1995, respectively.

(9) Sales Commitments

NPOSR sells crude oil, natural gas, and various natural gas liquids (NGL) produced from NPR-1, NPR-3, and NOSR-3. Products are sold under contracts ranging from one month to one year. Invoice prices are based on established indices which are adjusted monthly with a specific bid premium or discount applied to the index specified in the sales contracts. NPOSR had the following product sales commitments under the applicable pricing mechanism in effect at September 30, 1996:

Product	Unit of Measure*	Bid Quantity	Index**	Premium / Discount Low	Premium / Discount High
NPRC					
Crude Oil	Bbls/day	15,000	NYMEX	$(2.0850)	$(1.8480)
Crude Oil	Bbls/day	29,350	Postings	(0.0514)	0.2570
Natural Gas	MMBtu/day	77,800	Index Prices	(0.0048)	(0.0027)
Natural Gasoline	Gallons/day	113,500	Postings	(0.0199)	0.0000
NGL	Gallons/day	219,500	OBG	(0.0649)	0.0671
NPR-3					
Crude Oil	Bbls/day	1,800	Postings	$(0.7200)	$1.2600
NGL	Gallons/day	6,500	OBG	(0.8500)	(0.0200)
NOSR-3					
Condensate	Bbls/month	200	Postings	$(1.0000)	$(1.0000)
Natural Gas	MMBtu/day	7,400	Index Prices	(0.3348)	(0.3348)

* Units of measure: Bbls = barrels; MMBtu = Million british thermal units
** Description of indices:

NYMEX - Invoice prices are indexed to the average of closing sweet crude oil prices reported by the New York Mercantile Exchange for the last 10-days of the near-month. The invoice price is constant during the delivery month.

Postings - Postings are prices at which refineries offer to buy oil. NPR-1 oil, NPR-1 natural gasoline, NPR-3 oil and NOSR-3 condensate are sold at a bonus/discount to the average of the three highest postings for their region. The invoice prices may change several times each month.

Index Prices - Natural Gas prices are calculated once each month and are tied to the monthly index prices reported by *Inside FERC's Gas Market Report* and *Natural Gas Week's Natural Gas Intelligence.*

OBG - NGL invoice prices are calculated once each month, and are indexed to spot prices published in *Bloomberg's Oil Buyers' Guide.*

(10) Pension and Other Retirement Benefits

Bechtel has a defined-benefit pension plan covering all full-time employees. The benefits are based on years of service and the employee's highest five (5) consecutive years of compensation. Bechtel and/or individual employees may in future years make contributions to the plan, acting under the advice of the actuary, to meet the minimum funding requirements of the Employee Retirement Income Security Act of 1974 to maintain the plan and trust for employees. The following table sets forth the plan's status as of September 30, 1996 and 1995:

		1996	1995
Actuarial present value of benefit obligations:			
Vested benefit obligation	$	18,278,162	16,230,897
Accumulated benefit obligation	$	18,645,478	16,787,791
Projected benefit obligation for services rendered to date	$	24,702,881	23,440,470
Plan assets at fair value		(21,052,179)	(18,684,413)
Plan assets less than projected benefit obligation		3,650,702	4,756,057
Unrecognized net loss		(3,425,517)	(5,495,648)
Unrecognized prior service cost		168,849	187,878
Unrecognized net asset recognized over 15 years		2,399,057	2,723,930
		2,793,091	2,172,217
Less Chevron's portion		614,480	474,233
Accrued pension cost*	$	2,178,611	1,697,984

* of which $1,749,611 and $931,754 represent unfunded liabilities for 1996 and 1995, respectively.

The net pension cost includes the following for 1996 and 1995:

		1996	1995
Service cost-benefits earned during the period	$	1,303,924	1,594,823
Interest cost on projected benefit obligation		1,756,756	1,713,744
Actual return on plan asset		(1,608,675)	(3,147,214)
Net amortization and deferral		(116,284)	1,837,944
		1,335,721	1,999,297
Curtailment (voluntary termination) effect		-	(2,251,369)
		1,335,721	(252,072)
Less Chevron's portion		293,859	(55,456)
Net pension cost (gain)	$	1,041,862	(196,616)

(10) Pension and Other Retirement Benefits (continued)

Assumptions used in accounting for the pension plan for 1996 and 1995 are as follows:

	1996	1995
Discount rate	7.75%	7.50%
Rate of increase in compensation level	5.00%	5.00%
Expected long-term rate of return on assets	8.50%	8.00%*

* Incorrectly reported in the FY 1995 combined financial statements.

The discount rate is 7.75% as of October 1, 1996.

In addition to the defined-benefit pension plan, Bechtel sponsors defined-benefit plans that provide postretirement medical and dental benefits to full-time employees who meet minimum age and service requirements. The plans are contributory, with retiree contributions adjusted annually, and contain other cost-sharing features such as deductibles and coinsurance. The accounting for the plans anticipate future cost-sharing changes to the written plans that are consistent with Bechtel's expressed intent to increase the retiree contribution rate annually for the expected general inflation rate for that year. Bechtel's intent to fund the cost of these postretirement benefits is subject to the discretion of DOE.

The following table sets forth the plan's status as of September 30, 1996 and 1995:

	1996	1995
Accumulated postretirement benefit obligation:		
Retirees	$ 4,647,000	1,900,000
Fully eligible active plan participants	2,852,000	3,658,000
Other active plan participant	7,825,000	6,689,000
Total accumulated postretirement benefit obligation	15,324,000	12,247,000
Plan assets at fair value	-	-
Accumulated postretirement benefit obligation in excess of plan assets	15,324,000	12,247,000
Unrecognized net gain	1,571,000	3,405,000
	16,895,000	15,652,000
Less Chevron's portion	3,716,900	3,443,440
Accrued postretirement benefit cost included in unfunded liabilities	$ 13,178,100	12,208,560

(10) Pension and Other Retirement Benefits (continued)

Net period postretirement benefit cost for 1996 and 1995 includes the following components:

		1996	1995
Service cost	$	889,000	954,000
Interest cost		1,065,000	1,099,000
Actual return on plan assets		-	-
Net amortization and deferral		-	-
		1,954,000	2,053,000
Curtailment Effect		-	(1,615,000)
		1,954,000	438,000
Less Chevron's portion		429,880	96,360
Net periodic postretirement benefit cost	$	1,524,120	341,640

For measurement purposes, an annual rate of increase in the per-capita cost of covered benefits (i.e., health care cost trend rate) of 8.5 percent (medical) and 7.1 percent (dental) were assumed for 1996. Both rates were assumed to decrease gradually to 5.5 percent by the year 2002 and remain at that level thereafter. The health-care cost trend rate assumption has a significant effect on the amounts reported. For example, increasing the assumed health-care cost trend rates by one percentage point in each year would increase the accumulated postretirement benefit obligation as of September 30, 1996 by $2,402,000 and the aggregate of the service and interest cost components of net periodic postretirement benefit cost for the year ended September 30, 1996 by $388,000.

The weighted average discount rate used in determining the accumulated postretirement benefit obligation was 7.75 percent as of September 30, 1996. Funded costs for post retirement benefits other than pension amounted to $304,000, and $164,000 for 1996 and 1995, respectively.

The following table sets forth the reconciliation of unfunded pension and other retirement benefits as of September 30, 1996:

		Total	Chevron's portion	DOE's portion
Unfunded pension liability	$	2,243,091	493,480	1,749,611
Funded portion		550,000	121,000	429,000
Total pension liability	$	2,793,091	614,480	2,178,611

Unfunded pension liability (SFAS No. 87)	$	1,749,611
Accrued unfunded post retirement benefit cost (SFAS No. 106)		13,178,100
Total pension liability	$	14,927,711

(10) Pension and Other Retirement Benefits (continued)

All permanent DOE employees participate in either the Civil Service Retirement System (CSRS), or the Federal Employees Retirement System (FERS). DOE makes matching contributions equal to 7 percent of pay to the CSRS. Most employees hired after December 31, 1983, are automatically covered by FERS and Social Security. Employees hired prior to January 1, 1984, can elect to either join FERS and Social Security or remain in CSRS. A primary feature of FERS is that it offers a savings plan to DOE employees, which automatically contributes 1 percent of pay and matches any employee contribution up to an additional 4 percent of pay. Total DOE contributions for the two plans amounted to $422,472 and $466,254 for 1996 and 1995, respectively.

All regular employees of the contractors are eligible to participate in company sponsored 401(k) retirement plans. Bechtel matches employee contributions fifty cents per dollar for employee contributions up to 6 percent of compensation for all plan participants. Fluor Daniel matches employee contributions dollar per dollar up to 3.5 percent of compensation plus 1.5 percent for all participants for employees retaining project benefits. Fluor Daniel matches employee contributions dollar per dollar up to 4 percent for new project employees covered under Fluor Daniel benefits. New employees are also eligible for benefits under the Fluor Daniel Employees' Retirement Plan where Fluor Daniel contributes 7 percent of applicable compensation. Total contributions to these plans amounted to $843,564 and $970,225 for 1996 and 1995, respectively.

(11) Commitments and Contingent Liabilities

(a) Ownership Adjustments

As described in note 1, DOE shares ownership of the oil and gas reserves of the Elk Hills NPR-1 unit (Elk Hills) with Chevron. Participating percentages are determined in proportion to the weighted acre-feet of commercially productive formations (zones) underlying their respective surface lands as of November 20, 1942. The participating percentages in effect at September 30, 1996, were calculated based upon equity studies dated in 1957 for the Shallow Oil Zone (SOZ), 1980 for the Stevens Zone, 1994 for the Dry Gas Zone (although the two parties have tentatively agreed to continue using the 1942 percentages pending resolution of the SOZ), and 1976 for the Carneros Zone. In accordance with the Unit Plan Contract, production participation (proportionate participating percentages) for Elk Hills will be adjusted retroactively to 1942 at such time that updated equity studies are completed and agreed upon by the two parties.

(a) Ownership Adjustments (continued)

DOE and Chevron are in the process of revising the participating percentages of the Shallow Oil Zone. In November 1995, an independent petroleum engineer hired by both parties to study the issue released a report showing DOE's participation in the Shallow Oil Zone decreasing from 70.0119 percent to 65.7786 percent. If the participating percentages in this report are adopted, DOE would owe Chevron approximately 12.7 million barrels of crude oil due to past production and 3.9 million barrels of future production based on remaining reserves at September 30, 1995. This could equate to Chevron receiving all of DOE's share of production from the Shallow Oil Zone for approximately 3.5 years to pay back the 12.7 million barrels. At $15 per barrel, the 12.7 million barrels of payback oil is worth approximately $190 million, and the 3.9 million barrels of future additional production is worth approximately $58.5 million. DOE, NPRC believes that the consultant study contains serious methodological errors, and has challenged the results. The next stage in resolving the dispute is the responsibility of the Assistant Secretary for Fossil Energy, who can accept or reject the report, or ask for additional work. On December 12, 1996, Chevron filed a lawsuit asking a federal court in California to order the DOE to make a final determination of the SOZ participating percentages. Chevron claims the final decision was due October 10, 1996, but that DOE missed the deadline.

During FY 1995, DOE and Chevron completed a redetermination of participating percentages that increased DOE's percentage for the Dry Gas Zone from 77.0492 percent to 83.8726 percent. The two parties have postponed a settlement agreement for the Dry Gas Zone pending resolution of the Shallow Oil Zone dispute. Participating percentages for all zones are being finalized for divestment as required by the 1996 Defense Authorization Act (see note 19, "Divestment of Naval Petroleum Reserve No. 1"). The non-Unit Asphalto Zone is owned 100 percent by DOE and therefore participating percentages in this zone are not a consideration.

Management of NPOSR believes that the reserve figures found in NPR-1's long-range plan reasonably reflect the hydrocarbons to be recovered from NPR-1. The reserves are being updated as part of the DOE prepared upside study currently in progress.

(b) Environmental and Site Restoration

NPOSR and other oil and gas entities have, in recent years, become subject to increasingly demanding environmental standards imposed by federal, state, and local environmental laws and regulations. It is the policy of NPOSR to endeavor to comply with applicable environmental laws and regulations.

NPOSR is obligated for environmental cleanup and site-restoration requirements at NPR-1 and NPR-3 as individual wells and facilities are abandoned and, ultimately, as operations are terminated. Estimated cleanup and restoration costs at NPR-1 are approximately $328 million (based on FY 1995 Long Range Plan, proved reserves development case). NPOSR started recognizing an unfunded liability for the estimated restoration requirements at NPR-1 in 1993, and as of September 30, 1996, NPRC's unfunded liability is approximately $43 million. The accrual for NPR-1 is based on actual revenues in relation to total estimated revenues over the remaining life of the facility. The estimated cleanup and restoration costs at NPOSR-CUW is approximately $6.4 million, which was entirely recognized and accrued for in FY 1995. Total NPOSR accrued costs as of September 30, 1996 and 1995 amount to $49,738,360 and $38,360,360, respectively.

(c) Litigation and Claims

At present, NPOSR is a party in various administrative proceedings, legal actions, alleged personal injury, and claims brought by or against it. In the opinion of NPOSR management and legal counsel, the ultimate resolution of these proceedings, actions, and claims will not materially affect the financial position or results of operations of NPOSR.

Currently, there is one case pending which involves a claim with the Energy Board of Contract Appeals (EBCA). In 1985, the appellant filed a claim alleging it had been overcharged for crude oil purchased from DOE in November 1979. The appellant argues DOE improperly interpreted certain terms in the contract and claims damages and interest of approximately $1.85 million. While this case was pending, the EBCA decided a parallel case involving interpretation of the same contract clauses. Because of the similarity of the issues, DOE filed a motion for summary judgment, which was granted in favor of DOE in August 1994. The unsuccessful party in the parallel case appealed the EBCA decision to the U.S. Court of Appeals for the Federal Circuit. In December 1995, the Federal Circuit rejected EBCA's utilization of *stare decisions* and collateral estoppel and remanded the case to EBCA for trial on two issues. The parties have established a tentative trial scheduled to begin March 1997.

(12) Fund Balances

Fund balances include the following as of September 30, 1996 and 1995:

	1996	1995
Unexpended appropriations:		
Unobligated:		
Available	$ 13,359,320	14,420,676
Unavailable	424,593,078	424,664,028
Undelivered orders	78,675,858	95,177,205
	516,628,256	534,261,909
Invested capital	523,949,846	531,174,207
Cumulative results of operations	(1,465,269)	23,542,449
Less future funding requirements	65,154,335	51,958,222
Total	$ 973,958,498	1,037,020,343

(13) Revenues

Revenues included the following at 1996 and 1995:

	1996	1995
Sales of product:		
Crude oil	$ 315,898,970	305,566,528
Natural gas	39,628,292	35,501,529
Propane	18,424,460	16,344,262
Butane	10,591,009	7,208,381
Isobutane	4,441,098	3,919,290
Gasoline	18,479,957	10,236,354
Natural gas condensate	84,609	40,150
Total from sales of products	407,548,395	378,816,494
Royalties	1,383,593	1,715,352
Pipeline tariff	370,797	561,250
Total from all activities	409,302,785	381,093,096
Other income*	2,876,247	1,989,127
Total	$ 412,179,032	383,082,223

* Includes $2,422,688 and $1,945,573 in sales of excess electric power from cogeneration facility in 1996 and 1995, respectively.

(14) Program and Operating Expenses

Operating expenses (by program) include the following during 1996 and 1995:

	NPRC		NPOSR-CUW		NPOSR TOTAL	
	1996	1995	1996	1995	1996	1995
Operations and maintenance	$ 100,366,511	131,298,979	8,887,262	11,183,316	109,253,773	142,482,295
Drilling	35,492,257	22,688,787	6,371,332	11,845,220	41,863,589	34,534,007
Facilities construction	7,779,333	15,577,640	-	-	7,779,333	15,577,640
RMOTC	-	-	1,435,204	787,121	1,435,204	787,121
Program direction (HQ included)	9,908,553	6,251,784	1,389,197	1,498,783	11,297,750	7,750,567
Depreciation	39,079,163	36,876,459	5,471,911	8,422,315	44,551,074	45,298,774
Environmental restoration	11,378,000	7,901,140	-	6,359,220	11,378,000	14,260,360
Gross expenditure	204,003,817	220,594,789	23,554,906	40,095,975	227,558,723	260,690,764
Less joint interest reimbursement	28,343,817	36,196,133	43,667	29,947	28,387,484	36,226,080
Gross DOE expenses	175,660,000	184,398,656	23,511,239	40,066,028	199,171,239	224,464,684
Less capital expenditures	31,607,186	25,040,923	6,371,332	11,845,220	37,978,518	36,886,143
Net expenses	$ 144,052,814	159,357,733	17,139,907	28,220,808	161,192,721	187,578,541

(15) Other Expenses

Other expenses included the following at 1996 and 1995:

	1996	1995
Unit operator fee	$ 5,305,450	5,367,000
State sales taxes	1,494,012	1,091,116
Liability insurance	1,335,674	1,882,686
Professional services	1,066,943	918,887
Computer hardware, software, and maintenance	1,517,304	2,337,673
Security services	900,478	905,863
Employee training	499,089	652,352
Temporary office labor	510,252	499,584
Inventory devaluation	-	5,457,386
Scrap sales	(672,445)	(409,313)
Other	1,814,368	2,140,412
Total	$ 13,771,125	20,843,646

(16) Significant Customers

The following customers each accounted for greater than 10 percent of total revenue from public sources at NPR-1 and NPR-3, during 1996:

Customer	NPR-1	NPR-3	NOSR
Texaco Trading / Texaco Refining/ Texaco Natural Gas	$ 59,232,432	-	-
Celeron Gathering/Celeron Trading & Transportation	73,118,561	-	-
Koch Oil	47,224,523	-	-
Sinclair Oil	-	9,928,739	-
EOTT Energy	-	1,631,216	-
Pan Energy Gas Services	-	-	3,020,984

(17) Impairment of Assets

Effective September 30, 1995, NPOSR-CUW adopted Statement of Financial Accounting Standard No. 121 (Statement 121), *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of.* Statement 121 sets forth circumstances under which an entity must review long-lived assets for impairment. One of the criteria occurs when the entity has experienced a current period operating loss combined with a recent history of operating losses as is the case of the NPOSR-CUW operations. Impairment of the revenue generating assets occurs when the carrying value of those assets may not be recoverable.

The impairment loss in the accompanying 1995 combined statement of operations and changes in net position is associated primarily with the assets used in oil and gas production. These assets include capitalized drilling costs, completion costs steam generation facilities, flowlines, production equipment, and related facilities which are being depreciated using the units-of-production method of depreciation. The amount of the loss was calculated as the difference between the carrying value of the assets as of September 30, 1995, and the estimated expected future cash flows discounted at 10 percent. The amount of the impairment loss for NPR-3 and the combined amount for NOSR Nos. 1 and 3 are $8,852,023 and $7,151,676, respectively.

(18) Change in Recording Liabilities to the U.S. Treasury

Effective October 1, 1995, NPOSR adopted DOE Accounting Handbook (Handbook), Chapter 13, paragraph 10 *Miscellaneous Receipts*. The Handbook requires that miscellaneous receipts be recorded in conformity with account codes as defined in the United States Government Standard General Ledger (SGL) chart of accounts. The SGL requires that certain miscellaneous receipts, which pursuant to law are required to be remitted to the U.S. Treasury be accrued as a liability to the U. S. Treasury at the time the miscellaneous receipt receivable is established. As of October 1, 1995, NPOSR established a liability and reduced fund balance for the amount of miscellaneous receipts receivable at that date. This resulted in an adjustment to beginning fund balance of $23,322,363.

(19) Divestment of Naval Petroleum Reserve No. 1

The Defense Authorization Act for FY 1996 (Act), which authorizes and outlines the process for the sale of NPR-1, was approved by Congress and signed into law by President Clinton on February 10, 1996. The Act requires that the sale be completed within two years from the date of enactment, or February 10, 1998. As outlined in the Act, DOE must contract the services of a team of divestment advisors to administer the sale, prepare a reserve report, finalize equity with Chevron, and establish a minimum acceptable price for the Government's approximate 78 percent share of the Elk Hills field. The current time line established by DOE for the divestiture calls for a solicitation of offers to be issued in April 1997, with purchase proposals due in September 1997. Sale of the Government's interest in the Elk Hills field could be the largest sale of a single federal asset since the privatization of Conrail in 1987.

U.S. DEPARTMENT OF ENERGY

NAVAL PETROLEUM AND OIL SHALE RESERVES

Combining Statement of Financial Position

September 30, 1996

	NPRC	NPOSR-CUW	Headquarters	Total NPOSR
Assets				
Entity assets:				
Intragovernmental:				
Fund balance with U.S. Treasury	$ 91,963,292	18,221,630	12,075,999	122,260,921
Accounts receivable, net	10,132	(150)	-	9,982
Advances and prepayments	-	6,000	-	6,000
Governmental:				
Accounts receivable, net	40,136,012	1,113,826	-	41,249,838
Advances and prepayments	101,765	9,791	-	111,556
Cash	3,000	1,500	-	4,500
Inventories held for sale, net	1,891,318	105,723	-	1,997,041
Operating materials and supplies, net	2,893,002	1,459,149	-	4,352,151
Property and equipment, net	502,296,389	17,297,806	3,500	519,597,695
Nonentity assets:				
Intragovernmental:				
Fund balance with U.S. Treasury - restricted	423,424,922	660,088	508,068	424,593,078
Total assets	$ 1,062,719,832	38,875,363	12,587,567	1,114,182,762
Liabilities				
Liabilities covered by budgetary resources:				
Intragovernmental:				
Other funded liabilities	$ 43,329,795	1,218,402	-	44,548,197
Governmental:				
Accounts payable	21,504,989	2,724,953	1,244,168	25,474,110
Accrued payroll, benefits, and vacation pay	3,608,729	566,728	62,165	4,237,622
Other funded liabilities	550,000	260,000	-	810,000
Total liabilities covered by budgetary resources	68,993,513	4,770,083	1,306,333	75,069,929
Liabilities not covered by budgetary resources:				
Governmental:				
Accrued annual leave	280,850	78,919	128,495	488,264
Pension and other retirement benefits	14,927,711	-	-	14,927,711
Environmental restoration liabilities	43,379,140	6,359,220	-	49,738,360
Total liabilities not covered by budgetary resources	58,587,701	6,438,139	128,495	65,154,335
Total liabilities	127,581,214	11,208,222	1,434,828	140,224,264
Net Position				
Balances:				
Unexpended appropriations	493,322,001	17,614,869	5,691,386	516,628,256
Invested capital	505,189,391	18,756,955	3,500	523,949,846
Cumulative results of operations	(4,785,073)	(2,266,544)	5,586,348	(1,465,269)
Less future funding requirements	58,587,701	6,438,139	128,495	65,154,335
Net position	935,138,618	27,667,141	11,152,739	973,958,498
Total liabilities and net position	$ 1,062,719,832	38,875,363	12,587,567	1,114,182,762

U.S. DEPARTMENT OF ENERGY

NAVAL PETROLEUM AND OIL SHALE RESERVES

Combining Statement of Operations and Changes in Net Position

Year ended September 30, 1996

	NPRC	NPOSR-CUW	Headquarters	Total NPOSR
Appropriations	$ 129,386,000	9,007,000	10,040,000	148,433,000
Program revenues and expenses:				
Revenues:				
Sales of product	393,748,447	15,554,338	-	409,302,785
Other income	2,841,364	34,883	-	2,876,247
Total revenues	396,589,811	15,589,221	-	412,179,032
Expenses:				
Program and operating expenses:				
Personal services and benefits	37,840,790	5,272,847	1,919,348	45,032,985
Contractual services	36,064,606	2,410,690	3,859,632	42,334,928
Utilities, rent, and communications	3,092,929	1,175,924	37,687	4,306,540
Supplies and materials	9,966,832	1,063,431	-	11,030,263
Equipment not capitalized	5,112,357	26,424	-	5,138,781
Travel and transportation	3,919,897	265,256	68,992	4,254,145
Printing and reproduction	182,791	6,547	4,439	193,777
Other	12,551,395	1,219,730	-	13,771,125
Depreciation	39,079,163	5,471,911	5,389	44,556,463
Environmental restoration	11,378,000	-	-	11,378,000
Less joint interest reimbursement	20,760,619	43,667	-	20,804,286
Net expenses	138,428,141	16,869,093	5,895,487	161,192,721
Net income (loss)	258,161,670	(1,279,872)	(5,895,487)	250,986,311
Transferred to U.S. Treasury	426,093,725	13,065,068	-	439,158,793
Excess (shortage) of appropriations and net income (loss) over transfers	$ (38,546,055)	(5,337,940)	4,144,513	(39,739,482)
Net position:				
Net position, beginning balance	$ 995,988,553	34,023,564	7,008,226	1,037,020,343
Adjustment	(22,303,880)	(1,018,483)	-	(23,322,363)
Net position, beginning balance, as restated	973,684,673	33,005,081	7,008,226	1,013,697,980
Excess (shortage) of appropriations and net income (loss) over (under) transfers	(38,546,055)	(5,337,940)	4,144,513	(39,739,482)
Net position, ending balance	$ 935,138,618	27,667,141	11,152,739	973,958,498

U.S. DEPARTMENT OF ENERGY

NAVAL PETROLEUM AND OIL SHALE RESERVES

Combining Statement of Cash Flows

Year ended September 30, 1996

	NPRC	NPOSR-CUW	Headquarters	Total NPOSR
Cash flows from operating activities:				
Net income (loss)	$ 258,161,670	(1,279,872)	(5,895,487)	250,986,311
Adjustments affecting cash flow:				
Depreciation	39,079,163	5,471,911	5,389	44,556,463
Provision for inventory obsolescence	21,195	-	-	21,195
Increase in unfunded environmental restoration liabilities	11,378,000	-	-	11,378,000
Increase in unfunded pension, other retirement benefits, and accrued annual leave	1,813,861	9,458	(5,206)	1,818,113
Increase in accounts receivable	(20,349,594)	(177,319)	-	(20,526,913)
Decrease (increase) in inventories	1,659,272	(287,217)	-	1,372,055
Decrease (increase) in advances and prepayments	21,268	(12,788)	510	8,990
Increase (decrease) in accounts payable	(2,460,236)	(770,123)	1,211,398	(2,018,961)
Increase in other funded liabilities and accrued payroll, benefits, and vacation pay	42,150,995	1,391,584	360	43,542,939
Net cash provided by (used in) operating activities	331,475,594	4,345,634	(4,683,036)	331,138,192
Cash flows from investing activities - purchase of property, plant, and equipment	(31,607,186)	(6,375,107)	-	(37,982,293)
Cash flows from financing activities:				
Appropriations	129,386,000	9,007,000	10,040,000	148,433,000
Adjustment	(22,303,880)	(1,018,483)	-	(23,322,363)
Transferred to U.S. Treasury	(426,093,725)	(13,065,068)	-	(439,158,793)
Net cash provided by (used in) financing activities	(319,011,605)	(5,076,551)	10,040,000	(314,048,156)
Net cash provided by (used in) operating, investing, and financing activities	(19,143,197)	(7,106,024)	5,356,964	(20,892,257)
Fund balance with U.S. Treasury and cash, beginning of year	534,534,411	25,989,242	7,227,103	567,750,756
Fund balance with U.S. Treasury and cash, end of year	$ 515,391,214	18,883,218	12,584,067	546,858,499

U.S. DEPARTMENT OF ENERGY

NAVAL PETROLEUM AND OIL SHALE RESERVES

Combining Statement of Budgetary Resources and Actual Expenses

Year ended September 30, 1996

	Budget			
		Obligations		Actual
	Resources	Direct	Reimbursed	Net expenses
	$ 590,205,452	152,253,053	-	161,192,721

Budget Reconciliation

	NPRC	NPOSR-CUW	Headquarters	Total NPOSR
A Net expenses	$ 138,428,141	16,869,093	5,895,487	161,192,721
B Add:				
Capital acquisitions	31,607,186	6,375,107	-	37,982,293
Changes in inventories	937,271	(292,290)	-	644,981
Joint interest reimbursements	28,343,817	43,667	-	28,387,484
C Less:				
Depreciation	39,079,163	5,471,911	5,389	44,556,463
Unfunded environmental restoration	11,378,000	-	-	11,378,000
Other unfunded expenses	1,813,861	9,458	(5,206)	1,818,113
Other	1,825,503	-	-	1,825,503
D Accrued expenditures	145,219,888	17,514,208	5,895,304	168,629,400
E Less reimbursements	-	2,562,748	-	2,562,748
F Accrued expenditures	$ 145,219,888	14,951,460	5,895,304	166,066,652

PROGRAM PERFORMANCE MEASURES

Ia. ANNUAL PRODUCTION	NPR-1					
	TARGET PRODUCTION FY 1996	ACTUAL PRODUCTION FY 1996	PERCENT OF TARGET FY 1996	TARGET PRODUCTION FY 1995	ACTUAL PRODUCTION FY 1995	PERCENT OF TARGET FY 1995
Crude Oil (Barrels)	17,211,336	16,893,523	98.15%	18,925,516	17,917,473	94.67%
Natural Gas (MCF)	99,387,350	104,368,718	105.01%	103,502,878	95,177,926	91.96%
Propane (Gallons)	64,987,384	47,018,296	72.35%	44,364,055	48,252,992	108.77%
Butane (Gallons)	36,095,227	29,575,153	81.94%	27,591,236	27,296,461	98.93%
Natural Gasoline (Gallons)	57,195,957	45,356,551	79.30%	42,284,925	42,778,287	101.17%
Isobutane (Gallons)	11,712,000	8,741,673	74.64%	8,869,500	8,738,868	98.53%

Natural gas production for FY 1996 and FY 1995 includes 82,910,754 Mcf and 73,889,941 Mcf, respectively, which was reinjected, lost to shrinkage, or used in various field operations including the generation of electricity.

Ib. ANNUAL PRODUCTION	NPR-3					
	TARGET PRODUCTION FY 1996	ACTUAL PRODUCTION FY 1996	PERCENT OF TARGET FY 1996	TARGET PRODUCTION FY 1995	ACTUAL PRODUCTION FY 1995	PERCENT OF TARGET FY 1995
Crude Oil (Barrels)	536,308	586,505	109.36%	702,625	647,611	92.17%
Natural Gas (MCF)	1,830,000	2,406,400	131.50%	1,910,045	2,010,218	105.24%
Propane (Gallons)	402,600	614,224	152.56%	594,950	498,141	83.73%
Butane Plus (Gallons)	1,244,400	2,005,677	161.18%	1,883,035	1,788,667	94.99%

All natural gas production is reinjected into the oil reservoir or used for enhanced oil recovery and other field operations. FY 1996 propane and butanes plus production increased (and exceeded FY 1996's target levels) due to the purchase and injection of natural gas into the oil reservoir for enhanced oil recovery purposes.

Ic. ANNUAL PRODUCTION	NOSRs					
	TARGET PRODUCTION FY 1996	ACTUAL PRODUCTION FY 1996	PERCENT OF TARGET FY 1996	TARGET PRODUCTION FY 1995	ACTUAL PRODUCTION FY 1995	PERCENT OF TARGET FY 1995
Crude Oil (Barrels)	1,860	3,225	173.39%	2,190	2,706	123.56 %
Natural Gas (MCF)	3,366,320	3,582,392	106.42%	3,639,444	2,928,129	80.46%

All NOSR production is sold.

1d. ANNUAL PRODUCTION	TOTAL					
	TARGET PRODUCTION FY 1996	ACTUAL PRODUCTION FY 1996	PERCENT OF TARGET FY 1996	TARGET PRODUCTION FY 1995	ACTUAL PRODUCTION FY 1995	PERCENT OF TARGET FY 1995
Crude Oil (Barrels)	17,749,504	17,483,253	98.50%	19,630,331	18,567,790	94.59%
Natural Gas (MCF)	104,583,670	110,357,510	105.52%	109,052,367	100,116,273	91.81%
Propane (Gallons)	65,389,984	47,632,520	72.84%	44,959,005	48,751,133	108.43%
Butane & Butane Plus (Gallons)	37,339,627	31,580,830	84.58%	29,474,271	29,085,128	98.68%
Natural Gasoline (Gallons)	57,195,957	45,356,551	79.30%	42,284,925	42,778,287	101.17%
Isobutane (Gallons)	11,712,000	8,741,673	74.64%	8,869,500	8,738,868	98.53%

This measures the degree of success in achieving stated production targets for a given fiscal year. It is computed by dividing the actual production by the target production for each product.

2. LIFTING COSTS	NPR-1		NPR-3		NOSRs		TOTAL	
	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995
Direct Cost (Govt. share)	$49,714,060	$66,718,765	$4,273,668	$5,439,057	$162,220	$363,238	$54,149,948	$72,521,060
BOE Produced	38,463,058	37,587,578	1,049,950	1,036,639	602,591	490,728	40,115,599	39,114,945
Lifting Cost per BOE	$1.29	$1.78	$4.07	$5.25	$0.27	$0.74	$1.35	$1.85

Lifting costs are costs incurred to produce a barrel of oil and equivalent gas after completion of drilling and before removal for sale or transportation, and are computed by dividing direct costs by production. This measure reflects the unit cost to the Government of producing one barrel of oil equivalent (BOE).

3. DOWNTIME PER WELL	NPR-1		NPR-3		NOSRs		TOTAL	
	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995
Downtime Per well	13.09	15.00	12.26	11.49	7.80	0.87	12.67	13.15

This measure is the average number of days per well that producible wells are shut down for maintenance, remedials, etc., and is computed by dividing the total number of days producible wells are down for the fiscal year by the total number of producible wells. Under 20 days is considered an accepted level of performance.

4. MANPOWER COSTS PER WELL	NPR-1		NPR-3		NOSRs		TOTAL	
	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995
Direct Labor Cost	$32,601,689	$41,765,415	$1,552,084	$1,771,578	$105,654	$70,961	$34,259,427	$43,607,954
Active Wells	904	921	609	620	38	39	1,551	1,580
$ Per Active Well	$36,064	$45,348	$2,549	$2,857	$2,780	$1,820	$22,089	$27,600

This measure expresses labor costs per active well, and is computed by dividing direct labor costs by the total number of active wells.

5. OPERATING COSTS	NPR-1		NPR-3		NOSRs		TOTAL	
	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995
Operating Costs	$101,814,322	$122,481,274	$8,466,132	$9,945,486	$1,538,823	$2,627,228	$111,819,277	$135,053,988
BOE Produced	38,463,058	37,587,578	1,049,950	1,036,639	602,591	490,728	40,115,599	39,114,945
$ Per BOE Produced	$2.65	$3.26	$8 06	$9 59	$2 55	$5 35	$2.79	$3.45

This measure is defined as the total operating costs, including headquarters and other overhead, per BOE. Capital investments for drilling, completions, and facilities are excluded from this measure. NPR-3 costs of $214,863 for National Energy Policy Act compliance and $1,448,177 for RMOTC costs are also excluded in calculating this performance measure. In FY 1995, NPR-3 operating costs excluded $6,359,220 in environmental restoration costs, $787,121 for RMOTC, and $79,437 for other nonprogram related costs.

Headquarter's costs of $2,736,158 were allocated among the field sites based on their expenses for the fiscal year. During FY 1996, NPR-1, NPR-3, and NOSR were allocated $2,465,344, $205,310, $65,503, respectively. Total FY 1996 headquarters costs were $5,895,487, but the remaining $2,665,833 and $493,496 was not included in this performance measure since they relate to one time divestment costs for NPR-1 and a study to evaluate the future of the remaining NPOSR properties. The FY 1995 headquarters costs amounted to $2,335,454, all of which was allocated as follows: NPR-1 $2,064,465; NPR-3 $203,538; and NOSR $68,450, respectively.

6. NET PROFIT MARGIN PER BOE	NPR-1 and NPR-2		NPR-3		NOSRs		TOTAL	
	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995
Gross Revenues	$396,589,811	$368,331,744	$12,445,369	$12,213,813	$3,143,852	$2,536,666	$412,179,032	$383,082,223
Net Expenses	$140,893,485	$159,357,733	$11,733,400	$15,711,292	$3,743,466	$5,283,737	$156,370,351	$180,352,762
Net Revenues	$255,696,326	$208,974,011	$711,969	$(3,497,479)	$(599,614)	$(2,747,071)	$255,808,681	$202,729,461
BOE Produced	38,463,058	37,587,578	1,049,950	1,036,639	602,591	490,728	40,115,599	39,114,945
Net Profit/(Loss) Per BOE	$6.65	$5.56	$0.68	$(3.37)	$(1.00)	$(5.60)	$6.38	$5.18

This measure is defined as net revenue per BOE, and is computed by subtracting net expenses from gross revenues and dividing by BOE produced. NPOSR believes this is the most important performance measure. Total costs are equivalent to operating costs included in performance measure No. 5 plus depreciation expense.

7. RETURN OF PLANT PROPERTY & EQUIPMENT	NPR-1		NPR-3		NOSRs		TOTAL	
	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995	ACTUAL FY 1996	ACTUAL FY 1995
Net Revenues	$255,696,326	$208,974,011	$711,969	$(3,497,479)	$(599 614)	$(2,747,071)	$255,808,681	$202,729,461
Net Asset Value	$502,296,389	$509,768,366	$6,290,141	$5,647,838	$10,994,832	$10,746,772	$519,581,362	$526,162,976
$ Net Revenues Per $ Net Asset Value	$0.51	$0.41	$0.11	$(0.62)	$(0.05)	$(0.26)	$0.49	$0.39

This measure is the relationship of net revenues to the value of net assets, and is computed by dividing net revenues by net asset value.

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Independent Auditors' Report on Compliance with Laws and Regulations

Deputy Assistant Secretary
Naval Petroleum and Oil Shale Reserves
United States Department of Energy:

We have audited the combined financial statements of the U.S. Department of Energy (DOE) Naval Petroleum and Oil Shale Reserves (NPOSR), as of and for the year ended September 30, 1996, and have issued our report thereon dated November 15, 1996.

We conducted our audit in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and the Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements.* Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free of material misstatement.

Compliance with laws and regulations applicable to NPOSR is the responsibility of the management of NPOSR, a unit of the DOE. As part of obtaining reasonable assurance about whether the combined financial statements are free of material misstatement, we tested compliance with laws and regulations that may directly affect the combined financial statements and certain other laws and regulations designated by OMB and DOE, including:

- Clean Air and Water (Contract Clause FAR 52.223-2)
- Cost Accounting Standards (Contract Clause FAR 52.230-3)
- State and Local Taxes (Contract Clause DEAR 970.5204-23)
- Litigation and Claims (Contract Clause DEAR 970.5204-31)
- Federal Managers' Financial Integrity Act (FMFIA) (DOE Order 413.1)
- Environmental Protection (Contract Clause DEAR 970.5204-62)

However, the objective of our audit of the combined financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

As part of our audit, we obtained an understanding of management's process for evaluating and reporting on internal control and accounting systems as required by FMFIA and compared NPOSR's most recent FMFIA reports with the evaluation we conducted of NPOSR's internal control structure.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin 93-06.

This report is intended for the information of the management of NPOSR and DOE. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

KPMG Peat Marwick LLP

Salt Lake City, Utah
November 15, 1996

KPMG Peat Marwick LLP

60 East South Temple
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Salt Lake City, UT 84111

Independent Auditors' Report on the Internal Control Structure

Deputy Assistant Secretary
Naval Petroleum and Oil Shale Reserves
United States Department of Energy:

We have audited the combined financial statements of the U.S. Department of Energy (DOE) Naval Petroleum and Oil Shale Reserves (NPOSR), as of and for the year ended September 30, 1996, and have issued our report thereon dated November 15, 1996.

We conducted our audit in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free of material misstatement.

The management of NPOSR, a unit of the U.S. Department of Energy, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that transactions, including those relating to obligations and costs, are executed in compliance with applicable laws and regulations that could have a direct and material effect on the combined financial statements and any other laws and regulations that OMB, NPOSR management, or the DOE have identified as being significant and for which compliance can be objectively measured and evaluated; funds, property, and other assets are safeguarded against loss from unauthorized use or disposition; transactions are executed in accordance with management's authorization and properly recorded and accounted for to permit the preparation of reliable financial reports in accordance with the provisions of OMB Bulletin 94-01, *Form and Content of Agency Financial Statements*, and to maintain accountability over the assets; and that data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projections of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of the changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the combined financial statements of NPOSR for the year ended September 30, 1996, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, we assessed control risk, and we performed tests of the internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the combined financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

Our evaluation of the controls for performance information was limited to those controls designed to ensure the existence and completeness of the information. With respect to the performance measures control objective, we obtained an understanding of relevant internal control structure policies and procedures designed to permit the preparation of reliable and complete performance information, and we assessed control risk.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants and OMB Bulletin 93-06. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure which, in our judgment, could adversely affect the organization's ability to ensure that the objectives of the internal control structure, as previously defined, are being achieved.

Those matters that we consider to be reportable conditions are summarized below according to location:

Naval Petroleum Reserves in California (NPRC)
Elk Hills, California

Updating Policy and Procedure Manuals

Audit Comment:

Part I Section H.014 of DOE's contract with Bechtel Petroleum Operations, Inc. (Bechtel) requires that Bechtel maintain policy and procedure manuals which reflect actual operating practice. Bechtel's manual on operating procedures for several functions in the accounts payable department does not reflect actual operating practices. This condition existed because Bechtel management has not formally approved the procedural changes being used, nor documented the new procedures by updating the procedures manual. The absence of approval for changed procedures could result in control practices which allow errors or fraudulent activity to go undetected.

Audit Recommendation:

We recommend the Acting Director, NPRC, direct Bechtel to approve and document all procedural changes in the accounts payable department to ensure that controls are adequate to mitigate potential error or fraudulent activities.

Management Response:

Concur. The accounts payable procedures have been updated to reflect current practice. Drafts of the procedures are currently in the approval cycle. The estimated completion date is March 31, 1997.

System Control Checks and Balances

Audit Comment:

Effective internal controls include, where possible, system controls which automate routine checks and balances and eliminate the potential for human error. Bechtel's accounting system is programmed with controls to reject payments which exceed aggregate purchase order limits. Of 25 payments tested, one exceeded the purchase order limit. The accounting system failed to reject the payment because its computer program is not designed to include labor charges when totaling coded charges on an invoice. In performing the check the system is programmed to sum all invoice charges with a specific code. However, labor is assigned a different code. As a result, the potential exists for the improper payment of invoices where labor cost is a component of total charges in an invoice.

Audit Recommendation:

We recommend the Acting Director, NPRC, direct Bechtel to modify its computerized payment program to include labor charges when totaling invoices to prevent improper payments.

Management Response:

Concur. Bechtel is in the process of modifying its computerized payment program to include labor charges when totaling invoices to prevent improper payments. The estimated completion date is March 31, 1997.

Naval Petroleum and Oil Shale Reserves in Colorado, Utah, and Wyoming (NPOSR-CUW)
Casper, Wyoming

Controls Over Stores Inventory

Audit Comment:

Effective internal controls require the separation of duties between the functions for purchasing, receiving, and custody of stores inventory. The stores inventory manager at NPR-3 is responsible for ordering, receiving, issuing, and maintaining all stores inventory. The assignment of a single individual to perform stores inventory functions was caused by a reduction in force. This situation increases the potential for fraudulent activity or misuse of government property.

Audit Recommendation:

We recommend the Director, NPOSR-CUW, direct Fluor Daniel, Inc. (Fluor Daniel) to ensure adequate separation of duties are established and maintained for the inventory function to mitigate the potential for fraudulent activity. At a minimum, the purchasing function should be assigned to a person who is independent of the receiving and custody function.

Naval Petroleum and Oil Shale Reserves
U.S. Department of Energy

Management Response:

Concur. Fluor Daniel management is in the process of restructuring the procurement and inventory control functions at NPR-3. The responsibilities of the stores inventory manager will no longer include purchasing after the reorganization is complete. The estimated completion date of the reorganization is September 30, 1997.

Management stated that, while the recent reduction in personnel may represent a reduction of internal controls, the possibility of significant loss of property is not considered likely. The level of inventory maintained at NPR-3, the limited number of high dollar items in stock, and the integrated receiving, purchasing, and payment system help mitigate the potential for fraudulent activity or misuse of government property.

STATUS OF PRIOR YEAR FINDINGS

The purpose of this section is to provide a status report for those comments reported on, in the prior year for which management has considered, but are still pending resolution or require further attention.

Naval Petroleum Reserves in California
Elk Hills, California

Verification of Authorization by Accounts Payable

Audit Comment:

Bechtel's operating instruction 130-001, (B)(3)(m)(1) on expenditure processing procedure, requires the accounts payable department to verify that all service field ticket dollar amounts over $1,000 are properly authorized and within authorized limits, with a random check performed on those tickets below $1,000. Our sample of invoices taken during the audit of the 1995 financial statements showed that 2 out of 13 invoices representing about $18,000 out of $77,000 were not properly authorized. According to Bechtel's accounts payable department, they do not consistently verify approval authority or limits for each field ticket because the volume processed is not manageable with current staffing levels. As a result, the possibility exists for Bechtel to pay for services without proper authorization.

Audit Recommendation:

Bechtel should improve verification controls to ensure that field tickets over $1,000 are properly authorized and within limits.

Management's Response:

Bechtel's management is currently in the process of determining best business practices for NPRC. Once determination has been made, Bechtel will seek to obtain approval from NPRC. Best business practices will be determined and incorporated into the Bechtel operating instructions by August 31, 1996, for NPRC approval.

Naval Petroleum and Oil Shale Reserves
U.S. Department of Energy

Status:

Bechtel's management has determined that the best practice in this area is to assign the responsibility to the cost account managers and has designed report number MMC91-1 to assist them with this responsibility. The procedure was incorporated into draft Procedure 409-035P.FIF. At the end of fieldwork, management formally approved the procedure. Since the procedure became effective after the end of the audit fieldwork, management's actions will be reviewed for adequacy as part of the fiscal year 1997 audit.

* * * * *

A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material to the combined financial statements being audited, or material to a performance measure or aggregation of related performance data, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses, as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we reported to the management of NPOSR in a separate letter dated November 15, 1996.

This report is intended for the information of the management of NPOSR and DOE. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

KPMG Peat Marwick LLP

Salt Lake City, Utah
November 15, 1996

KPMG Peat Marwick LLP

60 East South Temple
Suite 900
Salt Lake City, UT 84111

Deputy Assistant Secretary
Naval Petroleum and Oil Shale Reserves
United States Department of Energy:

We have audited the combined financial statements of the U.S. Department of Energy (DOE) Naval Petroleum and Oil Shale Reserves (NPOSR), as of and for the year ended September 30, 1996, and have issued our report thereon dated November 15, 1996. In planning and performing our audit of the combined financial statements of NPOSR, we considered the internal control structure in order to determine our audit procedures for the purpose of expressing our opinion on the combined financial statements and not to provide assurance on the internal control structure. We have not considered the internal control structure since the date of our report.

During our audit, we noted certain matters involving the internal control structure and other operational matters that are presented for your consideration. These comments and recommendations, all of which have been discussed with the appropriate members of management, are intended to improve the internal control structure or result in other operating efficiencies. They are summarized below according to location:

Naval Petroleum Reserves in California (NPRC)
Elk Hills, California

Royalty Revenue

Audit Comment:

Unit contracts with the various leaseholders at the Buena Vista Oil Field (NPR-2) require that DOE share in royalty revenues at the same price at which the leaseholders sell natural gas. A comparison of prices received for natural gas produced at NPR-2 between August 1995 and July 1996, for one leaseholder, disclosed that the prices ranged from 21 to 42 cents less per thousand cubic feet (mcf) than paid by leaseholders at other sites. When questioned, the leaseholder began an internal review and agreed that they had mistakenly underpriced royalty revenues totaling about $42,000 for the period January 1996 through June 1996. NPRC is currently reviewing, with the leaseholder, the adequacy of prices for the remaining period. NPRC does not have procedures established to verify the accuracy of prices at which natural gas was sold by leaseholders at NPR-2. This has resulted in an under collection of revenues and a misstatement of income in the financial statements.

Audit Recommendation:

We recommend that the Acting Director, NPRC, develop procedures that require a comparison of natural gas prices submitted by NPR-2 leaseholders to published prices or other leaseholder prices to ensure reasonableness. DOE should also assure that past royalty revenues from the sale of natural gas at NPR-2 were according to contract provisions.

Management Response:

Concur. Management stated that, although defined procedures for royalty invoicing do exist, the method of comparing gas/liquid prices offered by lessees will be formalized to ensure reasonableness. Management stated that NPR-2 royalty invoicing is based on pricing methodologies contained in historical lease agreements and that a "highest posting" pricing methodology is carried out for monthly oil prices. However, the lease agreements do not specify a posting methodology for gas/liquids. NPRC currently compares gas/liquid prices offered by lessees and investigates any significant differences. Management stated that their subsequent review of the above mentioned condition resulted in the recovery of approximately $42,000 from the leaseholder. Written procedures formalizing the process of comparing gas/liquid prices will be completed by February 10, 1997.

Management added that the DOE's long-term practice to ensure that past royalty revenues were in accordance with contract provisions has been to contract with the California State Controller's Office every two years to perform in-depth audits of NPR-2 royalties reported by leaseholders. The California State Controller's Office had not yet audited the royalty revenues discussed above, but will cover these revenues as part of their next audit scheduled to begin in July 1997. This audit has assured reasonableness of royalty revenues in the past, and the Department will continue this program.

Estimating Current Year Environmental Costs

Audit Comment:

Generally accepted accounting principles require that the financial statements show accrued liabilities which are both probable and estimable - such as future environmental cleanup costs. Bechtel Petroleum Operation, Inc.'s (Bechtel) method used to recognize future environmental costs is based on the ratio of actual current year revenues to total future revenues as estimated in the most recent Long Range Plan. The use of actual revenues instead of the estimated revenues for that specific year introduces a variable into the formula and causes the method to be flawed. For the past two years, NPRC's actual revenues were significantly lower than the estimated revenues in its Long Range Plan. These differences between estimated and actual revenues caused NPRC to understate the accrued environmental cleanup costs by $2,842,000.

Audit Recommendation:

We recommend that the Acting Director, NPRC, direct Bechtel to revise it's method for estimating the accrued liability for future environmental cleanup costs. To provide consistent allocation of such costs to the appropriate year, the method should use the estimated revenues for that year in its Long Range Plan for computing the ratio to apply to total estimated environmental cleanup costs. This method should also provide consistency whenever a new Long Range Plan is developed.

Management Response:

Concur. Bechtel revised its method for estimating the accrued liability for future environmental cleanup costs. The revised method used the estimated revenues for that year in the Long Range Plan for computing the ratio to apply to total estimated environmental cleanup costs. The method was revised in December 1996.

Current Year Expenses

Audit Comment:

Generally accepted accounting principles require that costs be expensed in the year incurred unless the costs are to be capitalized and depreciated over a period of time. Bechtel's year-end work-in-process (WIP) includes amounts that should be recognized as current-year expenses. Bechtel field personnel follow the procedure of coding any WIP costs to a capital Authorization for Expenditure (AFE) when they cannot readily determine that it is a current year expense. Bechtel's fixed asset personnel do not review and reclassify these costs as an expense until the AFE is closed. As a result, the financial statements understate current year expenses by about $230,000 and overstate capitalized WIP costs by about $230,000.

Audit Recommendation:

We recommend that the Acting Director, NPRC, direct Bechtel to establish procedures requiring fixed asset personnel to review all open AFE's at year end to identify and properly record any costs that are current-year expenses.

Management Response:

Concur. Bechtel modified its year-end closing procedures to include steps to ensure that fixed asset personnel review all open AFE's to identify and properly record any costs that are current year expenses. The procedures were modified in December 1996.

Personal Accountability for Furniture, Tools, and Sensitive Property

Audit Comment:

An effective property system must provide controls to reduce the potential for loss or misuse of tools and equipment. Bechtel's 1995 physical inventory of furniture, tools, and sensitive property could not account for 164 items valued at $113,356. The property consisted primarily of tools or equipment ranging from a wet-dry vacuum valued at $70 to a calibrator valued at $7,174. Bechtel's property systems require that such items be given a control number and responsibility assigned to an individual. A review of the list of missing items showed that most had been assigned to department supervisors rather than individuals actually responsible for using the items. The lack of individual responsibility appears to lessen the effectiveness of established property controls and increases the potential for loss or misuse of tools and equipment.

Audit Recommendation:

We recommend that the Acting Director, NPRC, direct Bechtel to strengthen established procedures for greater individual accountability for furniture, tools, and sensitive property assigned to employees. At a minimum, the strengthened procedures should include performing random employee inventory counts.

Management Response:

Concur. Bechtel revised its property and procurement management procedures to include an accountability statement that must be signed by each Bechtel employee having equipment and requires that all property be assigned to an individual who will be accountable for that equipment. In addition, the property custodians are required to perform periodic random inventories of the equipment in their area. Further, property and procurement management personnel will perform periodic reviews of the property custodians' records to ensure that equipment is on-site and accounted for. The revised procedure was approved in December 1996.

Naval Petroleum and Oil Shale Reserves
in Colorado, Utah, and Wyoming (NPOSR-CUW)
Casper, Wyoming

Reserve Study

Audit Comment:

Oil and gas reserve evaluations should be based on the most accurate and reliable information available. The fiscal year 1996 Oil and Gas Reserves Evaluation prepared for NPR-3 contained erroneous production quantities and computational errors. These errors caused the oil reserves to be understated by about 150,000 barrels. This condition existed because the reserve evaluation was not adequately reviewed for accuracy. As a result of the understated reserves, fiscal year 1996 depreciation expense was overstated by about $300,000.

Audit Recommendation:

We recommend that the Director, NPOSR-CUW, direct Fluor Daniel, Inc. (Fluor Daniel) to correct the error and establish procedures which require a thorough review of reserve evaluations to ensure the evaluations are accurate and based on reliable data.

Management Response:

Concur. Fluor Daniel will correct the error and establish procedures to ensure that future reserve studies are carefully prepared and are reviewed by appropriate supervisory personnel. The estimated completion date is September 30, 1997.

Physical Inventory Count

Audit Comment:

Effective inventory management requires periodic verification of inventory records through periodic physical warehouse inventories. Fluor Daniel made a complete physical inventory of the stores warehouse at NPR-3 in 1996. The counts indicated a write-on of inventory valued at about $65,000 and a write-off of inventory valued at about $140,000. Although inventory differences were identified, management did not ensure that these differences were reconciled and adjustments made to both the inventory and accounting records. This condition existed due to a lack of trained personnel to conduct the inventories and perform the necessary reconciliations in order to make the appropriate adjustments. As a result, Fluor Daniel cannot assure that recorded inventory value of about $600,000 at September 30, 1996, is accurate.

Audit Recommendation:

We recommend that the Director, NPOSR-CUW, direct Fluor Daniel to provide sufficient personnel to reconcile differences between physical inventory counts and inventory records and make adjustments to both the inventory and accounting records, where necessary.

Management Response:

Concur. Fluor Daniel will provide sufficient staff to reconcile the differences between the physical inventory counts and inventory records and make the necessary adjustments to both the inventory and accounting records. The reconciliation and adjustments will be made by March 31, 1997.

STATUS OF PRIOR YEAR FINDINGS

The purpose of this section is to provide a status report for those comments reported on in the prior year, for which management has considered, but are still pending resolution or require further attention.

DOE Chief Financial Officer
Washington, D.C.

Standard General Ledger Implementation

Audit Comment:

Office of Management and Budget (OMB) revised Circular A-127, Financial Management Systems (A-127), in July 1993 requires Federal agencies to record financial events throughout their financial management systems by implementing the U.S. Treasury's Standard General Ledger (SGL) at the transaction level, effective October 1, 1993. To comply with A-127, agencies must prepare financial reports and record transactions in a manner consistent with SGL rules, and should have supporting transaction detail readily available for SGL accounts.

Department field offices use the Departmental Integrated Standardized Core Accounting System (DISCAS) to process accounting transactions. DISCAS information is transmitted to the Department's Financial Information System (FIS) which summarizes and reports Department-wide financial information. Both DISCAS and FIS utilize the Department's chart of accounts rather than SGL accounts. The Department has prepared a program that crosswalks FIS amounts to the appropriate SGL accounts, however, the use of a crosswalk does not comply with the requirements to implement the SGL at the transaction level. The Department intends to convert DISCAS data fields to utilize Treasury's SGL account numbers, which would then provide SGL data at the transaction level. However, due to shortages of programming personnel and funding, the Department is unable to determine when the DISCAS modifications will be completed.

Audit Recommendation:

The Department should complete modifications in its federal financial systems to satisfy the SGL requirement as soon as possible.

Management Response:

We concur that we have not implemented SGL at the transaction level as required by OMB Circular A-127. Our plan has always been to complete this implementation with the implementation of the Management Analysis Reporting System (MARS) which has been delayed due to budget constraints. Phase II of MARS has been implemented in January of this year (1996). Transaction level implementation will occur in Phase III of MARS. Since we cannot determine when Phase III of MARS will be implemented, we are unable to determine the date for transaction level SGL implementation.

Status:

Although management concurred with the recommendation to implement SGL at the transaction level, management has not taken any further actions. Management stated that implementation could not occur until funding was available. At the present time, management was unable to forecast when funding would become available and SGL implementation would occur. While we recognize that funding constraints exist, implementation of the SGL at the transaction level is critical to satisfying both Departmental and Government-wide financial reporting objectives. Management should reconsider funding priorities in order to implement the SGL requirement.

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Should you have any questions concerning the matters presented herein, we would be pleased to discuss them with you at your convenience.

This report is intended for the information and use of the management of NPOSR and DOE. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

KPMG Peat Marwick LLP

Salt Lake City, Utah
November 15, 1996