



CRUDE AWAKENING



Bulletin of the Independent Petroleum Association of America

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IPAA's Crude Awakening bulletin was developed to separate fact from fiction on oil and natural gas issues; enhance understanding of domestic oil and natural gas exploration and production; and provide a link to the 7,000 independent oil and natural gas producers in the United States who provide the energy that has shaped the modern economy and fueled the economic growth upon which we depend.

National Energy Policy: Now Is The Time To Act!

This bulletin provides a summary of testimony by IPAA President Barry Russell on "National Energy Policy: Ensuring Adequate Supply of Natural Gas and Crude Oil," at a hearing before the House Commerce Subcommittee on Energy and Power on May 24, 2000. Russell testified on behalf of IPAA, the National Stripper Well Association (NSWA), and 32 IPAA cooperating associations representing independent petroleum and natural gas producers. Independent producers recognize the importance of our national resources and are the most damaged by the lack of a domestic energy policy. NSWA represents small business operators—producers with marginal wells—in the petroleum and natural gas industry.

Mr. Chairman, my testimony today will focus first, on several key factors that influence adequate supplies of natural gas and petroleum, and second, on actions that should be taken to improve future domestic supply.

Factors In Developing A National Energy Policy

Many factors affect the development of a sound national energy policy.

- **Fossil energy—particularly natural gas and petroleum-based energy—will continue to dominate energy supply in the United States.** According to the National Petroleum Council's (NPC) Natural Gas study, natural gas and petroleum account for 64.8 percent of our national energy needs. The reality is that the U.S. economy is driven by the availability of adequate energy supplies whether consumed by manufacturing, by transportation to and from jobs, or by the expanding role of computer use and the Internet. To suggest that an equally robust economy can be sustained without substantial energy growth ignores this reality. To suggest that natural gas and petroleum will not be the dominant share of this growth also ignores this reality.



House Energy and Power Subcommittee Chairman Joe Barton (R-TX)

- **Regardless of changes in world politics, energy supply remains a national security issue.** Currently, we import more than 55 percent of our nation's petroleum. And whether we like it or not, our sources of petroleum come from countries with a history of instability. For example, we are importing approximately 500,000 barrels per day from Iraq. Clearly, this is not a reliable source. We must recognize that shifts in any of our suppliers can dramatically and adversely affect our ration and our national economic security. We have seen the inevitable consequences of lost capital in the U.S. exploration and production industry. Petroleum prices now have reached levels not seen since the Persian Gulf War. Different segments of the economy have been threatened. Yet, in each case, the price and supply issues largely have been defined by the actions of foreign producer nations. Our policies *must* recognize this vulnerability.



IPAA President Barry Russell

- **Future domestic natural gas and petroleum exploration and production will increasingly depend on independent producers.** Generally, domestic petroleum production is divided roughly 60 percent from the lower 48 states onshore, 20 percent from the offshore, and 20 percent from Alaska. Since 1986, the share of onshore lower 48 states production by independents has increased from 45 percent to more than 60 percent. Independents also are becoming increasingly active in the offshore. Independent producers drill over 85 percent of the wells in the U.S., produce 40 percent of the petroleum, and produce over 65 percent of the natural gas. This trend will continue.

The reasons are straightforward. Large, integrated petroleum companies are driven by their need to generate adequate shareholder returns. This requires finding and developing large “elephant” fields. However, most of the U.S. is characterized by mature fields that yield more limited quantities of natural gas and petroleum. Many of the large U.S. field prospects, such as the Arctic National Wildlife Refuge (ANWR), are not available for development. In the offshore, moratoriums limit many options; those that are left are largely in the “ultra-deep” portions of the Gulf of Mexico. Compelled to fill their refineries, major integrated companies focus their development on the deep Gulf of Mexico and overseas. This leaves the brunt of future domestic resource development to independent producers—large and small. Independents rely on revenues generated solely in the upstream and are more susceptible to price swings that strip away critical financial resources.

- **Natural gas is an increasingly important element of domestic energy supply.** The NPC Natural Gas study concluded that domestic natural gas demand will increase from the current 22 trillion cubic feet per year (Tcf/yr) to 29 Tcf/yr by 2010. Most of this increase will be needed to fuel expanding electricity generation. Importantly, the NPC study concludes that future natural gas needs can be met through domestic resources supplemented by other North American resources:

U.S. gas demand will be filled with U.S. production, along with increasing volumes from Canada and a small, but growing, contribution from liquefied natural gas (LNG) imports....Two regions—deepwater Gulf of Mexico and the Rocky Mountains—will contribute most significantly to the new supply.... U.S. production is projected to increase from 19 TCF in 1998 to 25 TCF in 2010, and could approach 27 TCF in 2015. Deeper wells, deeper water, and nonconventional sources will be key to future supply.

Key factors to meeting future energy demand addressing domestic petroleum development:

Access to capital
Access to the natural resource base

Access to technology
Access to human resources

Actions Needed to Improve Domestic Energy Supplies

Access to Capital. The federal government needs to take actions to improve capital flow into this critical industry. Generally, there are two areas for possible action (1) tax reforms and (2) federally backed financial instruments. The most immediate focus should be on tax reforms.

IPAA Capital Access Policy Recommendations

Short-Term Tax Reforms

Tax reforms are essential to preserve existing domestic production. IPAA believes there are four key elements that should be enacted immediately:

- Create a counter-cyclical marginal well tax credit.
- Allow expensing of geological and geophysical costs and of delay rental payments.
- Allow a 5-year net operating loss carry-back for independent producers.
- Eliminate the net income limitation on percentage depletion for marginal wells and the 65 percent net taxable income limit on percentage depletion.

Other Tax Reforms

- Modify the Alternative Minimum Tax.
- Consider a development tax credit.
- Expand the Enhanced Oil Recovery tax credit.
- Consider what tax treatment should apply to the unconventional sources identified in the NPC study, like the current Section 29 tax credit, inactive well recovery, and reevaluating the elements of percentage depletion including the rate and the number of barrels of production that apply.

Federally Backed Financial Instruments

- We should federal financial instruments like the PADDIE MAC concept that would create a FANNIE MAE-like program to help lower the capital costs to the smaller producers so essential to maintaining the nation’s marginal wells.

Earlier this year, President Clinton released documents indicating that he intended to propose legislation to allow expensing of geological and geophysical (G&G) costs and of delay rental payments. He also indicated that he was evaluating proposals dealing with marginal wells.

We are at a rare juncture. Both Congress and the Administration are moving in the same direction regarding tax reforms for domestic natural gas and petroleum exploration and production. Both are looking toward provisions that will encourage exploration. Both are looking at ways to extend the life of domestic marginal wells—our true strategic petroleum reserve. Now is the time to act.

Will these steps guarantee that domestic production will rebound? Nothing is certain, but it will guarantee that more capital will get into this industry when it is needed. And it will avoid the mistakes of 1986 when Congress enacted Alternative Minimum Tax provisions just as the industry needed capital to rebound from low petroleum prices. This was one of many factors that resulted in the loss of 2 million barrels per day of domestic petroleum production from 1986 to 1997.

Our domestic petroleum and natural gas industry must compete for capital against high technology and Internet companies that are generating far higher returns than are likely from this mature but risky industry. We should look at tax reforms that can bring capital to this industry over the next decade and beyond. Investors need reasons to put their capital in domestic exploration and production companies. We must begin treating domestic natural gas and petroleum as critical elements of national economic security. Decisions on tax reforms should be made based on the importance of these domestically produced resources.

Access to the Natural Resource Base. Addressing the issues of access to the nation's resources under government-controlled lands is complicated. Recent successful laws that have addressed access are the Deepwater Royalty Relief Act, The Royalty Fairness and Simplification Act, and moratoriums on rules for illegally assessing new petroleum royalties. We are pleased to note that in a recent decision, *IPAA v. Armstrong*, the U.S. District Court ruled *that the government does not have the legal right to require producers to market at no cost to the lessor*, a matter at the heart of the petroleum royalty rulemaking. These actions have enhanced the development of federally controlled resources.

Royalty relief. The legislative requirements of the Deepwater Royalty Relief Act are expiring. The authority to continue royalty relief will rest in the hands of the Minerals Management Service (MMS). The Act has proven that its approach works. However, while its benefits have largely flowed to the major integrated petroleum companies, independents are now moving more aggressively into the offshore generally and the deepwater more specifically.

Differing access issues. A larger aspect of access to natural resources involves opening access to that which is not now available and halting the trend of further embargoes of western lands. Unfortunately, the Administration avoids dealing with the clear need to open government lands to exploration and production. It hides behind an environmental sensitivity argument that is proven wrong by its own Department of Energy (DOE) report. It focuses on arguments against opening ANWR and avoids dealing with access issues offshore and in the Rockies where the NPC Natural Gas study concludes that more than 200 trillion cubic feet of natural gas is either off limits or difficult to permit.

It is important to understand that access issues differ. ANWR and offshore activity off of California, the Eastern Gulf of Mexico, and the Atlantic are constrained by policy decisions, both executive and legislative, through prohibitions and moratoriums. These are based on outdated reactions to spills occurring in the past. The Administration's own study, *Our Ocean Future*, concluded unequivocally that offshore natural gas and petroleum production is a success story. We need to move into the 21st century and make enlightened decisions to use these critical national resources.

Because these are government lands, it is necessary that federal agencies issue permits for the exploration and production activities. These agencies are charged with the task of developing environmental management plans for areas under the National Environmental Policy Act (NEPA). NEPA can be used to create effective, environmentally sound management plans, or it can be used to delay and deny access. NEPA is only one of many laws that are involved in the planning or permitting processes and the Bureau of Land Management is only one of the agencies that must be accommodated. Others include the Endangered Species Act and the Fish and Wildlife Service, the Clean Water Act can involve both the Environmental Protection Agency and the Corps of Engineers when wetlands are concerned, and even the Clean Air Act.

Access Offshore

- IPAA believes it is critical to continue to provide a royalty structure that encourages offshore development. IPAA and others involved in the offshore are working together with MMS and DOE to create a royalty structure that will enhance domestic production. If this result does not occur, Congress will need to address offshore royalty policies.
- Offshore moratoria policies need to be revisited and revised.

Access in the Rockies

Access in the Rockies won't be resolved by a single act. Many areas are limited during certain times of the year by management plans designed to protect various species. While each plan individually provides opportunities for resource development, collectively, they interact to effectively prohibit natural gas and petroleum extraction.

The industry must deal with a mosaic of limitations. Some involve land that is completely excluded from natural gas and petroleum exploration and production.

- The Antiquities Act of 1906 has been used to declare areas as national monuments, thus placing them completely off limits.
- The Department of Agriculture is proposing to expand roadless areas in national forests that will preclude natural gas and petroleum development.
- Some national forests, like the Lewis and Clark National Forest, projected to be a world class natural gas source, have been administratively closed to natural gas and petroleum development.
- Wilderness areas have been created without an understanding of the resources that might be lost.

IPAA Access Policy Recommendations

If we are to provide the country with the domestic energy it deserves, we need to create national policies that allow access and environmentally sound development of our national resources.

- **Develop a land inventory.** Congress should compel the development of a land inventory to determine where the most likely resources lie. When actions like this have occurred in the past, they allow the disputes to be better focused. They allow the issues to be discussed in a real rather than hypothetical context which can lead to real solutions for specific areas.
- **Gain a clear understanding of the impediments to land access.** We need to know how many laws, regulations, conflicting management plans, and whatever else are in play. This perspective is essential to provide a real sense of how these actions can result in effectively foreclosing any development.
- **Allow reasonable access to the resource.** We cannot expect to meet our nation's needs for clean burning natural gas without reasonable access to the resource. The NPC Natural Gas study and all other analyses conclude that the Rockies contain significant extractable reserves of natural gas. Yet, in the Rockies access is being limited. It is either the unanticipated outcome of laws, regulations, and plans that unintentionally deny access or the manipulation of these laws to produce that outcome. In either case, access limitations are not the result of a clear policy decision. Consequently, we need a commitment from Congress and the Administration that these types of constraints will be eliminated or restrained and proper funding will be provided on a continued basis to allow environmental documents, leases, and drilling permits to be issued in a timely fashion.

Clearly, there are environmental extremists who will not support this essential development. But, as the DOE has demonstrated in its NPC report, it can be done—and done in an environmentally sound manner. However, it will take effort, and it will also take courage.

Access to Technology. Domestic natural gas and petroleum development have changed dramatically during the past two decades through the application of new technologies such as 3D and 4D seismic analysis, horizontal drilling, and the use of advance offshore technologies. The widespread availability of these and other technologies will be critical to meeting future challenges as well.

Access to Human Resources. During the 1998-99 low petroleum price crisis, the natural gas and petroleum extraction industry lost 65,000 jobs of which only 7,000 have returned. Employment has dropped below 300,000 from levels that exceeded 600,000 in 1984. These are highly skilled jobs at both the rig operator and engineering level. Many of the domestic industry workers are Hispanics. Once people leave the industry, however, it is hard to attract them back. Attracting new workers is equally difficult. Enrollment in petroleum engineering has consistently fallen over the past several years. While these are not issues that are dominated by federal policy decisions, they are nonetheless essential to meeting future natural gas and petroleum demand.

Conclusion

On balance, future supply of domestic natural gas and petroleum will require a clear recognition—by the federal government and the nation as a whole—that:

- Natural gas and petroleum provide a value as a domestic resource,
- The domestic industry has changed dramatically since the 1980s and will continue to change toward greater reliance on independent producers, and
- A clear commitment that the federal government is prepared to implement policies and to allow domestic exploration and production; to access the capital, the resource base, the technology, and the human resources that are needed to meet the challenges confronting the country.

The federal government must strive toward sound environmental regulatory programs that do not burden the industry with regulations and paperwork that provide little, if any, environmental benefits. In an era when future natural gas and petroleum production will depend on the amount of capital that must be invested, stripping this capital away through unneeded regulations is counterproductive and unwarranted.

Thank you, Mr. Chairman, for this opportunity to present our views.