

Independent Producers: Meeting America's Energy Needs

Big Oil. Big Oil and OPEC. Clearly, Big Oil will be a target as long as energy issues are debated. And, when Big Oil isn't the target, OPEC usually is. Unfortunately, attacking Big Oil and OPEC is not a real substitute for creating a sound domestic energy policy. Even worse, these attacks can result in reactionary policies that harm independent petroleum and natural gas producers – the producers who are the backbone of domestic production. Who are independent producers? Why be concerned? What needs to be done? Read on.

Who We Are

The domestic “upstream” part of the petroleum and natural gas industry – exploration and production or E&P – is characterized by thousands of companies operating in over 30 states and in the offshore. Overwhelmingly, these “independent” explorationists and producers receive revenues only from these upstream activities. Most employ fewer than 20 employees, but collectively, they are the link to future domestic supply.

Independent Producers Share of Domestic Activities

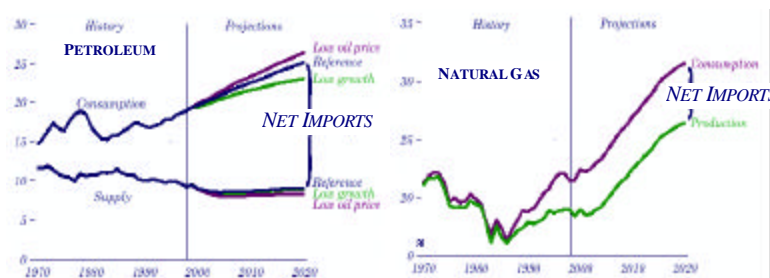
- ?? Wells Drilled – 85%
- ?? Petroleum Produced – 40%
- ?? Natural Gas Produced – 65%

Domestic petroleum and natural gas production has changed over the years, particularly since the mid-1980s. Maturing production areas in the lower 48 states and the need to respond to shareholder expectations have resulted in major integrated petroleum companies shifting their exploration and production focus toward the offshore in the United States and in foreign countries. More and more, these large companies must rely on large producing fields that are found only in frontier areas. Consequently, domestic production in both the lower 48 states and in the near offshore are areas where the role of independents is increasing. For example, the independent share of lower 48 states petroleum production has increased from 45 percent in the mid-1980s to over 60 percent by 1995 – and these states, despite their mature fields, still account for 60 percent of domestic oil production. Similarly, independent producers account for 65 percent of domestic natural gas production. These trends will continue. The nation will need a strong independent exploration and production industry to meet its future needs.

Why Be Concerned

Like it or not, the United States will remain dependent on petroleum and natural gas well into this century.

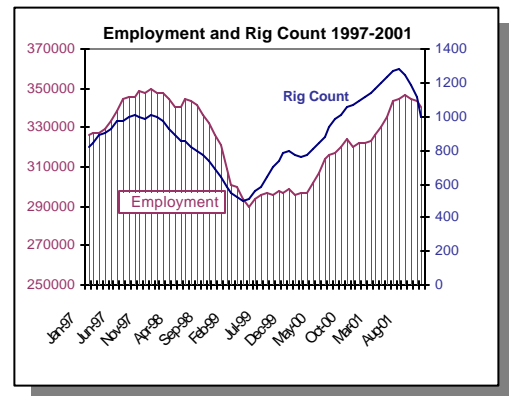
EIA Petroleum & Natural Gas Projections



The Energy Information Administration estimates that petroleum and natural gas will account for 66 percent of domestic energy consumption in 2015. A recent National Petroleum Council *Natural Gas* study projects that

domestic demand for natural gas will increase by more than 30 percent by 2010. At issue will be whether these increases come from domestic or foreign sources. To prevent more foreign dependency, the role of independent producers becomes more critical.

However, because they operate in the upstream, these independent producers are more susceptible to shifts in the commodity market prices of crude oil and natural gas. So, when petroleum prices fell to historically low levels in 1998 and early 1999, the effect on these producers was markedly worse than the large integrated petroleum companies. Capital expenditures fell by 30 percent or more, drilling rig counts dropped by 50 percent and E&P employment fell by 65,000. As prices recovered, capital was reinvested in new exploration and production, but even now it is constrained by the recovery of skilled employees. And once again, the cycle of crude oil and natural gas prices has shifted to prices that threaten not just the development of new resources but the continuing production of existing ones.



What Needs To Be Done

To increase domestic natural gas and petroleum production, independent producers must have access to the capital necessary to develop these resources and to the natural resource base. Access to capital is a critical challenge. The E&P business is both capital intensive and risky. However, to attract capital the industry must compete against both other domestic investment options that produce higher returns and the lure of lower cost foreign investments. Access to the natural resource base involves addressing national policies that are limiting the development of government controlled land both offshore and onshore.

At the federal level, the tax code continues to play a critical role in capital availability. Early federal income tax policy helped attract capital for domestic production; some recent policy have driven it away. The Windfall Profits Tax extracted some \$44 billion from the industry that could have otherwise been invested in more production. In 1986, as the industry was trying to recover from the last long petroleum price drop before the 1998-99 crisis, federal tax policy was changed to create the Alternative Minimum Tax that sucked millions more dollars from the exploration and production of petroleum and natural gas. These changes discourage capital from flowing toward this industry. And, without capital the ultimate result is lower production. Since 1986, domestic petroleum production has dropped by over 2.9 million barrels per day. Hearings throughout Congress have echoed with statements that more must be done to increase domestic production. Reform of the tax code is a key component.

Current federal policies seriously limit access to the national resource base. These policies must be restructured to meet future demand. Some of these restrictions are absolute moratoria on offshore development of key resource areas. Federal policies in the Rocky Mountains are halting the development of 137 trillion cubic feet of natural gas through a mix of prohibitions and permitting limitations. These constraints are based on outdated perceptions that production threatens sensitive environments. Federal policies toward government controlled lands are linchpins to meeting future natural gas and petroleum demand. The National Energy Policy recognized the magnitude of these limitations. Executive Orders to consider energy implications in federal decisionmaking and to convene a task force to improve permitting are important first steps in developing a response. But, more must be done. Future policies must be crafted to assure that the benefits of supplying this clean burning essential fuel and reducing national dependence on foreign oil are fully considered.

Finally, the fundamental uniqueness of independent producers and their role in supplying the nation's energy must be recognized and addressed. The price instability of the past four years demonstrates the scope of this challenge. Failure to respond to the low prices of 1998-99 has resulted in the loss of 700,000 barrels per day in domestic production – largely from the permanent closure of marginal wells that become uneconomic at low prices. Cuts in capital investment led to higher oil and natural gas prices in 2000-2001. As the nation now grapples with questions of national security, it cannot afford further losses in domestic oil production and reduced domestic capital spending to find and produce natural gas. Beyond the policies that need to be addressed on accessing capital and domestic resources, global oil policies will be significant. The US needs to recognize that low oil prices will have the most long term adverse effects on domestic supply of both oil and natural gas, on the independent producers that find and provide these supplies. Efforts must be undertaken to seek policies to assure a stable world crude oil market that protects US energy security.