

Natural Gas: It Can Meet Future Demand, But National Policies Must Change

The Energy Information Administration estimates that world energy demand will increase by 60 percent from 1997 to 2020; U.S. energy demand over this period would increase by about 27 percent. Of this increase, natural gas consumption is expected to grow by over 30 percent. At issue – can natural gas supply meet this need? In transmitting the results of its 1999 *Natural Gas* study to the Secretary of Energy, the National Petroleum Council (NPC) answers this question as follows:

The estimated natural gas resource base is adequate to meet this increasing demand for many decades.... However, realizing the full potential for natural gas use in the United States will require focus and action on certain critical factors.

Many of those factors involve national policy choices that must change. Two of the most critical are allowing access to the resource base and enhancing access to capital.

Access to the Resource Base

Unlike petroleum, natural gas supply is dependent on North American resources with 80 to 85 percent coming from the United States. However, much of this domestic supply is accessible only from government controlled lands. The current restrictions affecting access to these lands differ depending on the area, but all must be altered to meet future demand.

Offshore – Western and Central Gulf of Mexico

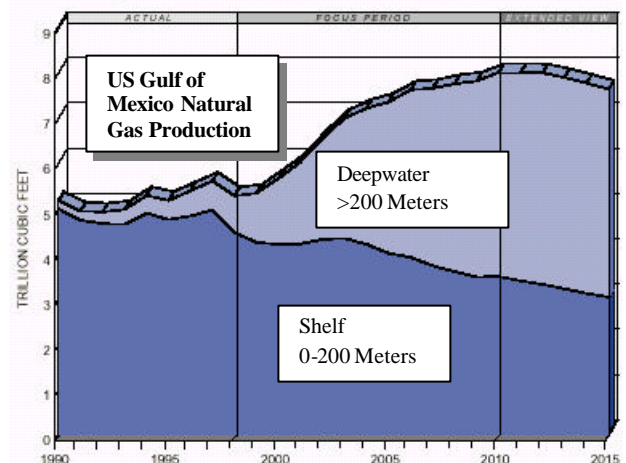
These portions of the Gulf of Mexico have proven to be a world-class area for natural gas as well as petroleum production, accounting for over 25 percent of domestic natural gas production. Production comes from the continental shelf, the deepwater, and the emerging ultra-deepwater. The NPC study projects that future production increases in these areas is essential to meet projected demand. However, future production increases will hinge on federal offshore policies. The most significant of these relate to royalty policies.

First, recent federal regulations on royalty valuation attempt to change the royalty collection point away from the lease.

This approach unlawfully taxes the producer and thereby discourages development. These regulations have been rejected in the *IPAA v Armstrong* case; however, future action of valuation procedures can significantly affect offshore investment. Second, offshore production is particularly suited for royalty-in-kind – paying the royalty with production instead of dollars. It is a more economical and fairer approach. Recent actions to fill the Strategic Petroleum Reserve could utilize 80 percent of this offshore royalty oil and should be encouraged. Third, the 1995 Deepwater Royalty Relief Act was extremely successful promoting activity in the deepwater Gulf. However, the 1995 program expired. The National Energy Policy recognized that offshore regulatory policies could inhibit the sound development of these resources. Its recommendations should be implemented and incentives for deep drilling in all depths in the deepwater, deep drilling for natural gas on the shelf, subsalt and highly deviated drilling should be considered.

Offshore – Eastern Gulf of Mexico, Atlantic Ocean, and California

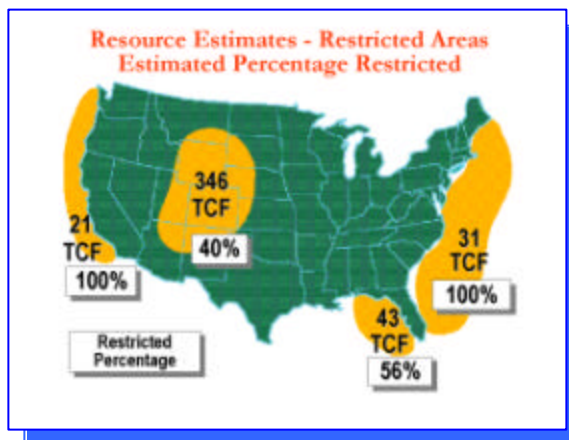
Developing the substantial domestic natural gas reserves in these three areas is prohibited by moratoria. President Clinton extended these moratoria for another ten years in 1998 saying, “First, it is clear we must save these shores from oil drilling.” This is a flawed argument ignoring the state of current technology; it results in these moratoria preventing natural gas development as well as oil. In fact, both the Eastern Gulf and the Atlantic reserves are viewed as gas reserve areas, not oil – those coasts are not at risk. Too often, these policies



are predicated on the events that occurred 30 years ago. For example, no Eastern Gulf of Mexico sale occurred from 1988 to 2001. The recent sale took place only under greatly reduced conditions, but it was an important first step. Federal moratoria policy needs to be reviewed. It needs to be based on a sound understanding of today's technology.

Onshore Restrictions – A Mosaic of Regulations and Prohibitions

Much of the onshore natural gas resource base is located in the Rocky Mountains where federal policy limits access to an estimated 137 trillion cubic feet of natural gas. The constraints differ. Monument and wilderness designations prohibit access to some areas. Regulations like the Forest Service roadless policy and prohibitions in the Lewis and Clark National Forest are equally absolute. At the same time the permitting process to explore and develop resources can work to effectively prohibit access. These constraints range from federal agencies delaying permits to revise environmental impact statements to habitat management plans overlaying one another to prohibit activity to unreasonable permit requirements that prevent production. There is no single solution to these constraints. What is required is a commitment to develop these access policies with a full recognition of the importance of developing the natural gas resource. 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. Similarly, the recommendation to expedite an inventory of resources under federal lands to determine where potential conflicts might exist will improve the debate over access.



Environmental Risk Is Not The Issue

Unfortunately, much of the natural gas production debate will rage over allegations of environmental risk. It should not be an issue. The Department of Energy's *Environmental Benefits of Advanced Oil and Gas Exploration and Production Technology* publication states the situation well. "Resources underlying arctic regions, coastal and deep offshore waters, sensitive wetlands and wildlife habitats, public lands, and even cities and airports can now be contacted and produced without disrupting surface features above them. Wildlife preserves and conservation easements are created and managed jointly by industry, environmental, and government stakeholders. In Alaska, such new approaches as ice pads and roads, multilateral completions, and annular injection of drilling wastes minimize environmental impacts while also reducing costs."

Access to Capital

The federal government also plays a key role in enhancing access to the capital needed to develop domestic natural gas. The federal tax code continues to play a critical role in capital availability to produce domestic natural gas. To meet future natural gas demand, producers must spend around \$40 billion per year through 2015 – an increase of approximately \$10 billion per year. To get these funds, this inherently risky industry must compete against both other domestic investment options that produce higher returns and the lure of lower cost foreign investments.

Short Term Tax Reforms

- ?? Allow expensing of geological and geophysical costs and of delay rental payments
- ?? Create a countercyclical marginal well tax credit
- ?? Eliminate net income limitation on percentage depletion for marginal wells
- ?? Eliminate 65% net taxable income limit on percentage depletion
- ?? Modify the Alternative Minimum Tax

Reform of the tax code will significantly determine the success of this effort. Today, there is wide support for a short list of tax reforms by both Republicans and Democrats. Many have already been passed by the Congress in some form. They should be enacted at once. Beyond these, further tax reforms to encourage new exploration and production should be developed and passed.