October 17, 2005

An Open Letter to Congress:

This letter will largely focus on the effects of hurricane storm damage on offshore natural gas production and the implications on the domestic natural gas market. However, it is equally important to recognize that the storms are affecting an already tight market. The Independent Petroleum Association of America (IPAA) represents the thousands of independent producers who supply over 80 percent of the nation's natural gas and whose members hold 90 percent of Outer Continental Shelf leases. Since the damage created by Hurricanes Katrina and Rita, serious concerns and confusion exist regarding the recovery of Gulf of Mexico natural gas production shut down during the storms. The most accurate information regarding this recovery is released by the Department of Interior's Minerals Management Service (MMS). MMS acquires information from all offshore producers and only it can provide comprehensive summaries of the offshore production status. As of mid-October, roughly 60 percent of Gulf natural gas production remains shut in. Information available anecdotally to IPAA confirms the situation presented by the MMS data. No industry group has the ability to provide a more comprehensive assessment than MMS. In addition, onshore Gulf Coast natural gas production has been similarly affected by the hurricanes but there is no single information clearinghouse on the magnitude of this impact.

Moreover, predicting the pace of recovery of Gulf natural gas production is impossible at this time. Too many issues must be resolved. The natural gas production, processing and transportation chain has several elements – all of which are recovering at different rates from the storm damage. First, producers must be able to reach their production facilities and repair them; this process is underway and the effects are being tallied. Damaged equipment must be repaired and destroyed equipment must be replaced. Demand for repair services and replacement equipment exceeds its current supply. Second, offshore pipeline gathering systems must be tested for damage and repaired. Third and perhaps most significant, onshore gas processing facilities must be repaired and restarted. This component of the natural gas delivery system is usually a seamless element, but in the current situation its importance cannot be overlooked. Much of the onshore gas processing capacity in Louisiana and some in Texas have been shut down. In some cases flooded facilities are the constraint, in others lack of power, in others equipment damage. However, without effective gas processing to remove liquids produced with natural gas, pipelines cannot accept the gas produced. Onshore pipelines represent the fourth element of the delivery system and they, too, have damage or power losses that must be addressed. In addition, there are also instances where natural gas is produced with crude oil or condensate and as a result the downstream liquids pipelines and processing facilities must be returned to service before the natural gas may be produced. Some offshore operators are taking the unusual and costly to measure of producing liquids into offshore barges and tankers which will then allow natural gas to flow as well.

These circumstances create serious concerns regarding natural gas supply capabilities this winter with attendant price implications. While most analyses suggest that adequate supplies will exist to meet "firm" contracts, this is only a part of the natural gas market. Much of the market is comprised of "interruptible" contracts that do not guarantee delivery of natural gas. These contracts involve both manufacturing and electricity generation. Some of this energy can be replaced from alternative energy sources, but much of it will compete for available gas supplies and drive the price accordingly.

In the natural gas commodity market, the "market clearing price" determines where the available natural gas will go. However, this price will continue to be a high one – and realistically – will reflect demand "destruction". Demand destruction hurts the economy as jobs will be at risk and manufacturing costs will be higher. Demand destruction has been a prevalent factor in the natural gas market for over a year. Moreover, the higher prices will have an adverse economic effect on those consumers who will be able to receive natural gas and some of that will fall on residential consumers.

IPAA believes that the Low Income Home Energy Assistance Program (LIHEAP) needs to be fully funded to reduce this impact. Clearly, the natural gas market will be stressed for many months including this winter. While producers are working as quickly as practicable to return Gulf of Mexico production to pre-storm levels, the current situation comes on top of an already stressed market. And, despite all man-made efforts to improve natural gas supply, ultimately, temperatures will play a key role in the winter market.

Natural gas price increases prior to the hurricanes were reflecting a market where supply was already limited. While crude oil prices have experienced a similarly tight world market, crude oil has greater flexibility than natural gas. Natural gas is a North American market where the United States and Canada provide essentially all the natural gas consumed in the United States. While liquefied natural gas (LNG) represents a growing component of supply, in the short term it is limited to existing facilities. Producers have been consistently increasing their development of domestic natural gas to respond to demand. Natural gas drilling rig counts continue to increase; the most recent weekly count is 1262 compared to 1057 a year ago. But production has remained relatively constant because new production has been coming from smaller reservoirs and the natural decline rate of existing and new wells has increased. In response to the storm related crisis, producers are looking for additional production from onshore wells – working closely with the federal land management agencies to seek expedited measures to develop more production as quickly as possible. Whether these efforts will enhance production this winter is uncertain, but producers are committed to this goal.

A major factor in the underinvestment in oil and natural gas wells and facilities that led to this crisis was government policies – particularly long term price controls on natural gas and the Windfall Profits Tax on oil. Most important, the United States – unlike any other country in the world – has made policy decisions to exclude the vast majority of federally controlled onshore and offshore lands from oil and natural gas development. Well over 50 percent of future U.S. oil and natural gas reserves underlie these lands. According to studies by the Department of Energy's National Petroleum Council, the U.S. is estimated to have over 100 years of natural gas supplies – if they can be accessed.

Some policymakers have called on industry to suppress prices. While these calls make for good press, they fail to recognize the nature of the natural gas commodity market. Even at the current high natural gas prices – and oil prices for that matter – producers are essentially price takers not price makers. Most natural gas contracts are based on a commodity market price at some market hub with an adjustment for quality and/or transportation. When the commodity market reacts to market forces – supply reports, demand reports, storage reports, weather forecasts or other information, the price changes up or down. The producer does not control these prices. Policymakers must also recognize that high prices have also led to greater investment in new natural gas reserves, like deep natural gas wells and tight formations, where the economics would not have justified the investment before. Independent producers are particularly active. John S. Herold recently determined that independents invest 150 percent of their domestic cash flow back into new production – a mix of internal and borrowed capital. Independents will continue to invest in domestic natural gas, but they are also being affected by higher energy costs and tight equipment service markets. For example, drilling rig day rates have doubled since 2000 and new rigs are available generally only if the producer is willing to guarantee long term leasing at these higher rates.

No one has the ability to accurately judge what the winter natural gas market will be. But, as producers, IPAA's members are aggressively trying to restart their Gulf Coast offshore and onshore facilities, maintain their active development programs and seek to speed this development.

Throughout the coming months, IPAA will use its website to provide additional information. Additionally, if IPAA can provide further assistance, please contact us at 202-857-4722.

Sincerely,

John B. Walker

John B. Walker
Chairman