Testimony Of Jerry Jordan Chairman Independent Petroleum Association of America

Committee on Energy and Natural Resources

US Senate

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Mr. Chairman, members of the committee, I am Jerry Jordan, Chairman of the Independent Petroleum Association of America and President of Jordan Energy, Inc., in Columbus, Ohio. IPAA represents the 7,000 independent oil and natural gas producers that drill 85 percent of domestic oil and natural gas wells and produce approximately 40 percent of domestic oil and 66 percent of domestic natural gas. We are the segment of the industry that is damaged the most by the lack of a domestic energy policy that recognizes the importance of our own national resources.

Let me say at the outset that we understand the pain that high energy prices can cause, and we sympathize with those who have been shocked by sudden price increases in heating oil and diesel fuel. But it is equally important to understand that a year ago we were watching friends in the oil patch we had known for decades being driven out of business, companies that had been handed down from grandfather to father to son closing their doors forever. Neither situation is acceptable. Dramatic price shifts harm everyone. We need to look for routes to stability for both producers and consumers.

There is another fact that is frequently lost in the debate over high heating oil or diesel prices. Crude oil costs 50 cents per gallon when it is $21 per barrel. At $30 per barrel, it costs about 71 cents per gallon. So, when heating oil or diesel prices soar by $1.00 per gallon in a week, the source of the problem is not the crude oil.

About a week ago, it was reported that Energy Secretary Bill Richardson said that the Administration was caught napping at the start of the current heating oil crunch in the Northeast. Well if that's true, the Administration must have been hibernating during the 18 months that oil prices dropped to historic lows in 1998 and 1999.

Almost a year ago, the Administration started an analysis under Section 232 of the U.S. Trade Expansion Act to determine whether oil imports pose a national security threat. It has yet to be completed.

For the past two years we have heard President Clinton speak repeatedly about his concern for the jobs of 10,000 American steelworkers that were lost due to foreign competition. We have heard nothing about the 65,000 American jobs lost due to low oil prices.

We met with representatives of the president when oil prices were at their depth. We asked that the president state clearly that he understands the value of domestic oil and natural gas production and the importance of maintaining and enhancing it. They are words he has never spoken. This year as 1997 prices have returned we now hear voices of complaint. Recently, President Clinton was quoted as saying that he believed oil prices were too high and that it would

be in the best interests of OPEC countries to lower prices. It is position echoed by many in Congress.

It is this consistent lack of interest in domestic oil and natural gas production that hurts the nation the most. Few in Washington seem to understand that today's problems result from prior decisions by our government.

Let's review the critical facts facing us today.

One, it is wrong to compare today's crude prices to 1998 and 1999. Those prices were at historic low levels. 1997 is a more appropriate comparison .

> Over the past two years the United States lived with unusually low crude oil prices. At the depth of the crude oil price crisis, crude oil was selling at prices – on an adjusted basis – not seen since the Great Depression. These prices were crippling the domestic oil and natural gas exploration and production industry. Over the eighteen-month time frame of low prices, the industry lost 65,000 American jobs. Even after months of higher prices, only about 7,000 of these have been recovered. Eighteen months of low oil prices resulted in devastating reductions in capital investment in the industry both domestically and worldwide. The consequences of this lost investment will take years to measure as existing wells were shut down prematurely and delays in bringing new wells into operation will no doubt limit the potential ability to meet expanding demand. The implications of those Depression-era prices are not just domestic. The lost investment extended to all producer countries.
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> Thus, if we are to realistically compare today's prices against a past price, we should look to late 1997 before the oil price crisis began. Then, the economy was booming as it is now – oil prices were not a constraint.

Two, we now import over 55 percent of our crude oil demand. Like it or not, this is a national security issue. Our economy could well be defined by the decisions of Saddam Hussein in the near future.

> There is pending an analysis under Section 232 of the U.S. Trade Expansion Act to determine whether the current level of oil imports presents a threat to national security. This assessment has been made five times before. In each instance the analysis concluded that a threat exists. However, perhaps now more than ever, the threat is as imposing as it was in 1973 when the Arab Oil Embargo crippled the American and European economies. While that crippling effect required the concerted effort of many Arab countries, today, it could accomplished by just one country – Iraq. Why?
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> Clearly, Iraq's actions are driven by its own political agenda. As it was prior to the Persian Gulf War, Saddam Hussein's objective is to dominate the Middle East. What he could not achieve militarily in 1990, he now seeks to achieve through the manipulation of other countries. Today, he seeks to rid himself of the UN sanctions, to gain the ability to control his nation's oil resources and spend that wealth how he chooses. He uses the failed UN humanitarian aid process to gain worldwide sympathy for the Iraqi children he prevents from receiving food and medicine that has been purchased for them. He uses the

greed of France and Russia and China to restore and improve Iraq's oil fields to weaken UN Security Council resolve. He uses radical Moslems to try to destabilize his Arab neighbors' governments. He will use an oil weapon as soon as it becomes available.

When will that be? Today, the world uses about 77 million barrels per day of oil. The oil price crisis of 1998-99 essentially resulted in a lost year of capital investment in maintaining existing oil production and developing new production. As a result the world's excess oil production capacity has diminished. Most of it is controlled by Saudi Arabia, which has long been considered the world's swing producer of crude oil. Estimates of this capacity vary. Some believe the Saudi's possess 6 million barrels per day of additional capacity; others believe it could be as low as 1.5 million barrels per day. Iraq currently exports about 2 million barrels per day, sometimes more. When the world's excess capacity is less than Iraq's exports, Saddam Hussein will control world oil prices. Then, our choice will be $50+ per barrel of oil or removal of UN sanctions or both.

Three, in 1986 we produced 8.5 million barrels/day of domestic oil; now, production has dropped to below 6 million barrels/day.

Prior to the last oil price crisis in 1986, domestic oil production was about 8.5 million barrels per day. By 1997, domestic production had dropped to about 6.5 million barrels per day – a 2 million barrel per day loss. In 1998, the Clinton Administration's energy strategy called for a 500,000 barrel per day increase in domestic oil production by 2005 – moving to a 7 million barrel per day target. Now, as a result of the 1998-99 price crisis, domestic production has dropped below 6 million barrels per day.

Four, this drop is oil production reflects changes in investment in the United States – a change largely due to the 1986 price crisis as major oil companies shifted their investments out of the U.S. lower 48 states onshore.

The 1986 oil price crisis demonstrated that the United States was the world's highest cost production area. In particular, the lower 48 states onshore is the highest cost area because it is such a mature area compared to the rest of the world. Combined with domestic policy changes like the 1986 tax reform law that created the Alternative Minimum Tax, the desirability of domestic oil development in the lower 48 states onshore dropped dramatically. As a result, the major integrated oil companies revised their investment strategies. They shifted their investment plans to develop large "elephant" prospects. In the United States these are located offshore or in Alaska – frequently in areas where development has been prohibited. Thus, our own policies led to a shift in capital deployment that encouraged foreign oil development over domestic.

Five, the role of independent producers has steadily increased since the mid-1980s. In the lower 48 states onshore which accounts for 60 percent of domestic oil production, the independent share has increased from about 45 percent to over 60 percent. This shift is irreversible and represents a profound change in the character of the domestic industry. Independent producers are primarily involved only in the upstream part of the industry and do not have the diverse resources of major integrated oil companies. They need different governmental policies.

For independent producers this shift in strategy by major oil companies has opened opportunities throughout the United States. While most of this effort has been in the lower 48 states onshore, independents are also moving aggressively into the offshore. At the same time, for independents to meet the challenge, they must have capital. Independents do not have the diverse resources of majors; they draw their income from the upstream part of the industry: producing oil and natural gas. Many are small business entities that draw their capital from their current production.

For these companies domestic tax policies like the AMT, like limitations on the use of percentage depletion, constraints on intangible drilling costs, efforts to limit the expensing of delay rental payments and geological and geophysical costs, constrain their capital retention and their ability to increase production. Price stability becomes a more critical concern to generate the ability to attract capital compared to other investments. They differ from major integrated companies and need policy structures that reflect these differences.

Six, independent producers account for 85 percent of wells drilled in the United States and produce 66 percent of the nation's natural gas.

In the United States, independent producers – with the capital to do it and access to the resources – are the aggressive explorationists. Their "wildcatter" image is not without merit. While they use far more sophisticated tools today, independents are still willing to develop new frontiers and rework old ones. They drill the most wells. And, they produce most of the nation's natural gas. So, as natural gas' role increases in the domestic energy supply mix, it is independents who will be the mainstay.

Seven, natural gas cannot economically be supplied to the U.S. market from outside the continental area. If it doesn't come from the U.S., it must come from either Canada or Mexico. Currently, Mexico does not export natural gas.

Natural gas differs from oil in one key respect – transportability. As a liquid, oil can be loaded on ships and sent around the world. Gas isn't as easy to move across oceans. Economically, natural gas must be supplied in large volume in the continental area where it is found. In North America, that means that the supply sources for the United States are domestic production, Canada, and Mexico. Today, U.S. supplies come from domestic production and Canada.

Eight, the National Petroleum Council's Natural Gas Study estimates that domestic natural gas supply must reach 29 trillion cubic feet per year by 2010. Natural gas and crude oil are intrinsically related – they are found together, they are produced together, and they require the same industry. Without a healthy domestic oil industry, we cannot have a healthy domestic natural gas industry, and we cannot meet future needs.

Natural gas is a key fuel to America's future. All credible energy studies predict the need for increased domestic natural gas use. It is a significant task. Building to a supply level of 29 or 30 trillion cubic feet per year by 2010 requires not just the development of new reserves but the replacement of existing ones. It will require capital, access to resources,

technology, and a trained workforce. It will also require a clear understanding that crude oil production and natural gas production are intrinsically related. Physically, they exist together. Physically, they are produced together. Economically, they require the same industry skills, the same capital, the same workforce. We cannot achieve the national goals for natural gas use without a healthy domestic oil industry.

For all these reasons we should be developing national policies to maintain and enhance domestic oil and natural gas production – but we have not. Over the past 15 years this nation has made policy choices that strip capital from domestic oil and natural gas production, limit access to essential resources, aid foreign producers, and under the guise of environmental righteousness limit logical options.

Let me address some of these.

- *The 1986 tax reform act stripped away critical capital after the 1986 oil price crisis through the creation of the Alternative Minimum Tax. Some of this effect was corrected in 1992 amendments. But President Clinton vetoed critical changes to the AMT and several specific provisions affecting independent producers that were passed by Congress in last year's tax bill.*

Domestic tax policy remains an important component to the maintenance and enhancement of domestic oil and natural gas production. Because domestic production must compete in a world market where foreign producer nations determine the price of oil, domestic producers cannot define the price framework and must operate within the price that exists. At the same time, domestic oil projects must compete for investors against foreign projects and against other investment opportunities. In the 1990's, their rate of return was 6 to 8 percent – paltry given the risk and capital intensive nature of the industry and certainly compared to the returns from many new high technology and internet companies. Even government regulated sectors, like pipelines and utilities, have typical returns between 12 and 14 percent.

It is in this context that one must look at the role of the federal tax code. The tax code determines how much income oil and gas producers will retain and how much capital will be available for reinvestment in maintaining production or developing new production. It influences the rate of return on projects and therefore the appeal of a project to investors. Independent producers typically drill off their cash flow. That is, they must have producing operations generating revenue to maintain and develop properties. Historically, independents have "plowed back" 100% of their after tax revenues into their operations. Thus, when their tax burden is reduced, it means more funding for domestic production of vitally needed oil and natural gas.

Clearly, at a time when we are trying to improve national security and when our imports of foreign oil already exceed our domestic production, it is counterproductive to tilt the incentives for investment to "push" more investment overseas, or limit its availability in the U.S. Many other countries allow full cost recovery before applying any income tax. The U.S. rules are already more complex and produce an overall higher tax rate on oil and gas development than many if not most foreign countries. Several industry analytic

companies have evaluated the investment climate in the U.S. versus foreign countries. On the basis of business and political risk for oil and gas production investment, the U.S. ranked 31st out of 111 countries. On the basis of leasing and fiscal tax policies, in a ranking system where individual states were compared to countries, the state of Texas ranked 180th. These analyses point to the problems facing investment in domestic oil and natural gas production.

Domestic tax policy needs to be crafted to encourage the maintenance and enhancement of domestic oil and natural gas production. The tax bill passed by Congress last year included five key provisions that would help retain capital for domestic production. These need to be included in the tax code.

Similarly, the National Petroleum Council's *Marginal Wells* study concluded that a marginal wells tax credit would provide countercyclical protection to the vulnerable marginal wells that produce about 20 percent of domestic crude oil and represent this nation's true strategic petroleum reserve. Last year, Congress at least appeared to be moving toward tax policies that would help the investment climate for domestic oil and natural gas production.

But, we must be watchful. Two of the current presidential candidates have proposed tax plans that would attack key elements of the current tax code that provide capital to the independent producer.

- *A linchpin to develop gas supplies consistent with the determinations of the NPC Natural Gas Study is access to resources. Yet, successive administrations have created offshore moratoriums to prevent environmentally safe development of domestic resources off California, in the Gulf of Mexico and in the Atlantic. The most egregious of these actions was in 1998. After going through the charade of commissioning a study of the risk to the oceans from offshore development – a study that stated unequivocally that offshore development was environmentally sound – President Clinton extended the California offshore moratorium another decade.*

For decades the nation has deliberated the use of its offshore resources with mixed results. In the Gulf of Mexico where drilling and production has been allowed, offshore development has provided substantial oil and natural gas resources to the nation. Offshore production now accounts for roughly 20 percent of domestic oil production and over 25 percent of natural gas production. This production has been both a technological and environmental success story. On the other side of the coin, unreasonable opposition to the offshore development of California and other areas has limited use of these potential resources. Under the guise of environmental righteousness, the nation is denied resources that can be produced in a clearly environmentally sound manner.

During the 1998 Year of the Ocean activities, the Heinz Center for Science, Economics and the Environment analyzed the history and potential of offshore production for the National Oceanic and Atmospheric Administration. It was unequivocal in its conclusions that offshore production can be done and done well. Yet, this assessment was ignored by

the Clinton Administration as it imposed another ten year extension to the California offshore moratorium.

- *For well over two decades we have debated whether to open the Arctic National Wildlife Refuge (ANWR) Coastal Plain to oil and natural gas development. It could yield a field on a par with Prudhoe Bay. Development has never occurred under the guise of environmental righteousness. Now, the latest question is whether the Clinton Administration will use the Antiquities Act again to wall off any development.*

Debate over the use of ANWR parallels the offshore debate. The nation is losing access to valuable potential resources that can be produced in an environmentally sound manner. The latest question will be whether the Clinton Administration will use the Antiquities Act to designate the area as a National Monument to prevent its development.

- *On a broader scale the Clinton Administration has consistently closed off access to national resources. In addition to offshore moratoriums and opposition to ANWR development, it has initiated policies to prevent access to forest land by preventing road construction. It has denied permits on federal land. It is an attitude that also pervades Congress. For example, the House has passed legislation to prohibit the development of natural gas resources under Mosquito Creek Lake in my home state of Ohio.*

- *IPAA initiated a Section 232 request regarding the level of crude oil imports in 1993. Despite a clear determination that the level posed a threat to national security, the Clinton Administration proposed no concrete policies to enhance or maintain domestic oil production. As mentioned earlier, another Section 232 assessment is pending, but there have been no recent indications that better policy options will be proposed.*

No Section 232 analysis has concluded that oil import levels do not pose a threat to national security. Now is the time to recognize that the while steps to improve energy efficiency, develop alternate fuels, diversify import sources, and other steps are useful, they are worthless without a strong domestic oil and natural gas production industry. Without sound policies that support domestic marginal well production, the nation loses its true strategic petroleum reserve. Without sound policies that support domestic natural gas production, the nation's most plentiful "alternate" fuel will never meet its potential.

- *The Environmental Protection Agency develops policies that undermine the domestic resources. For example, after initially opposing an erroneous court interpretation of the scope of underground injection control under the Safe Drinking Water Act, the Clinton Administration's EPA now opposes legislation to structure the law as it was originally intended, as EPA had originally argued before the court.*

The 11th Circuit Court of Appeals in the *LEAF v EPA* case erroneously interpreted the scope of the Safe Drinking Water Act's Underground Injection Control (UIC) program to

apply to the injection of fluids for the purpose of hydraulically fracturing geological formations to stimulate reservoirs for oil and natural gas production. EPA argued this position in the case, a case where no environmental damage was shown. It lost. Subsequently, the State of Alabama was threatened with the loss of its primacy to run the UIC program for coal bed methane operations. EPA compelled it to require the use of federally certified drinking water in hydraulic fracturing operations at substantial cost with no environmental benefit. However, EPA now opposes legislation that would correct the erroneous court decision.

If this Court interpretation is allowed to stand, it could threaten normal safe hydraulic fracturing operations at all oil and gas operations in all states. Congress must act. LEAF has filed another action in the 11th Circuit Court seeking a review of the EPA action in Alabama.

- *Implementation of the limited emergency oil and gas loan guarantee program has been so constrained that no loan guarantees have yet to be provided. Yet, in 1998 when oil prices were at their lows, the United States was sending funding to Russia and Mexico to develop their oil industries. We have shown more interest in a pipeline across Turkey than preserving domestic resources.*

Last year after considerable delay, Congress passed the Emergency Oil and Gas Loan Guarantee Program. While the congressionally imposed restraints on the program make it complicated to implement, the interpretation of the law by the Loan Guarantee Board has so limited the program that it has scared off many potential banks and producers from seeking the financial assistance. To date the first guarantee has yet to be granted and less than 25 applications have been received.

At the same time many independent producers are frustrated that while Congress was delaying action on this program and making it too constrained, while the Administration was further limiting its application, the United States was sending funding to Mexico and Russia to enhance their oil production operations during the depths of the oil price crisis.

The Strategic Petroleum Reserve has been manipulated for budget tricks. Now, there are persistent efforts to use it to influence prices rather than when supplies are in jeopardy.

IPAA has consistently sought two objectives with regard to strategic reserves of petroleum. First, the nation needs to recognize the role of its marginal wells as a true strategic petroleum reserve that produces crude volumes approximately equal to imports from Saudi Arabia. Second, the Strategic Petroleum Reserve was created to deal with supply disruptions of crude oil; it should not be used to influence the market. IPAA objects to selling oil for budget purposes or releasing oil to affect prices.

As a nation we must define policies that recognize the ongoing importance of domestic oil and natural gas supplies. We cannot continue the current path of trashing crude oil as environmentally evil and banking on natural gas to meet future fuel needs.

We cannot continue a policy of reliance on foreign oil at prices that destroy the domestic producer. It will place our energy and economic future in the hands of foreign governments – first because we will lose our domestic oil resources, second because we will not be able to develop our domestic natural gas.

Instead, we must work together – both here in the United States and with foreign producer nations – to develop a stable oil and natural gas development framework. The next several months will test our resolve. Price pressures will continue. The Section 232 action will be completed. Policymakers can establish a sound framework for the future of domestic energy, or they can continue the failed policies of the past. Let’s hope for the right choice.