Statement of Mark B. Murphy President Strata Production Company on Behalf of the Independent Petroleum Association of America and the National Stripper Well Association

United States Department of Commerce on the Emergency Oil and Gas Guaranteed Loan Program Act of 1999

September 22, 1999

I am Mark Murphy, president of Strata Production Company, which is headquartered in Roswell, New Mexico. Strata is a small independent oil and gas producer with 10 full time employees. I am here today to testify on behalf of the Independent Petroleum Association of America (IPAA) which represents the interests of our nation’s 7,000 independent producers which produce approximately 40 percent of America's crude oil and 66 percent of America's natural gas. I am also testifying on behalf of the National Stripper Well Association (NSWA), which represents the small business operators in the oil and natural gas industry, producers with low volume, high cost stripper or marginal oil and natural gas wells.

We appreciate the opportunity to testify and wish to thank Secretary Daly and the United States Department of Commerce for its efforts to implement the Emergency Oil and Gas Guaranteed Loan Program Act of 1999. We especially wish to thank Senator Domenici and his staff for their authorship of this important piece of legislation. We also wish to thank Senator Byrd for his assistance and support during the legislative process, and those that worked so hard to navigate this legislation through the House of Representatives.

During the last 18 months America's independent producer and small service company sectors of our industry have been devastated by low crude oil prices. This has resulted in the loss of 56,000 jobs, business closures and a corresponding rippling effect throughout all businesses in local and regional economies where petroleum is produced. While prices have recently rebounded it make take as long as 18 to 24 months for the industry to recover from low prices due to the loss of critical infrastructure, experienced personnel and most importantly, cash reserves.

We believe that a well-structured Loan Guarantee Program for these small businesses could facilitate such a recovery. Such a program will not only help individual companies but also could provide the opportunity to stimulate local economics and to encourage new investment and lending by local institutions. The benefits of similar loan guarantee programs for the automobile, agricultural and other industries have proven successful at achieving such results.

IPAA and NSWA believe that for such a program to be successful for small petroleum industry companies and the nation as a whole, it must be based upon sound business and lending practices. These practices, both those of industry and of lending institutions, exist today. However, due to the nature of the emergency we are facing, some critical adjustments are needed. I will attempt to address each of these as I discuss the following elements of traditional oil and gas loans. These elements are:

1. Loan Processing and Required Documentation
2. Loan to Value Ratio and Amortization Term
3. Interest Rate

Loan Processing and Documentation:

In order to be effective the loan processing time should not exceed 60 to 90 days. This includes the time from the submittal of the loan request and required documentation to the lending institution until closing. While this may seem quick, a traditional oil and gas loan during normal times has been approved in 30 to 45 days. The additional 45 to 60 days should provide adequate time for review and approval by the appropriate governmental entity. However, in order to achieve such an approval time a concise streamlined package is all that should be required. This information should be consistent with that which has traditionally been required by lending institutions. These items primarily consist of a Reserve Report prepared by a qualified third party professional, generally a registered petroleum engineer, and a Financial Statement typically prepared by a Certified Public Accountant (CPA).

Registered petroleum engineers are readily available and are experienced in preparing reports for private companies, government and lending institutions utilizing standards set by the Society of Petroleum Engineers and recognized by the Security and Exchange Commission. It should not be required that such an engineer be an employee of a lending institution as this would greatly reduce the number of participating lending institutions and self employed engineers, geologists and other professionals who could indirectly benefit from the Program. Essentially, all independent producers have existing arms length relationships which such professionals who maintain data on and are familiar with the individual company's properties. This allows the preparation and submittal of such a report in a timely and cost effective manner.

The other major item included in the submittal is a Financial Statement, which traditionally is either compiled or reviewed by a CPA. Most smaller companies do not have audited Financial Statements prepared due to the prohibitive cost. We note that a requirement of the Program is that a company agree to an audit by the General Accounting Office before issuance of the loan guarantee and annually thereafter. We believe that this is a reasonable and prudent requirement. We would stress however, that the applicant company should only be required to provide Financial Statements consistent in form and content to that which has previously been required by lending institutions. Generally these Financial Statements are prepared by CPA firms which are familiar with the nuances of oil and gas accounting in general and specifically, with an individual company's accounting practices.

Loan to Value Ratio and Amortization Term

Traditional energy loan amounts have generally not exceeded 50 percent of the discounted future net value of the Proved Developed Producing (PDP) properties. This amount is extremely conservative given that the market value of such properties has historically been 90 to 100 percent of such value especially if the properties contain upside development potential. This development potential typically receives an engineering classification of Proved Developed Non Producing (PDNP) or Proved Undeveloped (PUD) reserves. In order to establish thresholds which provide reasonable collateral values and loan amounts, loan to value ratios established under the Program should be increased.

While the specifics of the loan terms are best left to the banks and the individual companies utilizing the Reserve and Financial Reports, we would suggest that general guidelines should provide for a loan amount equal to at least 75 to 85 percent of the future net value of the PDP portion of the collateral. In addition, just as the market place recognizes value for the PDNP and PUD reserve categories so should the Program. Therefore, we would recommend that the loan amount could be increased by an amount equal to 50 percent of the PDNP reserve value and by an additional amount equal to 25 percent by the PUD reserves. These amounts would provide much needed developmental capital allowing a producer to reclassify reserves and thereby enhancing the collateral value and by providing corresponding benefits to the service sector and local economies.

Just as loan values have been traditionally capped at 50 percent of the reserve value, amortization periods have typically not exceeded the financial "half life" of the PDP future net income discounted at approximately 10 percent. Unfortunately this approach will not allow for the extended amortization terms needed by industry. Therefore, we recommend that two elements should be considered.

First, utilizing a discount rate of 10 percent penalizes long life properties by severely reducing the "Present Value" of estimated future income. This discount rate should be reduced to a rate more approximating the current rate of inflation or certainly a rate which does not exceed the Program's interest rate. A present value discount of five to seven percent would appear to be adequately conservative and more realistic for the Program.

The second element is the methodology for establishing the amortization term. A reasonable approach to this should be consistent with the determination of the loan to value ratio. In other words, the term should consider first the value assigned to the PDP reserves and secondly the additional cash flow derived from the development of the PDNP and PUD reserves. In other words, if 75 percent credit is given to PDP reserves then the term should provide for a period of time equal to 75 percent of the estimated future net income. If 50 and 25 percent credit is given to the PDNP and PUD reserves, respectively, then the term should provide for this as well. One alternative would be for the loan to be reamortized prior to the expiration of the Program (i.e. December 31, 2001). This process would envision the updating of the Reserve Report to account for the change of classification of the reserves as a result of development. At this time the loan could be reamortized on the basis of 85 percent of the life of the PDP reserve value. However, notwithstanding the particulars of an individual company's properties and the development schedule, we recognize that the amortization period can not exceed the statutory repayment deadline of December 31, 2010.

This approach is generally consistent with current lending practices but would allow for longer amortization periods while providing a high collateral value more consistent with the market place.

Interest Rate

The amortization term and the interest rate are clearly the most important components of a loan restructuring. We understand that the Program's Board is to determine a reasonable interest rate. We agree that this rate should be based upon the average yield on outstanding obligations of the United States with maturities consistent with the repayment term of the loan. Secondly, we recommend that an interest rate cap, which the administrative agency and the lending institution can charge, also be included in the regulations governing the Program. We understand that similar programs administered by the USDA and Small Business Administration contain a 2 percent interest rate cap. We believe that this would also be appropriate for the Program and would provide the interest rate relief, which is essential to the success of the Program.

Other Considerations:

While the documentation, loan processing, loan to value ratio, amortization term and interest rate are of primary concern other items should also be considered when structuring the specifics of the Program. Some of these are:

- A sale of an individual property and a corresponding paydown in principal should not affect the loan guarantee. The sale of assets within the normal course of business is common in the industry and a partial release of collateral as long as it is accompanied by an appropriate principal reduction should be allowed under the Program.
- The acquisition of additional interest in a company's existing properties and/or the acquisition of additional properties utilizing traditional lending sources must also be allowed. In many cases these type of acquisitions are critical to the development of the existing properties which in turn enhances the collateral value.
- Many local and regional banks are interested in participating in the Program and represent a larger and more diversified opportunity for small companies seeking financing. Some existing Programs (e.g. SBA and others) contain incentives for these "smaller" banks. These incentives should be fully explored and considered.

Summary

A well-constructed program has the potential for allowing a significant portion of the domestic petroleum industry to recover from the devastating impact of low crude oil prices experienced during the last 18 months.

The Board must ensure that regulations and borrowing requirements for the program utilize the best and most effective elements from the U.S. Department of Agriculture and the Small Business Administration programs. The application process for the program must be streamlined, efficient and user friendly for applicants and their lending institutions. The Board must seek to establish criteria that will allow struggling producers and service companies to quickly qualify and receive guarantees, and create an environment where lending institutions will not be apprehensive about working with companies to obtain a guaranteed loan.

IPAA and NSWA are committed to seeing such a program established which a) is based upon sound business and lending practices, b) provides the relief needed, and c) protects the investment of the American people in this important industry.

We believe that the elements of such a program include higher loan to value ratios, extended terms, lower interest rates and the opportunity to expand and diversify the list of energy lending institutions and to provide benefits to related professional entities and service companies in the towns and regions where independent producers reside.

This concludes my comments. Thank you for holding this hearing and for granting me the opportunity to testify.