**Statement of Steve Layton**
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**The Woodlands, Texas**

**Committee on Energy and Natural Resources**
**U.S. Senate**

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*Washington, DC*

Thank you, Mr. Chairman. My name is Steve Layton. I am a third generation independent oil producer based in The Woodlands, Texas.

I have the honor of testifying on behalf of more than 8,000 independent oil and natural gas producers as a representative of the Independent Petroleum Association of America (IPAA).

Today's hearing is intended to examine the current state of the petroleum industry. I must say at the outset that I have never seen the domestic petroleum industry facing a more complicated and potentially devastating set of problems than it now does. The industry has faced a low oil price crisis for the past year, but today's problems are very different and far more threatening than the ones that began the problem.

A year ago, the price crisis was started by a combination of events – the collapse of Asian economies, a warmer than normal winter in the northern hemisphere, and ultimately a market share fight between Venezuela and Saudi Arabia. The events created a surplus of oil in the international market and prices fell. The production most at risk was marginal oil wells in the United States – wells that produce about 20 percent of America's domestic production, an amount equivalent to our imports from Saudi Arabia. And, I might add the wells from which I make my living.

Now, we have experienced a year of low oil prices – historically low prices that threaten the very heart of U.S. oil production. Domestic oil production is divided into three general areas – the onshore lower 48 states, offshore, and Alaska. The onshore lower 48 states account for about 60 percent of total domestic oil production. The Energy Information Agency has released a recent report that over 60 percent of this onshore lower 48 production comes from independents, a percentage that has increased by ten percent over the past ten years. It reflects an irreversible trend. Major oil companies are leaving the onshore lower 48 states. Particularly since 1986 when the last price crisis occurred, major oil companies have turned their attention away from the onshore lower 48 states shutting in or selling off their production. They have concluded that these wells do not produce the volumes they need to meet the return on capital that they seek. Majors now operate in the United States primarily in the offshore and Alaska, but more and more they are seeking their new production overseas.

Consequently, the onshore is now the principal province of independent producers. In contrast to the majors, independents do not have the capital and other resources to carry them through

protracted lean times. As the Energy Information Administration (EIA) put it, referring to an earlier period of low prices:

> Poor profitability in the majors' upstream operations in low-oil-price years can sometimes be offset by better performance in downstream operations. Lacking this integration, the independents were devastated by the oil price collapse, earning a negative rate of return on investment for years immediately following the price collapse.

At current prices, most – if not all – of the onshore lower 48 production is at risk of loss.

The vital infrastructure of our industry is being shattered. Last week, the rotary rig count of oil wells dropped to an all time low, 122. At this number the only oil wells being drilled in the United States are being driven not by a desire to find oil but by the need to meet a lease commitment.

This loss of activity reflects the serious impact low oil prices will have on future production. All oil wells deplete over time. While new technology has made the discovery of oil more effective, it has also allowed oil reserves to be depleted more quickly. Some recent studies suggest that the current oil depletion rate in the Gulf of Mexico is now averaging 26 percent per year. This is dramatically higher than historic rates of 3 or 4 or 5 percent per year. What it suggests is that the industry must spend more money to meet future demand and maintain its reserves. One recent analysis shows the magnitude of difficulty of this task. Looking at ten of the best major oil and gas companies over the past ten years it shows that these companies' exploration and production capital expenditures totaled $260 billion – at a time when a vast overcapacity in the oil service industry kept prices down. For this expenditure, these companies increased their daily oil and gas production by 0.9 percent. Reserves were increased by almost 13 percent, but most of this was natural gas and a sizeable portion was in Central Asia where more needs to be invested to bring it to the world market. Oil reserves were increased by about 1.7 percent.

This brings to bear two key points. First, these were probably the best ten companies, ones with the best financial base. Other companies would have fewer resources. Second, these results will not be achieved without substantial investment. These historic low oil prices are savaging capital expenditure budgets with cuts of 20 to 40 percent so far. Without investment, reserves cannot be replaced.

Behind these numbers is a realization that jobs are being lost by the tens of thousands, skills that will not be recovered by the industry in the future. For the past several weeks we have read about the intense concerns over steel imports into the United States that could cost 10,000 jobs. The Houston Chronicle reported that the American Petroleum Institute estimates 1998 job losses in the industry to be 30,000. IPAA analyzed the domestic oil industry based on economic multiplier factors associated with lost revenues. This analysis concludes that the domestic oil industry has lost 50,000 jobs or more from the current price crisis. Moreover, the country has lost over $1.7 billion in lost federal royalties and state severance taxes, without even assessing the lost income taxes, property taxes, or sales taxes.

On an almost daily basis we see reports of job losses in our industry. Following are some excerpts from the December issue of *Transactions In Oil & Gas* demonstrating the magnitude of these losses:

> **Pioneer Natural Resources Inc.** (Irving, TX) reports further job cuts and restructuring. It will close its Houston and Oklahoma City offices, moving some stuff to Irving. It will cut about 80 employees in Midland from the 170 there. Early this year, it cut about 150 employees from its Midland staff and 50 elsewhere, cutting its six divisions to three. It will cut about 170 employees total in the latest effort, including some from its 100 or so in Argentina and Canada.
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> **Occidental Petroleum** Corp. reports that it will cut an additional 500 jobs above the 550 cuts reported in the October and November *Transactions*. Cuts to come from Bakersfield E&P, Los Angeles headquarters and the Dallas chemical business
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> **BHP Petroleum** reports its planned job cuts to exceed 100, probably up to around400 if my calculations are right. Cuts from the asset and resource teams. BHP to move many other employees to active regional offices, including head of exploration, moving from London to Houston.
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> **BP Exploration Alaska** to make an unspecified number of layoffs by the end of the first quarter of 1999. BP employs 968 in Alaska with 1,000 contract workers.
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> **Equitable Resources Inc.** reports plans to cut about 50 of its employees at its downtown Pittsburgh headquarters. It will transfer another 50 to other Equitable offices and leave about 50 downtown. It also plans to sell its nine-story headquarters building in Pittsburgh.
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> **Seagull Energy** shuts down its third-party gas marketing business, laying off about 23 employees.
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> **Pan Western Energy** (Tulsa) reports it will discontinue producing its marginal properties until oil prices improve.
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> **Schlumberger** reports plans to cut a further 2,900 employees this quarter, raising the total to 5,600.

Without this infrastructure it is not only the nation's oil industry at risk but its future natural gas use as well. This country has a vision of building a future on expanded use of clean burning natural gas. The industry has been challenged to increase natural gas production by about 40 percent – that is a net increase of 40 percent. It will require production not only for that increase but to replace supplies that are depleted during the same timeframe. It cannot happen without a healthy oil industry. Oil and gas are found together. They rely on the same tools, the same science, the same skills, the same financial resources.

If we lose our onshore lower 48 production, our reliance on foreign oil will increase from about 55 percent to over 70 percent. In 1995 the Clinton Administration concluded that our current import level represented a threat to national security, but it concluded that the threat could be met

by diversifying import sources. It is a flawed strategy. Diversity is not security. Today, we import twice as much oil on a percentage basis from the OPEC countries that embargoed us in 1973 as we did then. If we build our energy lifeline on foreign, particularly Middle Eastern, oil, we are placing our economic future in the hands of dictators like Saddam Hussein.

In fact, we would submit that Iraq now controls world oil prices. We would submit that the current U.N. sanctions program has failed on two counts. First, it has failed in its primary mission to provide humanitarian aid to the Iraqi people. Second, it has handed Saddam Hussein the victory he lost in the Gulf War. He invaded Kuwait to control oil prices; now he does and he is penalizing his enemies.

**Why do we believe this?**

First, world oil prices are essentially set by the last barrel sold. A year ago, Iraq exported about 700,000 barrels/day. In December 1998, it exported about 2.3 million barrels/day. By March it will have another 500,000 barrels/day of capacity on line. Iraq was the only OPEC country to boost its oil revenue in 1998. As other OPEC countries have reduced production to stabilize oil prices, Iraq has become the swing producer of world oil. The swing producer sets the price.

Second, Saddam's objectives differ from other oil producers. He wanted higher oil prices when he invaded Kuwait – money he needed to build his military forces. Now, he can't spend money to buy arms. But, he can – by keeping oil prices low – punish his enemies, first by reducing the income to Saudi Arabia, Kuwait, Iran, and others; second, by driving critical U.S. production to be shutdown and plugged forever.

Third, looking purely at demand and productive capacity, today's surpluses should not drive prices to their historic depths. We estimate that worldwide production capacity currently exceeds demand by about 4 percent.

However, this surplus could change as a number of events occur. They are:

> Demand will increase. Currently, the International Energy Agency is projecting demand growth over the next year of 1.5 percent. This is slightly below recent demand growth of about 2.0 percent. It is based on slow recovery of Asian economies. If Asian economies recover more quickly, demand will increase more rapidly.
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> Depletion will occur. As stated above, oil well production will deplete over time. Recent information suggests that the rate of depletion from new wells is faster than older ones were at the same stage of operation. Moreover, as low prices reduce the profitability of wells, the wells will not be maintained, will not be reworked, and depletion at these wells will increase. The rate of this depletion will determine the amount of new production that must be developed to maintain productive capacity or increase it to meet demand.
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> New production will be brought on line. The question is how much and how soon. As stated above, maintaining production levels requires substantial investment. Increasing production requires even more investment. But the reality is that capital expenditures are being cut and cut dramatically. Without adequate investments new production will be diminished.

It would only take a 3 percent worldwide depletion rate under currently projected demand increases to turn the current surplus capacity into a deficit without new production coming on line. Historically, such a tight balance puts upward pressure on prices; it does not drive them to historic lows.

As Daniel Yergin wrote:

> Not only in oil, but in almost any industry…a 99 percent utilization rate and a one percent security margin would be considered an extraordinarily precarious supply-demand balance.

But, Yergin was not commenting on today's circumstances; he was describing the world situation in 1973 prior to the oil embargo. A tight balance plays into the hands of Saddam Hussein. Today, Saddam can punish his neighbors by keeping oil prices low; another year or two from now, he can punish the West by cutting production and driving prices up after our domestic resources have been ravaged.

Taken together, sixty percent of this country's oil production is at risk; the industry's vital infrastructure is being shattered; capital budgets are being decimated; maintenance of existing production is diminished which will increase resource depletion; and, our strategy of reliance on foreign imports has placed our energy future in the hands of Saddam Hussein. It is a frightening picture and one that is all too real.

**What then can be done?**

Certainly, there are a number of legislative and administrative actions that can and should be undertaken and undertaken quickly.

There are a variety of tax measures that should be enacted quickly. These include: a marginal wells tax credit, extending the suspension of net income limitation on percentage depletion, expensing geological and geophysical costs, expensing delay rental payments, expanding the definition of enhanced oil recovery, and inactive well recovery. Additional measures are being developed such as providing a longer carryback time for net operating losses. These should be considered.

New efforts to consider the potential for loan guarantees or some similar measures to bridge producers through these difficult times need to be developed.

Purchasing domestic oil for the Strategic Petroleum Reserve could help reduce current inventory levels, but action needs to be taken quickly – well before we reach fiscal year 2000.

Within the scope of the Energy and Natural Resources Committee, there may be ways to encourage the use of the Strategic Petroleum Reserve such as the use of forward sales or other measures. Some of these may require additional authority.

IPAA is developing a list of regulatory and legislative actions for oil wells on federal land that could reduce costs. These should be completed for your consideration within the next week or so.

Beyond this, Congress and the Administration need to grapple with the issue globally. Last year, this country discouraged the efforts of Venezuela, Mexico, and Saudi Arabia to respond to low oil prices. The result has been to turn the international market over to Saddam Hussein. This country cannot stand by and ignore the implications of an unstable oil market. Nothing moves without energy. What benefits we derive today from low oil prices will be stripped away tomorrow from high ones. No one benefits from a rapidly fluctuating market. As a nation we recognized this decades ago in creating oil control commissions in the states. As the second largest producing nation in the world, the U.S. must step to the international table and participate in decisions that are made regarding oil supply. It must make clear that it values its domestic resources and that it will not let them be destroyed willingly.

We must recognize that the current U.N. sanctions policy must be revisited and restructured. We must find a way to truly supply suffering Iraqi citizens with the humanitarian support they need. At the same time we cannot continue a system that hands Saddam Hussein control of our future and that of his Arab neighbors. The United States, Russia, Saudi Arabia, Kuwait, Venezuela, Mexico, Great Britain and others need to craft a workable sanctions program that meets both of these objectives.

This industry – like farmers, like steel, like many commodities – is suffering in ways that it has not felt before. As those industries, we need the understanding of the Congress and the Administration of the value we provide to the nation. As those industries, we need the nation to recognize that its health is tied to ours. Energy is the lifeblood of our economy. Oil is the pivotal fuel. Domestic oil production safeguards our national security. It is a resource that must be preserved.