Testimony Of Tom Young On Behalf Of
the Independent Petroleum Association of America

Committee on Energy and Natural Resources U.S. Senate

July 12, 2001

Mr. Chairman, members of the committee, my name is Tom Young, Vice President of Business Development, Mariner Energy, Inc. Mariner Energy is a Houston-based oil and natural gas exploration and production company with principal operations in the Gulf of Mexico and along the U.S. Gulf Coast. Mariner has been an active explorer in the Gulf Coast area since the mid-1980s and has successfully grown its production and reserve base through the drill bit. Mariner is one of the most experienced independent operators in the Deepwater Gulf of Mexico, having operated nine field developments in the Deepwater Gulf since 1995.

Today, I'm testifying on behalf of the Independent Petroleum Association of America (IPAA). IPAA represents thousands of independent petroleum and natural gas producers that drill 85 percent of the wells drilled in the United States. Independent producers of both oil and natural gas have grown in their importance, and are a key component of our nation's energy supply. Independents produce 40 percent of our nation's oil output - 60 percent of the lower 48 states onshore production - and 65 percent of our natural gas production in the United States.

The presence of independents in the offshore is rapidly increasing. Not only do independents now hold 80 percent of all acreage under lease on the OCS, but as a group, independents have amassed as much acreage in the deepwater as have the majors. And, they participated in half the wells drilled in the deepwater Gulf of Mexico in 2000. In total, it is estimated that independents hold more than 40 percent of the active leases in the deepwater Gulf.

The March 2001 Central Gulf of Mexico Lease Sale 178 further demonstrated the substantial presence of independents in the offshore. With high bids from 90 companies totaling over $505 million - up from around $300 million a year ago - industry has clearly stepped up its activity level in response to today's marketplace. At sale 178, of the 90 companies bidding, 77 were independents (86percent).

Today's hearing focuses on legislative actions the Senate may take to increase the supply of energy resources from federal land (including the OCS). This testimony will focus on recommendations for both onshore and offshore federal lands. Oil and natural gas reserves lying beneath federal onshore and offshore lands will play a critical role in meeting the nation's energy needs. The Administration's National Energy Policy highlights the need to examine the potential for regulated increase in the oil and natural gas development on federal lands as part of increasing energy supplies. We agree with President Bush that we can increase energy supply and protect the environment. We can accomplish both goals to ensure this country has access to its oil and natural gas resources lying beneath government controlled lands.

Today, I will discuss the steps Congress can and should take now to increase production tomorrow. Indeed, if some of these steps had been taken yesterday, our nation's energy situation would be far less uncertain today.

The Congressional Role

The predominant areas where Congress and the Administration play a major role in promoting or inhibiting domestic oil and natural gas production are: providing access to the natural resource base and providing access to essential capital.

I. Access and Permitting Constraints

A national energy policy must recognize the importance of accessing the natural resource base. In 1999, the National Petroleum Council (NPC) in transmitting its natural gas study, "Meeting the Challenges of the Nation's Growing Natural Gas Demand", concluded:

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

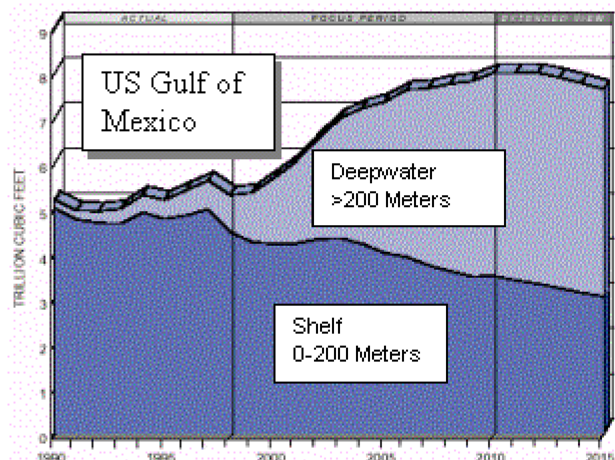
Much of the nation's untapped natural gas underlies government-controlled land both offshore and onshore. These resources can be developed in an environmentally sound and sensitive manner. The Department of Energy recently released a comprehensive report, Environmental Benefits of Advanced Oil and Gas Exploration and Production Technology, demonstrating that environmentally sound technology is available. And, it is being employed, when exploration is allowed.

Without policy changes, many of which can be initiated by Congress, the nation may not be able to meet its needs. The NPC study projects demand increasing by over 30 percent over the next decade. This will require not only finding and developing resources to meet this higher demand, but also replacing the current depleting resources. While many analysts are focusing on how much more natural gas demand will grow, it is equally important to recognize what is happening to existing supply. All natural gas wells begin to deplete as soon as they start producing. However, as our technology has improved, we now are able to identify probable reservoirs more effectively. This allows us to find and more efficiently produce smaller fields. The decline rate is increasing due to the limited extend of many or these new reservoirs.

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 most cost effectively accessible 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

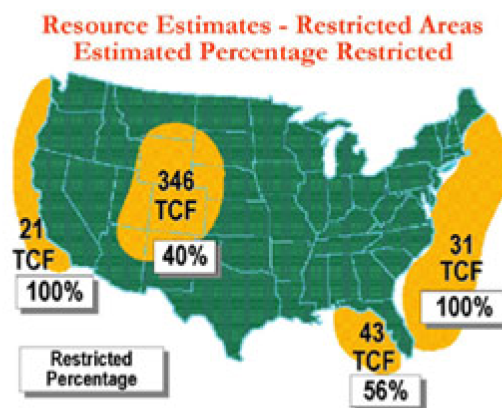


projects that future production increases in these areas are essential to meet projected demand.

A Minerals Management Service (MMS) report on Future Natural Gas Supply from the OCS estimates the future natural gas production from the shelf and slope of the Gulf of Mexico in a high case peaking at 6.7 trillion cubic feet (TCF) in 2010 followed by a decline. However, recently published MMS data indicates much lower expected natural gas from the Gulf of Mexico. Using new data, the high case estimation could peak in 2002 at about 5.22 TCF.

The Subcommittee on Natural Gas on the U.S. Outer Continental Shelf of the OCS Policy Committee recently reported, "Based on this projection, it can be concluded that unless exploration and development scenarios in the Gulf of Mexico changes dramatically, the production from the Gulf of Mexico may not be able to meet its share of expected future natural gas demand of the U.S." Later in this testimony, I will discuss what IPAA believes needs to occur to reach the expected 8.0 TCF of natural gas annual production from the Gulf of Mexico (National Petroleum Council's estimate for 2010) and, as well, to increase oil production.

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



The substantial domestic natural gas reserves in these three areas are unavailable because of Congressional or Administrative moratoria. President Clinton extended this moratorium until 2012 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 this moratorium preventing natural gas development as well as oil. In fact, both the Eastern Gulf and the Atlantic reserves are viewed primarily as gas reserve areas, not oil. Too often, these policies seem to be predicated on the events that occurred 30 years ago. Federal moratoria policy needs to be reviewed and revised to reflect advances in the industry's technology. Based on the MMS' 2000 resource assessment, the MMS determined that offshore moratoria forgo conventionally recoverable 16 billion barrels of oil and 62 trillion cubic feet of natural gas. Of course these estimates are based on little or no exploration and could be much more significant if exploration is allowed. In the western and central Gulf of Mexico, estimates have proven to be much greater after exploration.

Onshore - Rockies

Onshore, the NPC Natural Gas study estimates that development of over 137 TCF of natural gas under government-controlled land in the Rocky Mountains is restricted or prohibited. A recent study by the Energy Information Administration concludes that about 108 TCF are under restriction. Significantly, these estimates largely based on assumptions that about 40 percent of the resource base were off limits or severely restricted. However, a recent Department of Energy analysis of a key area in the Green River basin puts this number closer to 68 percent. Regardless

of the exact number, the amount is significant. A Congressionally mandated inventory of these resources is underway. While an important first step, it is equally important to recognize that access to these resources is limited by constraints other than explicit moratoria. These constraints that often result in 'de facto' moratoria vary widely. Examples include monument designations, Forest Service "roadless" policy, and prohibitions in the Lewis and Clark National Forest.

If these areas contain natural gas or oil, they can be developed in an environmentally and balanced manner. IPAA was disappointed with recent votes in the House of Representatives that will prohibit pre-leasing activities in monuments designated as of January 20, 2001. This type of limitation, not based on science and technology, will negatively impact domestic oil and gas supplies and ignores the need for balanced domestic energy policy.

At the same time the permitting process to explore and develop resources often works to effectively prohibit access. These constraints range from: federal agencies delaying permits while revising environmental impact statements; to habitat management plans overlaying one another thereby prohibiting activity; and, to unreasonable permit requirements that prevent production. There is no single solution to these constraints. What is required is a commitment to assure that government actions are developed with a full recognition of the consequences to natural gas and other energy supplies. IPAA believes that all federal decisions - new regulations, regulatory guidance, Environmental Impact Statements, federal land management plans - should identify, at the outset, the implications of the action on energy supply and these implications should be clear to the decision maker. Such an approach does not alter the mandates of the underlying law that is compelling the federal action, but it would likely result in developing options that would minimize the adverse energy consequences.

IPAA's Priority Near-Term Recommendation for Increasing Access to Production from the OCS and Onshore Federal Lands:

Energy Accountability.

If there is one immediate action the Congress and/or the Administration can take that will have a dramatic affect on increasing oil and gas production in the near-term, it is the successful implementation and funding of an energy accountability mandate. If all federal agencies associated with decisions affecting oil and gas development are held accountable for how their decisions impact national energy supply, production will increase.

Such a requirement is contained in the Administration's National Energy Policy:

"Issue an Executive Order directing all federal agencies to include in any regulatory action that could significantly and adversely affect energy supplies a detailed statement on the energy impact of the proposed action."

A similar provision is contained in S. 388, the National Energy Security Act of 2001. Independents all agree that this type of requirement should be implemented immediately to bring balance in the land use decision-making.

IPAA's Near-Term Recommendations for Increasing Access to Production from the OCS:

1. **Sale 181**

IPAA and its member companies have long considered Sale 181 to be a high-priority issue. It represents an important component of our future in the offshore. Scheduled for December 2001, it would be the first eastern Gulf of Mexico Lease Sale since 1988, and for some of our members that confine their activities to the Gulf of Mexico, the first opportunity to bid outside the central and western Gulf of Mexico ever.

The Original Sale 181 area was estimated to hold about 7.8 TCF of natural gas and perhaps 1.9 billion barrels of oil. The natural gas resources could be used to meet the nation's growing natural gas demand-estimated to increase by 30 percent from today's level to nearly 30 TCF/yr by the year 2010. It is noteworthy that the NPC natural gas study cited earlier, assumes Sale 181 occurs on time, with all tracts offered, and that development proceeds without delay. The NPC study projects that Sale 181 could result in adding 356 billion cubic feet (BCF) per year in new gas production by the year 2010 - production that would be lost if the Sale were not held or restrictions inhibited exploration and production.

Back in the early to mid-1990's the MMS engaged in a comprehensive consultation with Alabama and Florida as well as other coastal states, about leasing in the eastern Gulf of Mexico. Both States expressed concerns about leasing and both requested that leasing not occur within certain distances to their states - 15 miles in the case of Alabama and 100 miles in the case of Florida. Sale 181 was crafted to meet both of these criteria and was placed on the current 5-year schedule by the MMS. Congress subsequently ratified this decision through the appropriations process. Based on this buy-in from coastal states, industry began to prepare - accumulating seismic data, reviewing geologic trends, conducting preliminary engineering studies - in anticipation of Sale 181. Independents have spent millions of dollars and expended thousands of personnel hours with the expectation that the Sale would occur as scheduled.

It now appears the Sale my take place in December as originally scheduled, but as a compromise, the Administration has agreed to reduce the Sale Area by approximately 75 percent of the original area. The decision to significantly reduce the Sale Area comes at a time when the country needs more energy of all kinds, and dramatically reduces the availability of acreage needed to satisfy the nations "near-term" energy needs. The original Sale Area contained acreage near infrastructure and in moderate water depths, both of which made the area a prime candidate for short cycle time (1-2 year) natural gas projects. Because the revised Sale Area is further from existing infrastructure and in ultra-deep water depths, the projects in the revised Sale Area will be much longer cycle time (4-10 years). Also, less data is available in the revised Sale Area, resulting in less certainty concerning the type of hydrocarbons expected. Not revising the Sale Area would have made a tremendous difference in the immediate opportunities available as well as in the bonuses received by the government.

By removing acreage available for leasing in shallow to moderately deep-water depths, (50' to 6,500') most independents have been removed from the Sale Process. The deepest announced development in the Gulf of Mexico is the planned Canyon Express development, in water depths slightly exceeding 7,000', expected on-line in mid 2002. The deepest producing field in the Gulf of Mexico is in approximately 5,500' of water. The revised Sale Area eliminates all acreage available in less than 6,500' water depths, with the majority of the acreage available for leasing in

greater than 7,000' water depths. This compromise has made the Sale an ultra-deepwater Sale, and essentially of no interest to Mariner, or other independents. Developments in these water depths exceed the currently available development tools and will be on the cutting edge of technology. This is not an area suited for most independents.

The revised Sale Area was derived to find balance among some very difficult political forces. Most of the Florida delegation opposed the entire Sale 181 area. In fact, the House of Representatives passed by 83 votes a provision that would have delayed leasing in the entire sale 181 area. Unfortunately, the views of many members of the Florida delegation, some 247 members of the House do not embrace the need to have the resources of the original Sale 181 area as part of the balanced and common sense approach to a sound energy policy. Yes, the Administration is proposing that a quarter of the Sale Area proceed which will contribute significant quantities of oil and gas to our supply. However, the new area as a result of this three-quarter reduction, is off limits to most independents and greatly restricts easily accessible and environmentally safe energy supply. We hope in the future the Administration and the Congress can agree to a more reasoned national energy policy.

IPAA would like to thank members of this Committee for recognizing the importance of a more robust sale 181 as part of sound national energy policy. Senator Bingaman has a provision contained in the Comprehensive Balanced Energy Policy Act of 2001 that mandates a sale 181 that would be reduced by a significantly smaller amount of area. As well, Senator Murkowski and others have been strong proponents of proceeding with sale 181 as proposed for the last five years. We applaud this Committee's recognition that offshore development is the very type of development that can occur in an environmentally safe manner and contribute significant volumes of natural gas to this country.

This sudden change of direction by the government after years of compromise and planning is something that is common in international ventures, but not expected domestically. Many independents choose not to explore internationally, due to the political risks involved. This compromise not only eliminates an area ripe for independents, but also causes us to re-think our decisions to explore solely domestically.

In the oil industry, sophisticated technologies now make it possible to locate and remove oil and natural gas with virtually no risk to the environment. In fact, the industry has been safely producing oil and natural gas from the Gulf of Mexico for decades. Unfortunately, opponents to offshore development ignore this fact. Although we understand the MMS is making plans to issue the Preliminary Notice of Sale 181 with the revised Sale Area, we are confident that our industry could develop all of Lease Sale 181 in a safe and environmentally responsible way and we hope that the decision will be revisited sometime in the near future.

2. The Five-year OCS Lease Sale Schedule

Every five years, the MMS takes on a very thorough process to draft a new five-year OCS Leasing Schedule. That process is now underway to establish a leasing program for the period 2002-2007. Industry, and other interested parties, provided comments to the MMS during the earlier stages of the process. A draft schedule should be ready for review very soon.

IPAA vows to work with the MMS to establish a schedule that helps meet the nation's growing appetite for energy. For many of our members, those that confine their activities to the Gulf of Mexico, it has meant annual sales in the central and western Gulf of Mexico. It is essential that these annual sales continue. IPAA is encouraged by the recommendation contained in the Administration's National Energy Policy that OCS oil and gas leasing and approval of exploration and development plans on predictable schedules should continue.

As this Country drafts a national energy policy, now is no time to be timid. Yet, we know that resistance in some regions to offshore exploration and production remains a major impediment despite the obvious energy needs. We have our work cut out for us if we are to be successful at making enough offshore lands available to meet the nation's energy needs. As noted above, the offshore is a prime contributor of natural gas - an environmentally preferable fuel. The next five-year plan must provide for leasing in unexplored areas, especially those containing natural gas.

Independents play a significant role in the development of offshore shallower water production. The next five-year plan needs to provide new leasing opportunities in shallower waters as well, otherwise investment dollars will flow oversees. IPAA is greatly concerned about the next five-year plan not offering any leasing in water depths in the Eastern Gulf of Mexico less than 1600 meters. This will greatly reduce opportunities for independents to deliver much needed natural gas and oil reserves to meet this country's demand.

One possible approach interested parties should consider during development of the next five year plan, in consultation with industry and affected states, is the identification of a small number of prime natural gas plays in moratoria areas to determine if limited pilots could demonstrate how oil and gas operations could be safely conducted in new areas. Such an approach would require congressional funding for scientific, environmental, and social/human impact studies. Any piloting would require site-specific stakeholder consultations.

3. Coastal Zone Management Issues

Coastal zone management (CZM) matters are increasingly important to independents operating in the Offshore. These matters play a direct role in offshore lease access. CZM issues have not historically been seen as a priority issue for independents operating in the western and central Gulf of Mexico, as states have not attempted to obstruct offshore activities under the Coastal Zone Management Act (CZMA). With an increased interest in the eastern Gulf of Mexico, independents' interest in CZM is heightened. It is one thing to have a lease sale; it is quite another to be allowed to explore, develop and produce from that lease once it is purchased.

A coastal state with a federally-approved coastal zone management plan is empowered to block offshore exploration and production plans, if the state can allege that the federal lessee's activity will have some affect on resources in the coastal zone. If the lessee's activity will have an effect, the activity must be consistent with the state's coastal zone management plan.

The coastal zone itself generally extends only 3 miles offshore, but extends 9 miles in the Gulf of Mexico off Texas and Florida. The effects test, however, can be used to extend the state's reach great distances from shore. The Interior Department itself determines before issuing leases that

the projects it expects lessees to undertake will be consistent with the plans of any affected states. But states can change their minds after the leases are issued.

A Federal lessee offshore must certify that both its exploration plan and production plan are fully consistent with the coastal zone plans of affected states. If a state disagrees, the lessee faces considerable delay in an appeal before the Secretary of Commerce.

Chief risks to lessees in current CZMA implementation are:

- Escalating compliance costs caused by unexpected interpretations of vague policies in state CZM plans,
- Delay costs caused by lengthy appeals process before Department of Commerce,
- Risk of losing lease rights without compensation when a state changes its mind on what its plan requires.

Congress should encourage a review of the CZMA and its consistency provisions. The Administration's National Energy Policy recommends that the President direct the Secretaries of Commerce and Interior to re-examine the current federal legal and policy regime (statutes, regulations, and Executive Orders) to determine if changes are needed regarding energy-related activities and the siting of energy facilities in the coastal zone and on the OCS. The review should include:

- A review of the Coastal Zone Management Act, particularly as amended in 1990,
- Implementing regulations, especially those finalized late in 2000 by the National Oceanic and Atmospheric Administration on consistency,
- State implementation programs, and
- Process issues, particularly as the process is used to delay projects.

4. **Congressional Funding**

IPAA recommends that the Congress adequately fund the MMS to ensure that its mission is not compromised during this critical period in which the Nation aggressively seeks new energy resources to meet growing demand. Specifically, IPAA recommends:

- Support the Administration's FY 2002 budget request increasing the MMS budget by $14.7 million to meet increased workload brought about by offshore program services and to implement royalty in-kind.
- Fully fund the MMS and other related agencies in future years to ensure they have the resources available to increase gas and oil supplies from the OCS.

- Require that appropriated funds be directed to education and outreach regarding the benefits the OCS program provides the Nation.

Funding is always difficult during budget reductions and tax cuts. However, investing in the offshore program provides taxpayers a great return on their investment. In FY 2000 alone, the MMS collected and distributed about $7.8 billion in mineral leasing revenues from federal and American Indian lands. IPAA would like to bring to your attention a proposal of Congresswoman Barbara Cubin (R-WY) whereby part of the onshore oil and gas royalty streams to fund those BLM offices responsible for generating production on which royalty payments are based. The vast majority of royalty payments come from offshore production and, similar to your proposal for the onshore, we recommend that a part of the offshore royalty stream should be directed to offshore programs that will promote increased production, especially natural gas.

For example, IPAA supports a collaborative effort for research, development, and transfer of technologies used in the production of natural gas, so long as there are not additional charges or costs such as increased royalties, taxes or surcharges. Other uses of the onshore and offshore royalty stream, including taking the stream in-kind, could include low-income programs and environmental projects.

IPAA's Near-Term Recommendations for Increasing Access to Production from Onshore Federal Lands:

5. **Congressional Funding**

Like President Bush's FY 2002 budget request for the offshore program, IPAA supports the President's proposed increases for the onshore federal oil and gas program. Specific items include:

- A $7.1 million increase to support improvements in the land use planning and accelerate the multi-year process of updating management plans. This is a good first step. The entire planning process needs to be reviewed, including the funding process.

- An $11.8 million increase for oil and gas programs, including energy resources surveys, Alaska North Slope oil and gas exploration, coal-bed methane permits, and oil and gas inspections.

- A $3.0 million dollar increase for Bureau of Land Management (BLM) to work with U. S. Geological Service (USGS), the U. S. Forest Service (USFS), and the Department of Energy to conduct an inventory of public lands and describe the impediments and restrictions to access and development. Chairwoman Cubin, along with Chairman Skeen, led the effort in the House for getting this included in the Energy Policy and Conservation Act (EPCA), which was signed into law late last year. We agree with the Administration's National Energy Policy that this inventory required under EPCA should be accelerated.

- A $2.0 million dollar increase to accelerate leasing by 15 percent and to process an additional 1,000 to 2,000 drilling permits in the most promising areas.

IPAA strongly supports a provision contained in S. 597, the Comprehensive Balanced Energy Policy Act of 2001, entitled Federal onshore leasing programs for oil and gas. This provision requires the appropriation of such sums as may be necessary to ensure expeditious compliance with National Environmental Policy Act requirements applicable to oil and gas. Outdated planning documents not based on science and current technologies are causing significant delays in developing onshore federal lands and increasing costs. However, we need to ensure that all future planning processes are accountable to their impacts on energy supply.

Similar to the proposal of using the royalty stream to fund BLM offices managing the production generating this royalty streams, IPAA also supports a provision contained in the Administration's National Energy Policy to direct royalties from ANWR to conservation efforts and eliminating the maintenance and improvements backlog on federal lands. If proceeds from ANWR do not become available in the foreseeable future, IPAA would advocate that Congress fund other sources of funding to eliminate this backlog.

6. Permitting Process

There are costly delays with every aspect on the onshore federal permitting process. In fact, there are a number of examples of approvals that are never granted resulting in reserves never being developed. The National Energy Security Act of 2001, S.388 reforms the permitting process in a subsection entitled Improvements to Federal Oil and Gas Lease Management.

This section contains a number of very important reforms. It allows a state, if willing, to conduct a number of non-environmental oil and gas approvals on behalf of the federal government. Our experience has been that states can perform oil and gas activities at a much lower cost and in much more timely fashion than the federal government. For decisions remaining with the federal government, the bill establishes reasonable timeframes for processing different documents related to oil and gas development. Additionally, it provides adequate funding for environmental documents. Timing is capital and if there are never-ending delays, this capital will be directed overseas or to private lands.

If Congress cannot pass such reform in the short-term, it should encourage the Administration to determine which of these reforms can be implemented administratively. In fact, if approval processes are improved, production will occur sooner resulting in more revenues to the treasury. The following are two examples of this:

- Approve Pending Drilling Permits. It is our understanding that hundreds of drilling permits are pending before the government. If these were approved, production would increase.

- Approve Balanced Planning Documents. If pending planning documents, like the one in Otero County, New Mexico, were approved, production will increase. The Otero County document should allow for development

and, if it did, up to 1 trillion cubic feet of gas could be delivered to market from one planning area.

IPAA agrees with two-related recommendations contained in the Administration's National Energy Policy:

- An executive order to rationalize permitting for energy production in an environmentally sound manner by directing federal agencies to expedite permits and other federal actions necessary for energy-related projects.
- Review public land withdrawals and lease stipulations, with full public consultation, especially with the people in the region, to consider modification where appropriate.

7. **Other Administrative Actions**

The government should not implement cost recovery regulations that would place unnecessary costs on every facet of the oil and gas program. These costs will further discourage small independent producers from developing onshore federal lands and are inappropriate given the billions of dollars the oil and gas industry pays each year to the federal government in the form of royalties.

Additionally, all regulation rewrite efforts that were mandated under Vice President Gore's "Plain English" Initiative should be terminated. The proposals issued for onshore oil and gas regulations under this Initiative proposed significant policy changes and would result in more uncertainty. Specifically, smaller independent producers are concerned about the proposed increase of bonding amounts. Bonds are rarely called for the purpose of reclamation. The vast majority of good operators on federal land should not be punished for the bad behavior of the few. Enforcement is the key.

Royalty In-Kind

IPAA has been a long-time supporter of RIK programs. By giving more tools to the federal government to maximize return to the American taxpayer when taking in kind, the program can be expanded. When royalty in-kind is expanded, more certainty is provided to the government and the oil and gas lessees; thereby making offshore and onshore federal lands more attractive for development. IPAA supports the RIK provisions contained in S.388. As well, we support funding and providing MMS needed RIK authorities in their FY 2002 appropriations.

Congress should promote and fully fund creative approaches for the use of royalty in-kind programs. For example, the House Subcommittee on Energy and Mineral Resources recently held a hearing examining how royalty in-kind could be used to help bolster the Low Income Home Energy Assistance Program during crisis periods. Utilities testified that there were a number of cost benefits that could accrue to the government and energy user under a royalty in-kind program.

II. **Providing Access to Essential Capital**

Because oil and natural gas exploration and production are capital intensive and high-risk operations that must compete for capital against more lucrative investment choices, much of its capital comes from its cash flow. The federal tax code and royalty policies play a critical role in determining how much capital will be retained. The Administration and Congress need to enact provisions designed to (1) encourage new production, (2) maintain existing production, and (3) put a "safety net" under the most vulnerable domestic production - marginal wells.

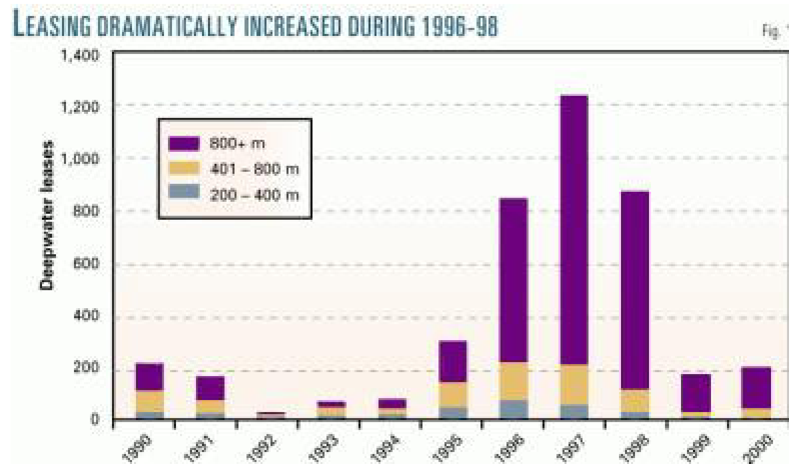
However, given that this Committee has jurisdiction over royalty policies, not the tax code, I will not discuss IPAA's tax proposals. Rather, I will address the area of royalty policies.

IPAA's Recommendations for Increasing Access to Capital for the OCS:

0. **Deepwater Royalty Relief**

The Deep Water Royalty Relief Act of 1995 (Act) provided for automatic royalty relief for all new oil and gas leases issued from 1995 through 2000 in waters deeper than 200 meters in order to stimulate exploration and production of natural gas and oil in the deeper waters of the central and western Gulf of Mexico. The portion of the Act that provided this automatic relief for new leases expired in November 2000.

The MMS has now put in place regulations that would leave to its discretion the use of any upfront royalty relief for future Gulf of Mexico lease sales. IPAA is concerned that, although the new MMS royalty incentives put into place for water depths greater than 800 meters, subsalt, and deep gas drilling are a good first step, they fall short of truly accelerating the rate of development and production of natural gas and oil in the Gulf of Mexico. Additionally, the MMS is not offering any relief for water depths between 200 and 800 meters.



To this end, IPAA supports the reauthorization of the original automatic royalty suspension volumes as contained in the expired provision of the 1995 Act. Such a provision is contained in S.388, the National Security Act of 2001. These terms led to a boom in natural gas and oil activities in the deep waters of the Gulf of Mexico in the five short years they were in place. At the most recent central Gulf of Mexico Lease Sale 178, where no royalty relief was offered for water depths of 200 to 800 meters, bidding activity fell sharply compared to that previously

experienced with royalty relief incentives. We believe if the Act would have been reauthorized, there would have been substantially more interest in these water depths and in ultra-deepwaters.

Would such a reauthorization of the Act cost the American taxpayer revenues? Simply put - no. Third party modeling demonstrates that a reauthorization of the act would have provided additional, not less, revenues to the American taxpayer. Increased production would occur, far outweighing the temporary loss of royalty. We should remember that prices will not always be this high and we need to encourage aggressive leasing now, to meet our production needs for the future.

We agree with Senator Murkowski's recommendation that under the auspices of a National Energy Policy Taskforce that the Secretaries of the Interior and Energy form a Gulf of Mexico Leasing Incentives Review Team to determine what level of incentives for all water depths are appropriate in order to ensure that we optimize the domestic supply of natural gas and oil from offshore areas that are not subject to current leasing moratoria. In particular, the team should further examine the field size distribution of the Gulf of Mexico resource base and the international competitiveness of the Gulf. Recommendations, as a result of this review, should be made in the context of the importance of the development of the natural gas and oil resources of the Gulf of Mexico to the Nation's future energy and economic needs. These recommendations should be implemented prior to the August 2001 western Gulf of Mexico lease sale.

1. **Deepwater Leases Issued prior to November 2000**

During Sale 178, the MMS adopted an important approach to stimulate activity in the 800 meter plus water depths - royalty incentives were offered on a lease-basis . For deepwater leases issued prior to sale 178, the MMS only offered royalty incentives on a field-basis. If the MMS would retroactively offer such relief on a lease-basis, this would greatly stimulate production from the deepwaters. Too many leases issued during the term of the Deepwater Royalty Relief act were found to be ineligible for royalty relief because of the existing policy of relief to be offered on a field-basis (vs. lease-basis) or the MMS' interpretation of the rules implementing this policy.

2. **High Risk Exploration on the Shelf**

In addition to the deepwaters, independents are quite interested in the significant natural gas and oil reserves that could be developed by deep drilling, drilling into subsalt structures, and drilling highly deviated wells. IPAA recommends royalty incentives be offered for (1) wells below 15,000 where there is no current production AND (2) extend royalty relief as embodied in Central GOM Sale 178 for new and existing leases for drilling of sub-salt prospects or prospect located in abnormal pressure conditions AND (3) for drilling highly deviated wells off existing platforms which might not otherwise have been attempted. In other words, these incentives would apply to expensive, high risk plays on new and existing leases. Such relief would, of course, be phased out at higher prices.

During Sale 178, the MMS took some important first steps. It offered a royalty incentive for new leases whereby natural gas is discovered for drilling in excess of 15,000 feet for water depths of 0 to 199 meters. Similar relief is needed for existing leases where production has not yet been established.

With regard to subsalt, the MMS recognized the high risk nature of exploring such a play in the OCS by offering for new leases a 2 year extension of the 5 year term should a well be drilled. But often more time is needed for geophysical imaging to refine subsalt drilling targets. What are truly needed are more incentives to encourage drilling.

3. Marginal Production on the Shelf

Independent producers report that there are significant resources still remaining on the Shelf that would be developed if royalty incentives were available. Marginal properties and/or fields are being left behind. IPAA understands that DOE had initiated modeling of different royalty incentives to stimulate production from marginal fields. This modeling effort should be completed and, if appropriate, royalty incentives implemented.

IPAA's Recommendations for Increasing Access to Capital for the Onshore:

1. High Risk Exploration Onshore

Like in the offshore, independents are interested in the significant natural gas and oil reserves that could be developed by onshore deep drilling. Royalty incentives should apply to expensive, high risk plays on new and existing onshore federal leases. Such relief would, of course, be phased out at higher prices.

2. Marginal Production Onshore

It has always been understood that much of the production lying beneath onshore federal lands is marginal. This is why the Bureau of Land Management continues to offer royalty relief for stripper oil wells (e.g., wells that produce less than 15 barrels per day) under certain prices. A similar program should be implemented for marginal natural gas wells.

3. The National Energy Security Act of 2001, S. 388

The National Energy Security Act of 2001, S.388 contains a provision entitled Royalty Investment in America. This provision allows lessees to forgo federal royalty payments during periods of low energy prices and instead make capital investments in energy production. During low prices this type of provision will reduce the likelihood of dramatic decreases in exploration, such as those during the 1998-99 downturn. This applies to both onshore and offshore production.

4. The Administration's National Energy Policy

The National Energy Policy acknowledges the contribution the Deepwater Royalty Relief Act made to increasing supply. It recommends that the President direct the Secretary of Interior to consider economic incentives for environmentally sound offshore oil and gas development where warranted by specific circumstances: explore opportunities for royalty reductions, consistent with ensuring a fair return to the public where warranted for enhanced oil and gas recovery; for reduction of risk associated with production in frontier areas or deep gas for formations; and for development for small fields that would otherwise be uneconomic.

IPAA supports this review and encourages the Administration to have this review include the above incentive proposals for both offshore and onshore federal production.

5. **The Comprehensive Balanced Energy Policy Act of 2001, S. 597**

This bill provides for a study to determine how production can be increased from State and privately controlled lands. We believe that many of the recommendations of such a study will fall in the capital side of the equation. How can we reduce costs for onshore production? We believe such a study should be expanded to include onshore and offshore federal lands and consider many of the recommendations contained above.

Royalty incentives, in conjunction with new tax policies, must be developed to encourage renewed exploration and production needed to meet future demand, particularly for natural gas. The NPC gas study projects future demand growth for natural gas and identifies the challenges facing the development of adequate supply. For example, the study concludes that the wells drilled in the United States must effectively double in the next fifteen years to meet the demand increase. Capital expenditures for domestic exploration and production must increase by approximately $10 billion/year - roughly a third more than today. Generating this additional capital will be a compelling task for the industry. As the NPC study states:

While much of the required capital will come from reinvested cash flow, capital from outside the industry is essential to continued growth. To achieve this level of capital investment, industry must be able to compete with other investment opportunities. This poses a challenge to all sectors of the industry, many of which have historically delivered returns lower than the average reported for Standard and Poors 500 companies.

In fact, as the past year has shown, capital markets have not shifted to supporting the energy sector. For the industry to meet future capital demands - and meet the challenges of supplying the nation's energy - it will need to increase both its reinvestment of cash flow and the use of outside capital. The role of royalty incentives and the tax code will be significant in determining whether additional capital will be available to invest in new exploration and production in order to meet the $10 billion annual target.

There's No Short Term Fix - Recovery Will Take Time

It will take time for any realistic future energy policy to achieve results. There is no simple solution. The popular call for OPEC to "open the spigots" failed to recognize that the low oil prices of 1998-99 reduced capital investment from the upstream industry all over the world. Only Saudi Arabia had any significant excess production capacity and no one knew just how much or whether the oil was of a quality that it could be refined in most refineries. The collateral damage of low oil prices on the natural gas industry is affecting gas supply today and will until the industry recovers. The producing industry lost 65,000 jobs in 1998-99. While about 65 percent of those losses have been recovered, they are not the same skilled workers. If measured by experience level, the employment recovery is far below the numbers. Less obvious, but equally significant, during the low price crisis equipment was cannibalized by operating and support industries who were decimated. It will take time to develop the infrastructure again to deploy new drilling rigs and provide the skilled services that are necessary to rejuvenate the industry.

Conclusion

Providing access to the resource base will be critical and requires making some new policy choices with regard to the onshore and offshore federal lands. Access has and can occur while we accelerate the protection and improvement of the environment, and increase our nation's energy security. A critical first step is to require agencies to measure and document the impact of their decisions on the development of energy resources.

Overall, attracting capital to fund domestic production under these circumstances will be a continuing challenge. This industry will be competing against other industries offering higher returns for lower risks or even against lower cost foreign energy investment options. The slower the flow of capital, the longer it will take to rebuild and expand the domestic industry.

These two issues are the ones that are particularly dependent on federal actions, and should be the immediate focus of this Congress and the Administration.

Energy production - particularly petroleum and natural gas - is an essential component that must be included and addressed at once. Independent producers will be a key factor, and the industry stands ready to accomplish our national goals, if policies reflect that reality.