

Testimony Of Virginia Lazenby

**On Behalf Of
The Independent Petroleum Association of America
And The National Stripper Well Association**

**Before
The Committee on Energy and Natural Resources
And The Committee on Foreign Relations U.S. Senate**

Mr. Chairman, I am Virginia Lazenby, Chairman and CEO of Bretagne G.P. I am a small producer principally producing oil from marginal wells. I have been involved in issues associated with national energy policy for many years. I am a past president of the National Stripper Wells Association and in 1998-99 served as the head of an Oil Price Emergency Team of the Independent Petroleum Association of America. I am a member of the National Petroleum Council and participated in the National Petroleum Council's *Marginal Wells* study. Today, I am appearing on behalf of the Independent Petroleum Association of America and the National Stripper Well Association. IPAA is the trade association representing the 7,000 independent domestic oil and natural gas producers. NSWA represents the small business operators in the oil and natural gas industry, producers with low volume, high cost stripper or marginal wells.

This hearing is addressing a key question – what is the threat to national security from oil imports. This is a question with only one answer – every Administration since Eisenhower's has concluded that the level of oil imports threatens national security. The Clinton Administration has made this judgment twice. The real issue is how great is the threat and what should be done.

Due to the time constraints involved in the preparation for this hearing, I am submitting for my written testimony the comments submitted to the Department of Commerce on behalf of the IPAA and the National Stripper Well Association with regard to the most recent analysis of the threat to national security posed by imported crude oil. I may have additional comments to make in my oral testimony.

Comments On National Security Investigation of Imports of Crude Oil and Petroleum Products

[Docket No: 990427107-9107-01]

On Behalf Of The Independent Petroleum Association of America And The National Stripper Well Association

This document presents comments by the Independent Petroleum Association of America (IPAA) and the National Stripper Well Association (NSWA) regarding the national security investigation of imports of crude oil and petroleum products by the Bureau of Export Administration. IPAA represents the 7000 independent oil and gas producers of America. NSWA represents the small business operators in the oil and natural gas industry, producers with

low volume, high cost stripper or marginal wells. IPAA submitted the Section 232 petition that resulted in the 1994 investigation of the impact of crude oil and petroleum products. IPAA and NSWA strongly believe that this prior investigation failed to significantly address the problems posed by increased reliance on imported crude oil. Consequently, IPAA and NSWA believe that the focus of this investigation should not be *whether* imports pose a risk to national security but *what* actions should be taken. These comments will review past efforts, present the reasons for action to support domestic oil production, and present a number of actions that should be taken by the President in response to the determination of national security risks posed by imported crude oil.

Past Actions

The two most recent Section 232 investigations into the national security implications of increased crude oil imports have agreed on one key point – increased imports pose a national security risk. In 1987, the investigation conducted under the Reagan Administration reported:

The Secretary of Commerce has concluded that there has been a substantial improvement in U.S. energy security since the last Section 232 petroleum finding in 1979. However, declining domestic oil production, rising oil imports, and growing Free World dependence on potentially insecure sources of supply raise a number of concerns, including vulnerability to a major supply disruption. The investigation found that the maintenance of U.S. access to sufficient supplies of petroleum is essential to our economic security, foreign policy flexibility, and defense preparedness. Given these factors, the Secretary of Commerce found that petroleum imports threaten to impair the national security.

Similarly, the investigation in 1994 by the Clinton Administration produced the following statement by President Clinton:

I am today concurring with the Department of Commerce's finding that the nation's growing reliance on imports of crude oil and refined petroleum products threaten the nation's security because they increase U.S. vulnerability to oil supply interruptions.

In 1987 imports of crude oil and refined products constituted 40.1 percent of U.S. demand. In 1994 imports were 50.8 percent of demand. In 1998, imports had increased to over 55 percent of demand. Clearly, there can be no other conclusion – imports represent a continuing and growing threat to the nation's security. At issue will be what actions should be taken to respond.

In 1995, President Clinton listed the following measures that his Administration intended to take to address the threat:

- Increased investment in energy efficiency.
- Increased investment in alternative fuels.
- Increased government investment in technology, to lower costs and improve production of gas and oil and other energy sources.
- Expanded utilization of natural gas.

- Increased government investment in renewable energy sources.
- Increased government regulatory efficiency.
- Increased emphasis on free trade and U.S. exports.
- Maintenance of the Strategic Petroleum Reserve.
- Coordination of emergency cooperation measures.

Unfortunately, this was a flawed program – a program that has failed to effectively address increasing imports or the national security threat. It is flawed because it places too little emphasis on elements that enhance domestic oil production.

The following items detail some of these flaws.

Increased investment in alternative fuels.

This item was primarily directed toward the extensive development and utilization of vehicles using alternative fuels by the year 2000. While it has been a laudable goal, it has produced little change in overall fuel demand, and even less in the context of reducing imports.

Increased government investment in renewable energy sources.

Renewable energy sources accounted for about 8 percent of U.S. energy consumption in 1997 – a decline of 3 percent from 1996. Of this amount, 55 percent was contributed by hydroelectric power, a source of energy that has little Administration support and limited likelihood of future expansion. Another 38 percent came from "biomass". Most of this was from waste incineration – another source with little Administration support. The remaining renewable energy contributions were geothermal (5 percent), solar (1 percent), and wind (< 0.5 percent). Clearly, none of these would make any significant reduction in imported oil use.

Increased emphasis on free trade and U.S. exports.

This component was primarily directed at improving the reliability of imported oil sources. However, the U.S. is now twice as dependent – on a percentage basis – on the foreign oil sources that participated in the 1973 oil embargo as it was then. This diversification strategy has failed. America remains largely dependent on the volatile Middle East for its imported oil. Protecting against the potential instability of Middle Eastern oil supplies consumes significant amounts of the U.S. budget. CNN reported last year that "military buildups that have kept U.S. ships, planes, and troops within striking distance of Iraq since the 1991 Persian Gulf war have cost U.S. taxpayers about \$6.8 billion...." This \$6.8 billion figure is in addition to annual expenditures of about \$50 billion to maintain a strong military contingent in the Gulf and it does not reflect the most recent actions in Iraq.

Maintenance of the Strategic Petroleum Reserve.

After the determination of the 1994 Section 232 analysis, the Administration supported efforts to sell 28 million barrels of Strategic Petroleum Reserve oil for budget purposes. It was not until 1998 that the Administration reversed its support for sales and not until the end of 1998 that the Administration initiated an effort to reacquire the oil it had sold. Moreover, even if it were full, the Strategic Petroleum Reserve provides at most a 90 day supply of crude oil.

Increased government regulatory efficiency.

While the concept of this element is to improve the regulation interaction between the government and the industry, it has fallen far short and in many respects the regulatory relationship has deteriorated. The most noteworthy example is the proposal by the Department of Interior to increase the royalties taken from the production of crude oil on federal lands by changing the valuation method. This proposed method ignores contracts producers signed with the federal government by collecting royalties on values downstream of the well. This proposal has been a serious barrier to developing a sound regulatory reform agenda between independents and the Administration. The issue has been characterized by a contentious relationship that has included name-calling by the Secretary of the Interior. Its outcome remains a key issue.

Additionally, the Bureau of Land Management has proposed a major rewrite of all of its oil and gas operating rules that have created serious unrest within the industry rather than a sense of a better regulatory agenda. This so-called plain English exercise has created additional uncertainty, costs, and barriers for developing federal lands. And, other elements of the Administration, such as the Forest Service have banned drilling for a potentially world class gas reserves in certain federal lands in Montana.

Recent efforts by the Administration have showed the potential for a better working relationship such as the use of "royalty in kind" to acquire oil for the Strategic Petroleum Reserve.

Expanded utilization of natural gas.

This element of the program would be a valuable element if it were approached appropriately. Unfortunately, it has not been. Although the Comprehensive National Energy Strategy (CNES) includes a goal to expand the nation's natural gas supply to meet a national use of 30 trillion cubic feet per year, the Administration's actions have not moved toward the essential steps that are necessary to meet this net 40 percent increase over current natural gas use. There are three key elements to the expanded utilization of natural gas: access to natural gas bearing resources, a regulatory structure that provides gas producers with adequate incentives to develop new gas, and an industry with the capital to develop the resource. Rather than assist in developing new resources, the Administration has limited access to likely potential resources. Producers are faced with a FERC proposal on pipeline rates that could further diminish the share of the natural gas price going to producers and therefore reduce their return on investment. Finally, as the past eighteen months have shown, there can be no healthy domestic natural gas industry without a healthy domestic oil industry.

The current approach adopted after the 1994 Section 232 analysis must be revised to include a specific and aggressive focus on what was described in the last paragraph of President Clinton's announcement:

Finally, led by the Department of Energy and the National Economic Council, the Administration will continue its efforts to develop additional cost-effective policies to enhance domestic energy production and to revitalize the U.S. petroleum industry.

More importantly, this aspect must be developed with a full recognition of the fundamental changes that have taken place in the domestic oil industry over the past 15 years – a factor that changes the type of actions that the federal government must take.

A Changing Industry and The Implications

Changes to the Domestic Oil Industry

Inherent in evaluating options to respond to the national security threat posed by ever-increasing imports of foreign oil is a clear understanding of the evolving nature of the domestic oil industry. Today's domestic industry has changed dramatically since the 1986 oil price crisis. The principal factor in this change is the shift in the role "major" oil companies are playing in the development of domestic oil resources. The 1986 price crisis changed the way majors viewed U.S. oil production. It began a clear shift in investment by majors in domestic oil production.

In rough terms, U.S. oil production comes from three areas – Alaska, the Gulf of Mexico offshore, and the onshore lower 48 states. Currently, about 20 percent of domestic production comes from Alaska; about 20 percent comes from the offshore Gulf of Mexico; and, about 60 percent comes from the lower 48 onshore – one-third of this from "marginal wells" producing less than 15 barrels per day. Since 1986, investment by major oil companies has shifted to exploration and development targets outside the United States. Within the U.S. majors are now primarily interested in developing Alaska and the deep water offshore. As a result the lower 48 onshore has increasingly become the province of the independents. The independents' share of this production has increased from about 45 percent in the mid-1980s to over 60 percent in 1997. It is an irrevocable shift in the structure of domestic oil production. It is a shift that must now be reflected in public policy decisions.

Clearly, independents are a different element of the oil and gas production industry than majors. They do not have the resources of majors such as refineries and chemical operations to buffer them during periods of low oil prices such as those in 1986 and again over the past eighteen months. Independents finance their operations differently than majors as a result. Recent assessments by IPAA to summarize sources of financing show that capital formation was generated primarily from the following four sources: end-users of the energy (29 percent), internally generated sources (26 percent), outside investors – oil and gas partners (20 percent), and banks (15 percent). During price crises three of these sources are impaired. Internally generated funds are limited. Banks are reluctant to increase their exposure. And, other oil and gas partners are suffering the same limitations. Thus, the end-users' role has increased substantially as other capital dries up and the end-users recognize their dire need for resources and are interested in developing reserves.

This reality must be a part of public policy considerations in fulfilling the objectives of the CNES. The CNES includes an objective to stop the decline in domestic oil production as a

means to improving national energy security. This objective is more clearly stated in the Fossil Energy Strategic Plan as follows:

Improve the capability of the U.S. petroleum industry to increase the supply of secure, domestic oil by an average of 0.5 million barrels/day in the 2001-2010 period while significantly reducing the environmental impact of oil production.

To put this objective in a clearer context, it was developed at a time when domestic oil production was on the order of 6.5 million barrels/day. It, therefore, translates into a national goal to increase domestic production to about 7 million barrels/day. That target starts from a production level that has now dropped below 6 million barrels/day. Clearly, it cannot be achieved without substantial reliance on the independent producer and substantial changes in national energy policy.

Yet, at the same time the independent producer has suffered the most significantly from the current price crisis. The statistics on damage to the industry are mind-numbing.

- Domestic production has dropped below 6 million barrels per day – the lowest since 1951
- Operating rig counts have hit historic lows
- Over 56,000 jobs have been lost in the industry since November of 1997
- More than 136,000 oil wells (25 percent of total U.S. oil wells) and 57,000 gas wells have been shut down
- \$2.21 billion in lost federal royalties and state severance and production taxes
- Capital budgets for oil and natural gas development have been savaged – down 25 – 30% with the biggest cuts in the US
- Indirectly – or perhaps directly – the price crisis has driven mega-mergers within the industry.

Taken together these factors define the devastation in the industry. Equally important, they lead to the realization that their consequences are not immediate or necessarily foreseeable. As the Energy Information Administration stated in its analysis "*Oil and Gas Development in the United States in the Early 1990's: An Expanded Role for Independent Producers*":

Although the majors' primary upstream (exploration, development, and production) investment targets shifted abroad, the reduced role for the majors in U.S. oil and gas production did not become strongly apparent until the 1990's.... Reductions in spending and production by other U.S. producers responding to the oil price collapse of 1986 and its aftermath, together with lags inherent between exploration and development activity and production accounted for this delay. Also, the majors did not become net sellers of U.S. oil and gas reserves until the 1990's.

In 1986, domestic crude oil production was 8.68 million barrels/day. Once the price crisis was past, little was done to develop responses. The changes to the industry were not understood. By

1997, domestic crude oil production had dropped to 6.45 million barrels/day – a loss of over 2 million barrels/day. This time, this crisis, action must be taken to avoid a similar loss of domestic production, of an important domestic resource.

Implications on the Nation's Natural Gas Objectives

Moreover, the implications are broader than crude oil. They are equally critical to domestic natural gas production. The CNES includes an objective to increase domestic natural gas use by a net 6 trillion cubic feet/year by 2010. This would require annual production level of about 30 trillion cubic feet/year. It is critically important to recognize that oil and gas are found together, produced together, draw from the same capital pool, and rely on the same infrastructure – both human and material. Over the past 18 months low oil prices have not only shut in 136,000 oil wells but 57,000 gas wells also. Capital budget cuts for new upstream development hit both oil and gas. The exploration and production (E&P) personnel necessary to accelerate and maintain a more active resource base development program have been devastated with employment in this sector shrinking by 56,400 – about 15% of its total – since November 1997. The requisite upstream service vendor segment to facilitate growth (drilling contractors, well service contractors, cement and stimulation vendors, well logging, oil country tubular goods) have also suffered dramatically. For example, from November 1997 through April 1999, the domestic drilling rig count dropped 50 percent. The rig count is a quick measure of the level of activity in the industry. While most of this drop has been in the oil side of the business – approximately a 60 percent drop – the natural gas side of the industry has seen about a 40 percent decline. Faced with these stark problems, capital will not easily flow to the upstream (E&P) segment of the business; it will require clear indications that adequate returns can be achieved on new E & P capital investment. Both elements of the industry must be considered. Without a strong domestic oil industry, we cannot have a strong domestic natural gas industry and the national goal of a 30 trillion cubic feet per year natural gas market will not be achievable.

The Consequences for National Security

Similarly, it is essential to recognize that domestic oil production is the nation's true strategic petroleum reserve. Far more than the hundreds of millions of barrels in the Strategic Petroleum Reserve, the ability to produce 6.5 to 7 million barrels/day of domestic oil is essential to America's national security. Oil is this nation's economic lifeblood. Without a stable oil supply the U.S. economy and the world's economic health are at risk.

The most recent price crisis has shown how much more vulnerable the crude oil market is to instability. This crisis showed how different the oil market has become in the past twelve years. In 1986, the market price was largely defined by the decisions of the Oil Producing Exporting Countries (OPEC). But, since then oil pricing has changed to be largely dependent on commodity futures markets – principally the New York Mercantile Exchange (NYMEX), the International Petroleum Exchange (IPE), and the Singapore Mercantile Exchange (SIMEX). These exchanges, like all markets, are subject to volatility and the potential to set prices based on factors that do not reflect the fundamentals of the industry.

The current price crisis is illustrative. Prices have reached historic lows in real terms. Yet, the fundamentals of the industry do not suggest that should be the outcome. Worldwide demand for

oil slowed in 1998 as a result of the Asian economic problems, but it did not decrease. Most projections suggest that oil demand will continue increase at a 1.5 to 2.0 percent per year growth rate. Similarly, most analysts suggest that the current worldwide productive capacity for oil is only 3 to 4 percent above current demand. Thus, without additional production coming on line, demand would exceed supply in the next two to three years. Moreover, this simple assessment does not address the natural depletion in oil production that occurs – and has been exacerbated from new drilling technologies and the lack of new investment as the price crisis drove investment down. These conditions in most industries – and historically in the oil industry – argue for upward pressure on prices not the catastrophic collapse that occurred.

Nevertheless, a price collapse occurred and it is important to recognize the factors that contributed to it. Generally, the triggering factors are attributed to three events – the collapse of Asian economies, warmer than normal winters in the Northern Hemisphere, and a market share competition between Venezuela and Saudi Arabia. These occurred in late 1997 and early 1998. This first phase was worsened by projections of vast oversupplies of oil by such institutions as the International Energy Agency (IEA). Reports by the IEA and others (many of which used IEA's data) projected excess supply while at the same time being unable to find the physical barrels that they projected. The markets continued to react and suppress prices – putting extreme pressure on domestic oil production.

As most OPEC and non-OPEC countries took action to reduce production to stabilize oil prices, the market was unresponsive. It then became evident that quietly Iraq was using the UN sanctions process to continue to destabilize the oil market. At the beginning of the oil price crisis Iraq was a minor factor – exporting 600,000 to 700,000 barrels/day of oil. But early in 1998 the UN sanctions process expanding the sales volume that Iraq could sell to \$5.25 billion every six months and allowing the expenditure of \$300 million every six months to refurbish its oil production capacity. Even though less than \$25 million of this allocation has been used, Iraq still increased its oil exports to as much as 2.5 million barrels/day. As other nations cut production, Iraq's increased – offsetting the effect on inventories, becoming the swing producer in setting price in the world market, and continuing to suppress world oil prices. Ultimately, this role was limited by Iraq's current productive capacity and by the decision by OPEC and non-OPEC countries to further reduce production. Yet, the potential implications are both insidious and profound.

If Iraq was able to exert this much influence on world oil prices under these circumstances, what are the implications to national security when the gap between demand and productive capacity close? As the gap closes, any producer nation that produces more than the gap can become the world's swing producer. That is, by reducing its production, it can create a supply shortage and drive prices upward. Or, it can increase production and drive prices downward.

Both options threaten U.S. national security. Shortages and high prices affect the economy adversely and the consequences are higher as the country becomes more dependent on foreign oil. Low prices directly impair the health of the domestic oil industry as they have in the current price crisis, leading to lost production and making the nation more susceptible to supply disruption. The current world oil market is heading in this direction and the Administration needs to take actions to respond to it and to value the nation's domestic oil production as an element of this response.

Action Steps

This Section 232 analysis needs to produce recommendations that fully value domestic oil production and to enhance its development. It needs to put a defined set of objectives on the broad framework suggested in 1994. These need to address a number of known areas of public policy and put in place ongoing commitments to address future emerging issues as the implications of the current price crisis are identified. It is also important to recognize that while the federal government needs to participate in the support of the domestic oil industry, there are a limited number of actions it can take.

Following are a specific set of recommendations.

Tax Policy

A pivotal option available to the federal government is reform of the tax code. Over the past several decades treatment of the oil and gas industry in the tax code has constrained the use of deductions and credits as opposed to the time when the national policy objective was to encourage domestic oil and natural gas development. Some of these constraints have been modified – many to the benefit of independents. However, as price fluctuations become more threatening, more must be done. For example, the National Petroleum Council's 1994 *Marginal Wells* report made the following statement:

Preserving marginal wells is central to our energy security. Neither government nor the industry can set the global market price of crude oil. Therefore, the nation's internal cost structure must be relied upon for preserving marginal well contributions.

The *Marginal Wells* report then went on to recommend a series of modifications to the tax code including a marginal wells tax credit and expensing key capital expenditures.

The proposed marginal wells tax credit is a good example of a well-reasoned countercyclical approach to the problem. It phases in when oil prices drop and phases out when they rise. It serves as a safety net in times price crises. It protects what was 20 percent of domestic oil production at the start of 1998 and what will always be a pivotal element of the nation's true strategic petroleum reserve – as long as it is preserved.

During periods of low oil or natural gas prices that threaten the future of domestic resources, it is essential to develop options to enable producers to retain a greater portion of their income. At the federal governmental level, adjustments to the tax code can provide a mechanism to allow producers to retain cash from existing operations or to recover it from prior years' operations. The oil and gas producing industry endorses changes to the tax code that would address these objectives.

Tax Credits

A countercyclical marginal well tax credit – a concept recommended by the National Petroleum Council's 1994 *Marginal Wells* report – that would be available during low oil and gas price fluctuations, including a ten year carryback and applicability against both regular and alternative

minimum taxes. This provision would serve as a safety net to small producers by providing additional revenue at a time when prices are low to keep wells operating.

The Marginal Well Production Tax Credit amendment to the Internal Revenue code will establish a tax credit for *existing* marginal wells. Marginal oil wells are those producing less than 15 barrels per day or producing heavy oil and for high water cut wells producing less than 25 barrels per day. Marginal gas wells are those producing less than 90 thousand cubic feet (Mcf) a day. The amendment will allow a \$3 a barrel tax credit for the first 3 barrels of daily production from an existing marginal oil well and a \$0.50 per Mcf tax credit for the first 18 Mcf of daily natural gas production from a marginal well.

The tax credit would be phased in and out in equal increments as prices for oil and natural gas fall and rise. The phase in/out prices are as follows:

OIL – phase in/out between \$14 and \$17

GAS – phase in/out between \$1.56 and \$1.89

The amendment would allow the tax credit to be offset against regular and the alternative minimum tax (AMT). In addition, for producers without taxable income for the current tax year, the amendment would provide a 10-year carryback provision allowing producers to claim the credit on taxes paid in those years. The carryback credit may be used to offset regular tax and AMT.

Modification of Alternative Minimum Tax (AMT)

A countercyclical restructuring of the calculation of Alternative Minimum Taxable Income (AMTI) to eliminate from the calculation certain preference items and adjustments. During low oil prices, this would reduce the income against which the AMT is calculated thereby leaving more income to maintain and develop production.

Modification of Percentage Depletion

Current law limits the use of percentage depletion in several ways thereby limiting the availability of capital to maintain and develop production. These provisions would: eliminate limitations on the use of percentage depletion across all properties; eliminate the current limitation on using percentage depletion in excess of 65 percent of net taxable income; and, allow excess percentage depletion to be carried back against past taxes. These steps will free capital for small producers to maintain and develop production.

Expensing Expenditures

The ability to recover expenditures as quickly as possible allows capital to be reinvested more rapidly. These provisions would assure that geological and geophysical costs and delay rental payments can be expensed in the year that they are incurred.

These fundamentally essential reforms to the federal tax code have been introduced in both the House of Representatives (H.R. 1971) and the Senate (S. 1042).

Financial Instruments

A second and new area for federal public policy related to domestic oil production is the creation of financial instruments to aid the industry in troubled times and improve capital development generally.

SBA Loans

The Administration has opened this idea by working with the Small Business Administration to use existing authority to provide small business loans to oil producers and related industry. However, it is a limited program.

Loan Guarantees

The Senate passed a broader loan guarantee program offered by Senator Pete Domenici during consideration of the 1999 Emergency Supplemental Appropriations Act (H.R. 1141). While not completed on that legislation, the provision has now been incorporated into H.R. 1664. The oil and gas loan guarantee program provides a two-year GATT-legal, \$500 million guaranteed loan program to back loans provided by private financial institutions to qualified oil and gas producers and the associated oil and gas service industry. The minimum loan to be guaranteed for a single company at any one time would be \$250,000 (subject to waiver); the maximum would be \$10 million. The board established to administer this would have the authority to determine the specific requirements in awarding loan guarantees, including the percentage of the guarantee, appropriate collateral, loan amounts, and interest rates. Repayment of the loans would be required within six years.

Loan guarantees are an approach that has been used by the federal government to facilitate the recovery of key domestic industries or municipalities in times of severe crisis. They have been used for Chrysler Corporation and New York City. The Department of Agriculture operates an ongoing loan guarantee program for farmers that addresses their problems during low commodity prices. In this case the concept would provide bridge financing to allow independent producers and the oil industry supply business to recover from the current price crisis.

PADDIE MAC

Another concept that deserves evaluation is called the "Petroleum Development Investment Management Corporation" – PADDIE MAC for short. This concept is pattern after other government sponsored enterprises (GSE) like Fannie Mae and Sallie Mac.

Under the Paddie Mac concept, loans would be made and serviced by banks and other oil and gas lenders in conformity with Paddie Mac guidelines. Paddie Mac would guarantee the non-recourse loans (volumetric production payments) secured by producing oil and gas properties. Independent engineering of reserves confirming sufficient future production to repay the loans would be required, standardized documentation used and future prices would be hedged through Paddie Mac. Paddie Mac would also make a secondary market for the guaranteed loans, assuring lenders of liquidity. Loans purchased would be bundled for sale in the capital markets as investment grade debt. Based on its GSE status, the cost of funds to borrowers are projected to be two or more percent less than most producers now pay, and hedging of future prices would be

more favorable than most producers get today. Efficient hedging would be available, separate from loans, to enable producers to insulate themselves from price volatility and disastrously low prices.

The Department of Energy has considered this concept in the past and the Administration should revisit it now.

Addressing possible financial instruments where the federal government can assist the domestic oil industry are a needed part of a total package.

Public Lands and Royalties

The U.S. is a mature oil producing area but there are still substantial oil reserves that can be developed. Additionally, world class gas reserves lay beneath federal lands and need to be developed to reach the national 30 trillion cubic feet per year goal. Many of these are on federal lands where federal policy defines both their access and their desirability. Both need attention in any policy option. The Administration needs to revisit its positions on access to public lands for production. The Department of Energy has shown how new production techniques reduce the environmental risks to public lands. Similarly, the federal government needs to recognize that the U.S. is competing for worldwide capital. Other governments have been responsive to the flight of capital. The federal government needs to recognize that just as the recent price crisis has forced change on the industry, it is time to determine how the federal government needs to change to draw its resources into the worldwide competition. There are options in all areas.

- Federal policymakers to find ways through existing federal laws and regulations to provide regulatory relief to small independent oil producers. For example, the Bureau of Land Management is allowing marginal oil well operators producing on public lands to suspend operations for up to two years without losing their leases. This suspension would waive the requirement that operators promptly plug wells that are not producing paying quantities until oil prices return to normal prices.
- With oil prices now at record lows, wells producing 50 barrels of oil per day or 120 Mcf/d are uneconomic. Royalties need to be reduced for these wells; otherwise they will be shut-in or abandoned, further reducing the benefits of domestic production. Better still would be a two-year royalty reinvestment policy for these uneconomic wells. If every royalty dollar for an uneconomic well is reinvested into keeping the well on line, the greater the return to the American public. Both the royalty investment account and reduced royalty approach would terminate when oil prices recover to economic levels.
- Other options include:
 - Temporarily suspend mandatory on-site maintenance tasks that do not pose a threat to public health, safety, and the environment, but which are costly for producers to carry out.
 - Delay any portion of the "Plain English" rule that creates additional regulatory burdens or costs.

- Reduce to \$1.00 an acre those lease rental charges which are currently over \$1 an acre. If a lease bonus is \$2.00 an acre or more, then waive first year rental.
- Eliminate rights of way and rental charges for pipelines, roads and other surface facilities.
- Speed up the processing of permits and applications to operate on public lands. Independents can't afford to have investment capital sitting idle while they wait for overdue approvals.
- Streamline processes related to the National Environment Policy Act (NEPA). Also, provide credits for costly environmental documentation work. These cost savings measures were developed from Interior Secretary Babbitt's Green River Advisory Committee recommendations.
- Transfer Bureau of Land Management oil and gas regulatory authority to state agencies to eliminate costs associated with complying with duplicative federal and state regulations.

These reforms to the federal regulatory structure have been introduced in both the House of Representatives (H.R. 1985) and the Senate (S. 1049).

Federal Royalty Regulations

Unfortunately, one federal regulatory initiative needs to be addressed directly – the Minerals Management Service (MMS) proposal to revise the current crude oil valuation process. The MMS's proposed oil royalty valuation rule making essentially raises royalties by implementing policies not consistent with the lease contract and increases uncertainty. IPAA does not oppose changes in the present oil royalty valuation system. But, independents need a fair and equitable oil royalty rule. Congress acted to delay implementation of this rule until October 1999 with the assumption that MMS would negotiate in good faith on this rule. Workshops have occurred, but independents have no way of determining if MMS plans to make changes to the rulemaking that will be beneficial. MMS needs to repropose the rulemaking for comment. Alternatively, the issue needs to be addressed through enacting legislation (S. 924) that would clarify the underlying issues in contention between the federal government and producers.

However, as discussed above, the broader issue here is creating a royalty policy that draws a fair balance between the revenue that can be raised and the value to national security to develop the resource to maintain a healthy domestic oil and natural gas industry. A comprehensive, but flexible royalty in-kind program can achieve this balance.

The United States Needs to Develop A Strong Role in World Oil Policies

As the second largest producing nation in the world and the largest consuming nation, U.S. policymakers must send a message that we value our domestic resources and that we will not allow the economically and strategically valuable domestic oil industry to be destroyed. Policymakers also have an obligation to step to the international table and participate in decisions that preserve excess producing capacity and thus avoid the inevitable short supply that low prices

guarantee. America must make clear that it intends to support America's struggling oil and natural gas producers.

Iraq presents an instant case. No one questions the need to provide humanitarian aid to the people of Iraq. It is equally clear that few believe that the current humanitarian aid program is effective. It needs to be reformed. At the same time the UN sanctions program handed Iraq an oil weapon that Saddam Hussein used effectively in 1998 and early 1999. The U.S. needs to recognize that Saddam Hussein will take advantage of every oil option he can to punish his enemies. In the past he was prepared to develop as much production as possible to keep prices low – punishing Saudi Arabia, Kuwait, and other OPEC countries as well as the domestic U.S. oil industry. If he is allowed unfettered access to capital to develop his oil industry, he will try to expand to a level where he can easily be a swing producer whether that is exporting 2.5 or 3.0 or 4.0 million barrel/day. Once there, he can decide whether prices are high or low. This is a fatal strategy for the U.S. economy and national security. The United States needs to be an active player in restricting the options provided to Iraq by the UN.

Commitment to the Future

Finally, the recommendations to the President must reflect a commitment to continue to address emerging issues as the consequent threats to domestic oil production appear from the current price crisis and future ones. No one can gauge the nature of these threats now. Some may come as OPEC countries grapple with their own interests as oil producing countries such as the current Iraqi threat. Others may arise as the current price crisis recedes. For example, over the past decade refinery investment – particularly along the Gulf Coast – has included equipment to better process heavy, sour crudes. This investment may weaken the natural demand for lighter, sweeter crudes from the mid-continent, depressing their relative price. Similarly, pipeline investments in the Gulf Coast have reversed historic crude pipelines carrying mid-continent crudes to Gulf Coast refineries. Now, these pipelines carry product to compete with mid-continent refineries that typically use domestic crudes. Pipeline investment in the north can allow Canadian crudes or crudes imported into Canada to compete in natural markets for domestic crude in the Midwest and mountain states. New fuel regulations will pressure smaller refiners that are normal customers of domestic oil producers, perhaps putting them out of business. Each of these examples poses an as yet undefined threat to domestic oil production. Each could require a different solution.

Conclusion

As this Section 232 analysis defines its recommendations, it needs to recognize that the underlying national security risk posed by imports must rely on sustained domestic oil production as a counter. Sustained domestic oil production requires a strong domestic oil industry, one that will be largely comprised of independent oil producers. Consequently, unlike the 1994 analysis, this Section 232 analysis must include a significant and substantial set of recommendations to value domestic oil production. Failure to include such a clear domestic oil component will produce a failed program, a program unworthy of national support, a program doomed to watch oil imports grow and to put America's national security at greater risk.