Testimony

Of

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Subcommittee on Energy and Mineral Resources

House Resources Committee

U.S. House of Representatives

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STATEMENT

OF

DIEMER TRUE

FOR

THE INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, THE AMERICAN PETROLEUM INSTITUTE, THE DOMESTIC PETROLEUM COUNCIL, THE INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS, THE NATIONAL OCEAN INDUSTRIES ASSOCIATION, THE NATIONAL STRIPPER WELL ASSOCIATION, THE NATURAL GAS SUPPLY ASSOCIATION, THE PETROLEUM EQUIPMENT SUPPLIERS ASSOCIATION, THE US OIL & GAS ASSOCIATION

AND

California Independent Petroleum Association

Colorado Oil & Gas Association

East Texas Producers & Royalty Owners Association

Eastern Kansas Oil & Gas Association

Florida Independent Petroleum Association

Illinois Oil & Gas Association

Independent Oil & Gas Association of New York

Independent Oil & Gas Association of Pennsylvania

Independent Oil & Gas Association of West Virginia

Independent Oil Producers Association Tri-State

Independent Petroleum Association of Mountain States

Independent Petroleum Association of New Mexico

Indiana Oil & Gas Association

Kansas Independent Oil & Gas Association

Kentucky Oil & Gas Association

Louisiana Independent Oil & Gas Association

Michigan Oil & Gas Association

Mississippi Independent Producers & Royalty Association

Montana Oil & Gas Association

National Association of Royalty Owners

Nebraska Independent Oil & Gas Association

New Mexico Oil & Gas Association

New York State Oil Producers Association

Ohio Oil & Gas Association

Oklahoma Independent Petroleum Association

Panhandle Producers & Royalty Owners Association

Pennsylvania Oil & Gas Association

Permian Basin Petroleum Association

Petroleum Association of Wyoming

Tennessee Oil & Gas Association

Texas Alliance of Energy Producers

Texas Independent Producers and Royalty Owners

Wyoming Independent Producers Association

Madam Chairwoman, members of the committee, I am Diemer True, Chairman of the Independent Petroleum Association of America (IPAA). This testimony is submitted on behalf of the IPAA, the American Petroleum Institute (API), the Domestic Petroleum Council (DPC), the International Association of Drilling Contractors (IADC), the National Ocean Industries Association (NOIA), the National Stripper Well Association (NSWA), the Natural Gas Supply Association (NGSA), the Petroleum Equipment Suppliers Association (PESA), the US Oil & Gas Association (USOGA), and 33 cooperating state and regional oil and gas associations. These organizations represent petroleum and natural gas producers, the segment of the industry that is affected the most when domestic energy policy does not recognize the importance of our own national resources.

This hearing is directed at examining what we believe is a growing natural gas supply and demand imbalance and the role that public lands and federal submerged lands could play in the solution. The role of federal lands in meeting future natural gas demand is a critical one and this hearing is a timely opportunity to address both that role and the general issues surrounding natural gas supply in the United States.

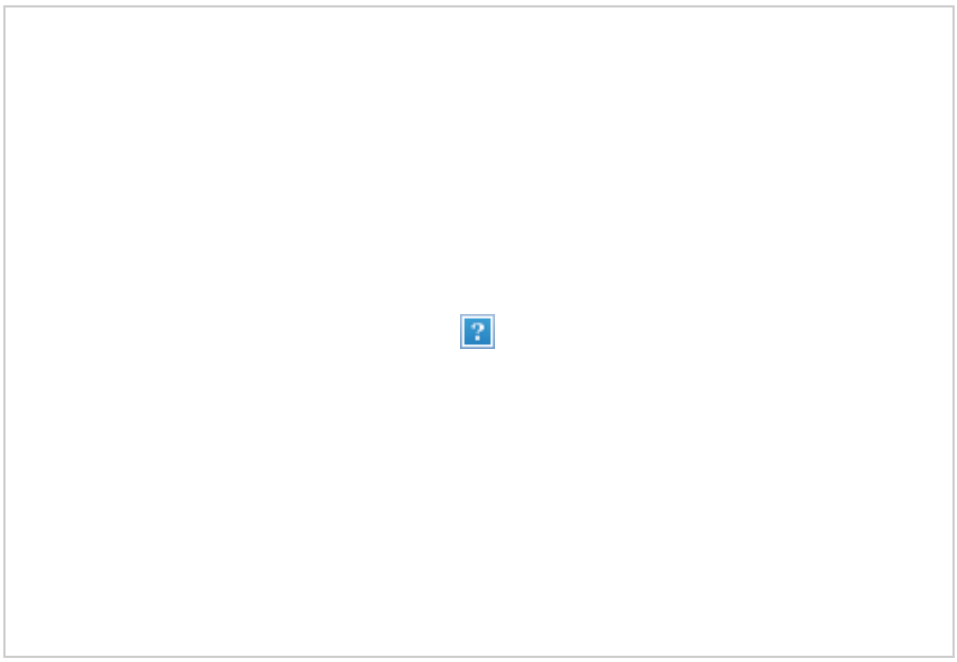
The Supply Challenge

Initially, it is important to put the current natural gas supply and demand situation in some perspective. At year-end 2000, we saw the consequences of natural gas supply shortages. As storage dwindled, prices soared and consumers had to deal with the consequences. The initial phase of this supply-demand imbalance reflected the effects of low oil prices in 1998-99 on capital availability to develop domestic natural gas supply. These historically low petroleum prices resulted in capital expenditure budget cuts for domestic producers exceeding 30 percent in 1999. The natural gas drilling rig count dropped by over 40 percent at its lowest point. In 1999, new wells failed to replace existing reserves.

The petroleum price recovery and the industry's recognition that future natural gas demand would increase led by more and more electricity generated by gas powered turbines triggered a robust rebound in drilling for natural gas. Rig counts went to record levels. But, the lag in new production caused by the low petroleum prices left a tight market by the end of 2000. Higher prices resulted in more drilling rigs

searching for natural gas.

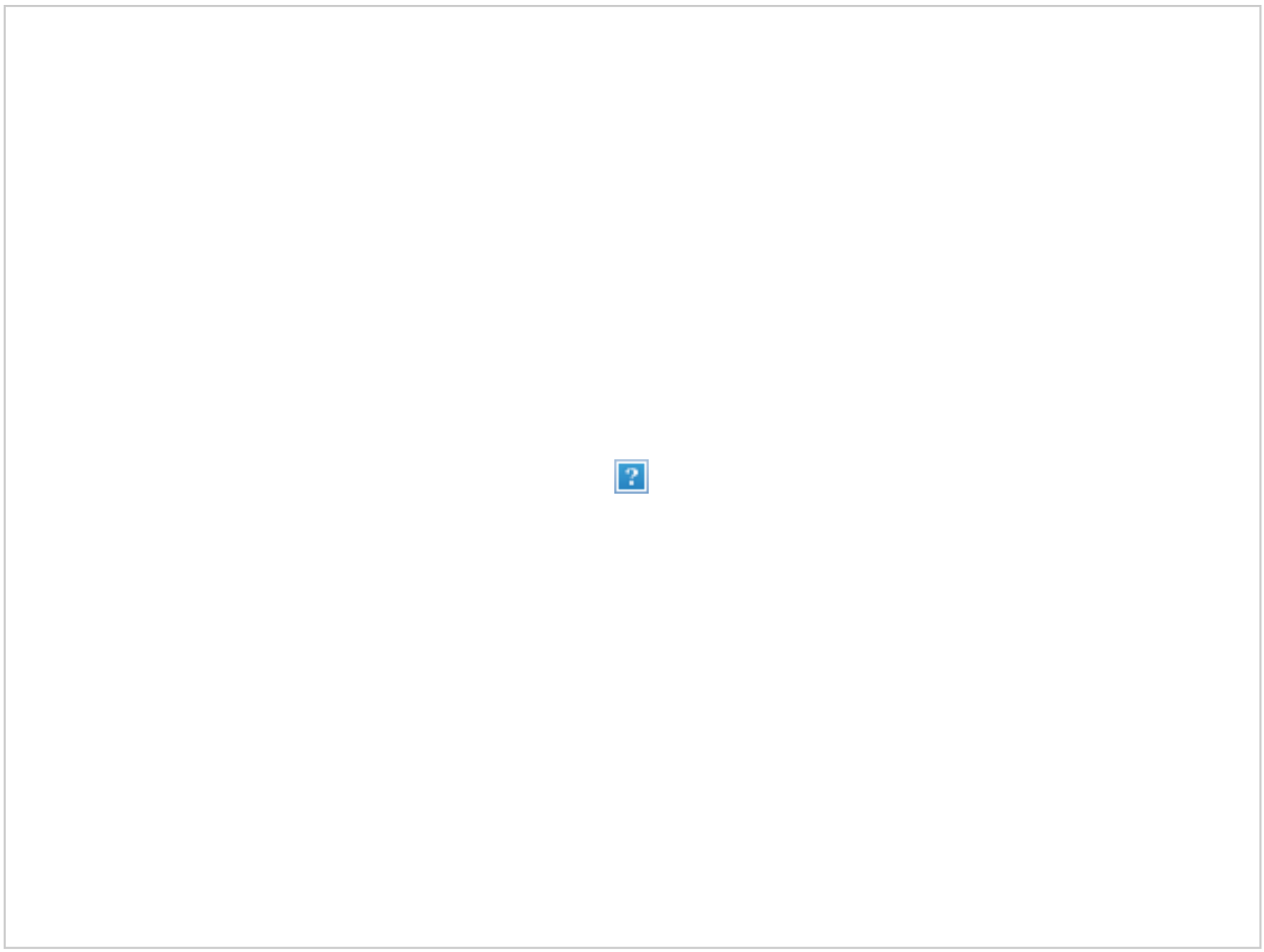
The higher prices also reduced short-term demand. In reality, the abatement of high natural gas prices resulted from significant demand decreases not from supply increases. Increased drilling activity simply could not increase supply in the time period that was involved.



In the latter months of the 2001, prices had fallen to levels comparable to the first part of 1999 and rig counts began to fall as well. By year-end 2001 rig counts had fallen to levels last seen in April 2000. While rig counts have currently risen to around 700, they are well below the 1000 rate that was achieved in the fall of 2001. The implication of these lower rig counts is clear – current supply levels may not be sustainable.

Maintaining Existing Supplies

The challenge facing natural gas producers is twofold – maintaining existing natural gas supply and increasing that supply to meet future demand. While analyses like the 1999 National Petroleum Council *Natural Gas* study have focused on the resources that need to be developed to meet future demand – particularly with regard to federal lands – the challenge of maintaining existing supply has not received the attention it deserves.



The first and perhaps most compelling challenge to maintaining existing supply is coping with increasing rates of depletion. Conventional natural gas wells begin to deplete as soon as they begin to produce. But over the past decade, producers have seen average depletion rates climb from 16 percent per year to 23 percent per year. In somewhat simplified terms this means that producers must initiate new production equal to a quarter of existing production each year just to stay even. New technologies like 3-D and 4-D seismic enable explorationists to find smaller reservoirs. Enhanced production technologies like horizontal drilling are allowing better and more environmentally effective development of reserves. But finding smaller reserves and producing them more effectively makes the challenge of maintaining existing natural gas supply more difficult.

Second, it is important to understand the extent of development of the existing resource base. Some opponents of accessing additional federal lands suggest that the current resource base should be the first

focus. In reality, it already is. Developing the current resource base for both conventional and unconventional natural gas is the source of existing supply. When the rig count grew to 1000, this is where it had to grow. But this resource base has supplied natural gas for the past 50 plus years. These mature reserves are harder and more costly to develop. New reserves in these areas are smaller and deplete faster or are deeper and more costly to develop. But, there is no doubt that these resources will continue to be developed as aggressively as natural gas prices justify development and capital is available to do so.

Some experts believe that domestic natural gas production in 2002 will decline from last year's level. This month, Raymond James and Associates reported that U.S. natural gas production has fallen for the fourth consecutive quarter. I agree with these assessments. They reflect the combined effects of higher depletion from existing production and less development of new wells. In a sense the market is also reflecting this reality. Despite natural gas storage volumes that would suggest adequate supply, the futures prices for natural gas have remained near or above $3.00 per thousand cubic feet.

Policymakers need to understand these implications clearly. Lower rig counts and higher depletion are adversely affecting available supply. Increases in demand from either higher economic activity or weather can stress the natural gas market, quickly creating supply shortages and the higher prices that follow.

These are the conditions that are defining the current supply and demand balance. Not only must they be addressed, but the industry must also be capable of increasing natural gas supply to meet future increased demand.

Future Supply Challenges

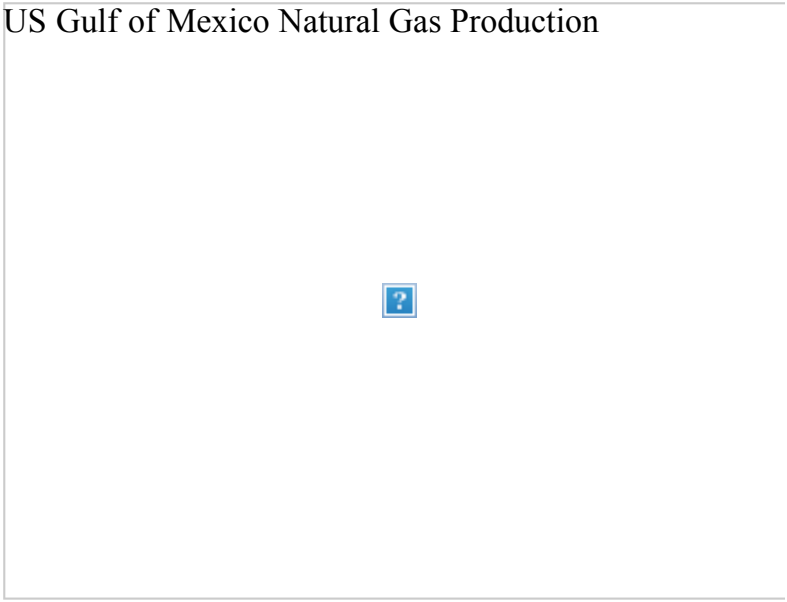
Despite the economic slowdown over the past year and despite the capital limitations that are devastating the merchant power industry that must invest in future electricity generation, natural gas demand will grow. Natural gas remains the most abundant and reliable clean burning fuel to meet national environmental objectives while enhancing the use of stable domestic fuel sources. National energy policy must recognize the importance of accessing the natural gas resource base. The National Petroleum Council in transmitting its 1999 *Natural Gas* study concluded:

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

Natural gas consumption is expected to grow by over 30 percent over the next 15 years. While recent events may have slowed the pace of this growth – an issue that is being assessed again by the National Petroleum Council – future natural gas consumption will likely grow at a pace that will require an energy policy that allows the full potential of natural gas to be developed. This cannot be done without more access to and development of government-controlled resources. However, development of these resources remains a substantial challenge.

Offshore - Western and Central Gulf of Mexico

US Gulf of Mexico Natural Gas Production



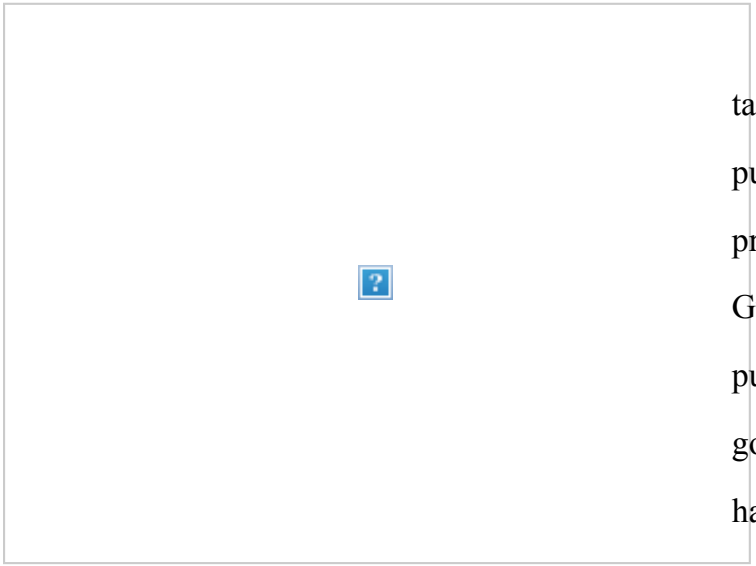
These portions of the Gulf of Mexico have proven to be a world-class area for natural gas as well as petroleum production, accounting for over 25 percent of domestic natural gas production. Production comes from the continental shelf, the deepwater, and the emerging ultra-deepwater. The NPC study projects that future production increases in these areas is essential to meet projected demand. However, future production increases will hinge on federal offshore policies. The most significant of these in the Western and Central Gulf of Mexico relate to royalty policies.

First, offshore production is particularly suited for royalty-in-kind (RIK) – paying the royalty with production instead of dollars. It is a more economical and fairer approach. Recent actions to fill the Strategic Petroleum Reserve could utilize 80 percent of this offshore royalty oil. RIK should be encouraged for natural gas. Second, the 1995 Deepwater Royalty Relief Act was extremely successful promoting activity in the deepwater Gulf. However, the 1995 program expired. Since its expiration, the Minerals Management Service (MMS) has provided more limited, but useful, royalty incentives in recent lease sales. The National Energy Policy recognized that offshore regulatory policies could inhibit the sound development of these

resources. Its recommendations should be implemented and further incentives for deep drilling in all depths in the deepwater, deep drilling for natural gas on the shelf, subsalt and highly deviated drilling should be examined.

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

Developing the substantial domestic natural gas reserves in most of these three areas is prohibited by moratoria. President Clinton extended these moratoria for another ten years in 1998 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 these moratoria preventing natural gas development as well as oil. In fact, both the Eastern Gulf and the Atlantic reserves are viewed as gas reserve areas, not oil – those coasts are not at environmental risk. Too often, these policies are predicated on the events that occurred 30 years ago. For example, no Eastern Gulf of Mexico sale occurred from 1988 to 2001. The recent sale took place only under greatly reduced conditions.



However, this year another ominous step was taken when the federal government decided to purchase leases that have not been developed, primarily due to regulatory limitations, in the Eastern Gulf of Mexico. This action led to calls for similar purchases off the coast of California and on other government controlled land. While each case may have specific merit, following such a course also serves to limit the available resource base at a time when it needs to be expanded.

Federal policy needs to be reviewed. It needs to be based on a sound understanding of today's technology. When the NPC analyzed natural gas reserves that were being inhibited by regulation of these areas, it concluded that over 70 trillion cubic feet of natural gas in these areas are precluded from development.

Onshore Restrictions - A Mosaic of Regulations and Prohibitions

Much of the onshore natural gas resource base is located in the Rocky Mountains where federal policy limits access to an estimated 137 trillion cubic feet of natural gas. The constraints differ. Regulations like the Forest Service roadless policy (currently stayed by court action) and prohibitions in the Lewis and Clark National Forest and in wilderness study areas are essentially absolute. At the same time the permitting process to explore and develop resources often can work to effectively prohibit access and development. These constraints range from federal agencies delaying permits to revise environmental impact statements to habitat management plans overlaying one another prohibiting activity to unreasonable permit requirements that prevent production. Following are several examples.

- In the Lewis and Clark National Forest – a multiple use federal land – the forest manager concluded that natural gas development was inconsistent with the development of the forest because it violated "a sense of place" and prohibited new leasing. There is no administrative mechanism to appeal such an arbitrary judgment despite the reality that there is no such basis for denying the use of the land. Court action to overturn the decision failed because the courts concluded that the decision was within the discretion of the forest manager.

- In the Jack Morrow Hills area, natural gas development is being delayed because the federal Coordinated Activity Plan (CAP) was challenged as outdated. As a result the Bureau of Land Management (BLM) has revised the federal Environmental Impact Statement (EIS) to reflect the higher level of natural gas development. Now, those who seek to prevent access to the resource base are challenging that EIS.

- Similarly, in the Buffalo, Wyoming BLM area, new challenges are underway to existing leases based on arguments that the current Resource Management Plan (RMP) does not allow the level of development that is underway. If such an interpretation is sustained, natural gas development in the entire Powder River Basin area could be strangled.

There is no simple or single solution to these constraints. What is required is a commitment to develop these access policies with a full recognition of the importance of developing the natural gas

resource. The National Energy Policy recognized the magnitude of these limitations. Executive Orders to consider energy implications in federal decisionmaking and to convene a task force to improve permitting are important first steps in developing a response. These early efforts have resulted in specific tasks within various Executive Branch departments that should improve the permitting process.

Energy Legislation Before Congress

With these perspectives on the challenges to meet current and future demand for natural gas as a reference point, the question becomes what provisions of the energy legislation now in conference between the House of Representatives and the Senate can improve access to and development of government controlled land, both onshore and submerged. There are several beneficial provisions, primarily in the House passed version of H.R. 4. These include:

Section 6202 provides for royalty incentives in the Western and Central Gulf of Mexico. It parallels the relief now being provided in recent lease sales – those occurring after the House passed its bill. The conferees need to work closely with the Administration to determine the most appropriate approach to assure continuing use of royalty incentives to maximize development of the Western and Central Gulf of Mexico.

Section 6204 provides for analysis of the Gulf of Mexico field size distribution, international competitiveness, and incentives for development. *Section 608* of the Senate passed bill addresses some of these same issues. The conferees should examine the best elements of each section to acquire the information needed to formulate future policy on offshore development.

Section 6222 provides for the Secretary of the Interior and the Secretary of Agriculture to jointly undertake a study of the impediments to efficient oil and gas leasing and operations on Federal onshore lands in order to identify means by which unnecessary impediments to the expeditious exploration and production of oil and natural gas on such lands can be removed. Such an analysis could provide policymakers with the information needed to address some of the key problems associated with the leasing process.

Section 6223 directs the Administration to eliminate unwarranted denials and stays of lease issuance and unwarranted restrictions on lease operations from the administration of oil and natural gas leasing on Federal land. *Section 602* of the Senate passed bill seeks to ensure timely action on leases and permits.

These sections need to be consolidated in a manner that both objectives can be met.

Section 6225 addresses the type of problem raised in the Lewis and Clark National Forest by providing for the involvement of the Secretary of Agriculture in such critical decisions.

Section 6231 and *Section 606* (of the Senate bill) provide for suspension of leases involving subsalt formations. These formations can be particularly difficult to develop and the suspension will allow for more time.

Section 6232 provides additional authority to develop RIK programs that will allow for more effective use of the highly desirable approach. RIK eliminates the complexities of determining the royalty value thereby saving both the government and the producer from the convoluted determinations that are now necessary and are frequently questioned – sometimes years after the sales occur.

Section 6233 provides for royalty relief for marginal wells on both federal onshore and offshore properties for both oil and natural gas. As with the marginal well tax credit passed by both houses of Congress, this relief encourages the continued production of these wells in times of low oil and/or natural gas prices. Retaining production from these wells is in the national interest and the provision should be included in the final bill.

Section 6234 provides for the reimbursement through royalty credits when a private party pays for environmental documents that are the responsibility of the federal government to prepare. Given the challenge of developing these key resources and the potential that adequate appropriations are not available, this is a common sense approach to meet the dual objectives of developing sound environmental documents and moving forward on permitting.

Section 610 of the Senate passed bill addresses the important issue of hydraulic fracturing under the Safe Drinking Water Act. While this is not an issue under the jurisdiction of the Resources Committee, it is an important issue to retain in any final bill. The *LEAF v. EPA* decision in 1997 by the 11th Circuit Court of Appeals incorrectly concluded that Congress intended to regulate the well stimulation process of hydraulic fracturing as underground injection. The Senate passed bill legislatively addresses this issue to eliminate the

potential of other litigation on this issue and to provide EPA with the tools to rely on existing state regulation of hydraulic fracturing. In the Rockies, hydraulic fracturing is used extensively on tight sands and shale formations. In the East, it is also used on coalbed formations because harder coal requires it to allow the natural gas to be released.

Collectively, these provisions in the House and Senate passed energy bills address many significant access and development issues. Final legislation needs to include them. Similarly, Congress needs to continue to work with the Administration to facilitate its efforts to improve the permitting process and its resource management efforts. Money will be an important component of the Administration's efforts, but other authority may be necessary as well.

Thank you for the opportunity to provide this perspective on the challenges facing natural gas production in the United States.