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BEFORE THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON NATURAL RESOURCES
SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES
REGARDING THE EFFECT OF THE PRESIDENT'S FY2013 BUDGET AND
LEGISLATIVE PROPOSALS FOR THE BUREAU OF OCEAN ENERGY
MANAGEMENT (BOEM) AND BUREAU OF SAFETY AND ENVIRONMENTAL
ENFORCEMENT (BSEE) ON PRIVATE SECTOR JOB CREATION, DOMESTIC
ENERGY PRODUCTION, SAFETY AND DEFICIT REDUCTION**

March 8, 2012

Mr. Chairman and members of the Subcommittee, thank you for the opportunity to appear here today to discuss the FY 2013 Budget request for the Department of the Interior.

As Senior Energy Policy Analyst at FBR, my goal is to provide objective and independent analysis of policy trends to help educate investors on the outcomes of regulatory developments. We do not take policy positions or advocate any course of action.

To that end, we have focused on understanding the impacts on the offshore industry of the 2010 Deepwater Horizon oil spill, subsequent moratorium, regulatory transformations, and the ensuing permitting regime. Clearly the spill and the events that followed have had widespread impacts and engender a great deal of passion. My comments today will focus only on providing context to Gulf activity levels and the implications for the future. My views are my own and do not necessarily represent those of FBR Capital Markets & Co.

Eighteen months after the end of the moratorium, the pace of permitting continues to depress drilling activity in the Gulf of Mexico. Even today, there are just 25 Mobile Offshore Drilling Units or "floaters" and 15 platforms drilling. That is 12% fewer floaters than were operating before the Macondo spill despite crude oil prices more than 25% higher.

This is especially important because, globally, the deepwater exploration sector is in the early stages of a powerful acceleration. Resource plays in West Africa and Latin America are driving increased demand for deepwater rigs and the global market could be undersupplied as early as April 2012 according to FBR analyst Rob Mackenzie. Persistently strong oil prices continue to promote capital expenditure while recent discoveries and technological improvements are opening West Africa and Latin America to economic development.

U.S. deepwater could also participate in the CapEx cycle with numerous drilling programs scheduled to begin before year-end and many analysts are predicting double-digit investment increases in U.S. GOM in 2012. The pace of Gulf of Mexico permitting has accelerated over the last year and there is significant optimism about U.S. deepwater exploration and development.

Some analysts have predicted that the rig count in the GOM will exceed 40 rigs before the end of 2012.

The Gulf of Mexico remains an attractive investment environment due to the size of the fields, quality workforce proximity to customers, political stability, and developed pipeline and refinery infrastructure. At the same time, greatly improved imaging technology is making new discoveries more cost effective. ExxonMobil, Chevron, and BP have all announced major finds, expected to be worth hundreds of millions of barrels.

In this context, it appears that the Department's permitting capacity needs significant investment in order to sustain a permitting regime on pace with the investment cycle. Despite the permitting improvements, we believe that there continues to be a permitting constraint on Deepwater Gulf of Mexico drilling activity. That is to say that the availability of permits, rather than economic or geologic factors, may continue to keep the level of deepwater activity below what would otherwise be demanded.

What is the real permitting pace?

There is a great degree of contention as to the actual permitting pace, and post-moratorium changes to the process and reporting do not allow for easy comparisons. We focus on the number of wells (Identified by the API well number) that have been permitted or re-permitted for the first time since the moratorium. This includes new wells but also revisions, sidetracks, and bypasses that are effectively new in that they are additive to offshore activity and because they require significant labor resources from permit writers.

We further break these down into three categories: labor-intensive wells requiring subsea containment; other wells not requiring subsea containment, including water injection and top-hole section work; and platforms which do not have a subsea BOP.

For the 12 month period ending February 29, 2012 the Department of Interior has issued permits for more than 100 unique deepwater wells including 61 new wells. This compares to 67 new wells permitted over the same period before Macondo and a 2006-09 average of 85 per year. In fact, the average of 8.7 additional wells per month exceeds the 2006-9 average of 7.1.

Isn't Gulf Activity "Back To Normal?"

It is insufficient to say that the permitting pace for a given period exceeds the pre-Macondo levels and conclude that activity can resume unconstrained. There is good cause to believe that the resource constraints at the Department will continue to weigh on the growth of GOM activity going forward. Our analysis focuses on two such factors: First, the rate of permitting required to grow gulf activity and the sustainability of permitting.

Playing Catch-up

At the time of the Deepwater Horizon disaster, there were 35 rigs in the Gulf of Mexico, 28 drilling and 7 either stacked or in the yard. Between six and eight permits a month was sufficient to maintain this activity level in large part because of a running stock of approved permits. Historically, there is a strong three-to-one ratio between the total backlog of permits outstanding (issued but not finished drilling) and the number of rigs working. It is important to remember

that operators generally prefer to have multiple permits lined up before mobilizing a rig and developing a field. Thus, we believe that in order to see sustainable Gulf recovery, the total number of permits held in backlog would need to be rebuilt to roughly three times the 28 rigs.

However, the moratorium and subsequent requirements for new permits eliminated that backlog. Rebuilding the backlog is complicated by two crucial factors. First, operators who receive a permit and put a rig to work will eventually finish drilling the well (removing the permit from the backlog) and require an additional permit. Thus, in order to build the backlog and grow the rig count, BSEE would need to replace the permits rolling off plus issue additional permits.

Moreover, operators eager to begin long-delayed drilling programs will conceivably use permits at a faster rate, delaying reconstruction of the backlog. As an illustration, if wells were drilled as soon as they were permitted, at the historical pace of 7.1 permits per month the rigs drilling count could not grow much beyond 28 (assuming 120 day wells) because permits in the 5th month simply replace issued in the first month.

Operators appear to be growing much more comfortable with the predictability and transparency of the BSEE permitting process, implying that they will put rigs to work on the expectation that the next permit will be available before work ends. Although this provides an immediate boost to the rig count, it also pulls forward the cannibalization of the backlog and delays return to the 3-to-1 equilibrium.

However, if the permitting pace does not keep growing fast enough to repopulate the backlog and operators are left with unpermitted rigs excess capacity could seek higher prices in other regions or rigs scheduled to come to the Gulf will be sublet abroad.

Additionally, the current rig count appears to be bolstered by longer drilling times in the new safety environment. This means that more rigs are needed to drill the same number of wells. This has two implications. First, fewer wells could mean less activity for related companies despite a rise in the rig count. Second, should drilling times normalize, even more permits would be required to fill the void.

Permitting Pace Going Forward

Our analysis depends heavily on our view that BSEE is capacity constrained in the number of permits that can be issued. We have continually argued that the lack of permits was due more to predictable bureaucratic manpower constraints than a coordinated policy decision. Thus, despite volatility in the month to month numbers, we continue to expect an average incremental permitting pace between seven and nine MODU permits per month.

That 23 permits were issued by the department of Interior in February is a credit to the diligence and talent of the hard working men and women of BSEE. Enforcing new requirements, including those for demonstrating subsea containment, has taxed the Bureau's resources, most specifically man-hours available to review permits. The average approval time for new Deepwater permits in the year ending February 2010 was 34 days whereas the average time for new wells in the year ending February 2012 was 111 days. Indeed, BSEE employees literally worked nights and weekends to achieve a permitting pace above the historic average despite additional approval times.

In our view, the permitting pace is dictated primarily by four factors: 1) The complexity of the well; 2) The thoroughness and accuracy of the application; 3) The available man-hours to review permits; and 4) The number of applications. The Bureau has worked through the learning curve within the new regulatory requirements to effectively communicate expectations to the industry and has driven down the average approval time from 94 days for applications submitted in first quarter of 2011 to 62 days for applications submitted in the fourth quarter.

This trend is a positive sign for 2013. To sustain 30 deepwater rigs in the Gulf of Mexico, we project that the industry would need more than 9 permits per month in 2012. To grow the rig count to 40 by the end of 2013, we project that the average would need to approach 11. Looking at what we call labor intensive permits - those most closely tied to sustainable GOM rig count growth - we see a consistent average of less than 5 deepwater permits per month.

However, it is not clear that the department can meet these goals at current staffing levels. Of the 8.7 permits a month issued over the last year, almost half were for platforms or wells not requiring subsea containment. Of the new wells, roughly 30 were batch set wells for which an operator lines up a group of permits for one field. These batches may not require subsea BOP review for tophole section work and the operator must apply for a permit revision before reaching TD.

These wells are a crucial part of the long-development cycle that characterizes the large deepwater GOM plays. The permits can be approved comparatively quickly in a group and allow the operator to develop a sequential plan and begin tophole section drilling. But the operator must seek an additional labor-intensive permit including subsea containment to drill to TD. In this respect, the headline number of permits approved can be a misleading indicator of the impact on near-term activity and agency resource adequacy. 9 permits issued in a batch would conceptually add work for only one rig, albeit for a much longer period of time. Moreover, the subsequent permit revision again demands BSEE resources.

Going forward, we believe it is reasonable to assume an average of 8-10 unique wells will be permitted each month with significant variance depending on application quality and periodic groups of batch set wells.

Adequate staffing will be crucial for the department to meet GOM demand for permitting in 2013 and beyond. As of year-end 2011, BSEE employed roughly 125 petroleum engineers and 91 inspectors. The budget request for FY13 envisions an additional 63 BSEE personnel for operational safety, offshore training, environmental enforcement and well bore integrity. Additional FY12 funding approved by Congress in December will go a long way to meeting this goal, but personnel will be a key challenge for the department going forward. The Bureau must manage staff turnover and retirements in the face of rising fast-moving global demand for engineers. The time-consuming federal hiring process and pay scale will continue to complicate the task of hiring and training staff to keep pace with demand growth. At the same time, such a transitional agency must carefully manage bureaucratic culture change in an environment of competing agency priorities.

Other Factors

Transparency and predictability of the permitting process has been crucially important to allowing operators to mobilize rigs under the expectation that permits pending at BSEE will be approved at a regular interval. As demand for permits accelerates, maintaining and fostering this predictability will be crucial for ensuring a hospitable environment for rigs to move into the gulf. In contrast, as the industry seeks more time-consuming permits for deeper wells with more complex engineering, the department needs resources to maintain a stable and predictable flow of permitting.

Comprehensive Transformation

When examining the permitting pace, it is important to remember that over the past 18 months, the Department of Interior has undergone a massive reform described as the most aggressive and comprehensive reform to offshore oil and gas regulation in U.S. history including significant structural changes to regulation and oversight. The Department has reorganized the former Minerals Management Service by dividing its multiple missions among three new entities: BOEM, the Bureau of Safety and Environmental Enforcement (BSEE), and the Office of Natural Resources Revenue (ONRR), a transformation finalized at the beginning of FY 2012.

The Department issued new rules tightening standards for well design, blowout preventers, safety certification, emergency response and worker training. Operators were required to submit new permit applications demonstrating compliance including spill response capability. Among the changes described by BSEE:

- Operators must demonstrate that they are prepared to deal with the potential for a blowout and worst-case discharge per NTL-06.
- Permit applications for drilling projects must meet new standards for well-design, casing, and cementing, and be independently certified by a professional engineer per the new Drilling Safety Rule. Drilling standards have been strengthened in the exploration and development stages, for equipment, safety practices, environmental safeguards, and oversight.
- New guidance, through NTL-10, requires a corporate compliance statement and review of subsea blowout containment resources for deepwater drilling, a key lesson of the Deepwater Horizon oil spill.
- BSEE imposed, for the first time, requirements that offshore operators maintain comprehensive safety and environmental programs. This includes performance-based standards for offshore drilling and production operations, including equipment, safety practices, environmental safeguards, and management oversight of operations and contractors. Companies will now have to develop and maintain a Safety and Environmental Management System (SEMS) per the new Workplace Safety Rule.

BOEM has also had a busy two years. It completed a supplemental environmental impact statement and held the final Western Gulf of Mexico (GOM) lease sale under the current Five-Year program and the first sale conducted after Macondo. BOEM issued the Proposed OCS Oil and Gas Leasing Program for 2012-2017 which it intends to finalize this year.

BOEM also completed a supplemental environmental analysis for the Chukchi Sea Planning Area that addressed key issues including the potential for a large oil spill. The Bureau is also

conducting site-specific environmental assessments on all deepwater exploration and development plans. It is scheduled to issue a draft Geological and Geophysical (G&G) Programmatic Environmental Impact Statement (PEIS) for areas in the Mid- and South-Atlantic paving the way for resource evaluation such as seismic surveys.

Conclusion

Since the Macondo spill, the successor agencies to MMS have undertaken a significant administrative transformation at the same time that the Department worked to catalyze a safety culture change in the offshore industry, craft and implement new regulations, and conduct environmental reviews, lease sales, and a permitting program, each with a greater workload. This transformation has been taxing on the Bureaus and the industry. Now, as the deepwater industry looks to take advantage of quickly growing opportunities, adequate permitting and review resources will be needed if growth is to continue unencumbered.

Disclosures

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