



February 1, 2008

Mr. Frank Rusco
Acting Director, Natural Resources and Environment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Rusco:

On behalf of the largest U.S. independent natural gas and oil exploration and production companies that are members of the American Exploration & Production Council (AXPC), I would like to provide several observations about the GAO's current inquiry regarding "government take" issues related to the fiscal regime under which U.S. federal oil and gas resources are developed.

These comments are in addition to individual company input, including comments from AXPC members, that you may receive. The company comments will provide special insights from the perspective of those who must make very significant investment decisions in this country and around the world every day.

First, this subject is extremely timely and important as we move toward potential new U.S. climate change policy. It must be emphasized that any such policy will certainly increase the already growing demand for clean-burning natural gas. And, since our North American natural gas resources in the ground are significant, the key determinants as to whether they will be explored, developed and produced in a manner that will meet the growing demand will be access to them and the fiscal regime that will either encourage or hinder their becoming reasonably priced supplies our consumers of all classes need.

Second, in its May 1, 2007, report on *Oil and Gas Royalties: A Comparison of the Share of Revenue Received from Oil and Gas Production by the Federal Government and Other Resource Owners*, the GAO correctly pointed out the inextricably linked and complex factors that determine where and to what extent investments will be made to find and produce oil and gas – in addition to the government royalties, taxes, fees and other "takes". Those factors include: access to potential resources; size of potential resource discoveries; exploration and production cost projections and experience including substantial regulatory compliance expenses – not the least of which is the cost of meeting requirements that make our operations among the most environmentally compatible in the world; and, above-ground political and other risks. The report also correctly discusses to some extent the likelihood of reduced energy production as costs (including government "takes") increase.

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However, a casual reader of the report might have been tempted to focus only on a relatively simplistic summary comparison of U.S. federal government takes with those of other national governments. Likewise, policymakers and staff members who read the forthcoming GAO report may do the same, to the detriment of careful policy consideration. For this reason we hope that the report will be clear on several points noted below.

The most active exploration and production companies such as the large independents (meaning non-integrated companies) of the AXPC, and thousands of smaller ones across the country, invest 100-percent of their cash flow to find, develop and produce energy. As the attached chart shows, they also have a history of investing as much as twice or more of their profits. So, any increase in costs – whether for drilling or for royalties, taxes or fees -- means that their budgets will be balanced by reduced investment. And in a mature oil and gas area like the United States where we see new natural gas wells decline at an average rate of more than 30 percent in their first year of production, decreases in investment and resulting activity declines will result very quickly in decreased energy supplies and higher consumer costs. Now more than ever we need to encourage responsible development of our domestic energy supplies to meet growing demand.

Government “takes” as reported by GAO and others may be significantly understated. Most other countries have a more “harmonized” or “revenue sharing” tax structure than that in the United States. Most taxes are collected by national governments, with shares distributed to political subdivisions. By contrast in our federal system of government, in addition to our national-level royalties, taxes and fees, exploration and production companies and their contractors and employees must pay state, county and local taxes and fees that are all part of the “government take”. However, these costs are certainly not all offset by credits against national royalty, tax or other assessments – nor are they likely to be included in any but the most sophisticated country-by-country comparison. Not including them will distort any “government take” conclusions.

Regardless of their levels, government “takes”, or costs, are considered for project investment planning in connection with many other factors, often by a complex modeling process. Perhaps most significant of these additional inputs are those related to the size of potential discoveries in relatively under-explored areas as opposed to mature ones such as the United States. Other things being equal (although we know they would not be), with the prospect of, for example, a billion-plus barrel oil discovery off the coast of West Africa with production over twenty years, there could clearly be the potential for higher investment planning tolerance of government tax and other costs than would be the case for a natural gas well in the San Juan Basin of the United States. However, also making the comparison difficult would be the potential for the West Africa concession to include terms for producer risk mitigation such as reduced takes during periods of cost recovery or low production levels.

The United States is virtually unique in that large production acreage is located on private or state-controlled lands, not just Federal lands. To the extent that the Federal royalty rate begins to exceed the average rate that producers pay on non-Federal lands, it stands to reason that producers will focus less on developing Federal acreage and more on drilling on private lands (and there are already many factors that make it relatively less attractive to drill on Federal lands, such as longer permit times and more burdensome environmental requirements). To the extent producers do shift their drilling priorities, the lost (or postponed) revenue to the Federal government will likely offset the benefit of higher royalty rates in the first instance. In other words, if the Federal government is attempting maximize revenue, the proper royalty comparison is not only to what other countries are charging, but also to what rates will tend to drive US producers to non-Federal acreage.

Finally, any discussion of government revenues from oil and gas production must come back to the question of energy supply benefits. In the United States, especially with the very sophisticated North American natural gas market, converting in-the-ground-resources to ample consumer supplies by exploration and production is the key to reasonable consumer costs.

A balanced and stable fiscal system for oil and gas resource development in the United States has contributed to remarkable private sector success in providing energy that our nation and its citizens need. Continuation of this balanced approach, coupled with improved resource access and permitting efficiency improvements (such as those in the Energy Policy Act of 2005) can help ensure a sound energy future. Conversely, higher costs and/or policy changes that signal less fiscal system stability will lead to inevitable results given laws of economics and logic: less investment, less energy production – with lower government “takes” – and higher consumer costs.

So, as you finalize the GAO report on the U.S. oil and gas fiscal system, the AXPC urges great care, and recognition of the points we and other energy company commentators are making. That way the GAO report can best help policymakers who must exercise great care as they consider fiscal system changes that could have serious, even if unintended, negative energy supply consequences.

Thank you.

Sincerely,

A handwritten signature in dark ink, appearing to read "W. Whitsitt", written in a cursive style.

William F. Whitsitt
President

Critical Energy Supply Investment: Independents Spend More than Earnings to Find and Produce Natural Gas and Oil

Capital Reinvestment Rates (J.S. Herold Historical Data)												
	2004			2005			2006			2004 - 2006		
	Capital Exp. \$MM	Net Income \$MM	Reinvest. %	Capital Exp. \$MM	Net Income \$MM	Reinvest. %	Capital Exp. \$MM	Net Income \$MM	Reinvest. %	Capital Exp. \$MM	Net Income \$MM	Reinvest. %
GLOBAL INTEGRATED OILS	-54,683	82,451	66%	-73,317	123,941	59%	-95,405	134,771	71%	-223,404	341,162	65%
OUTSIDE NORTH AM. INTEG./DIV. OILS	-60,754	57,489	106%	-101,366	98,664	103%	-76,546	82,362	93%	-238,667	238,515	100%
U.S. INTEGRATED OILS	-14,202	11,050	129%	-6,477	5,072	128%	-8,469	7,744	109%	-29,148	23,867	122%
CANADIAN INTEGRATED OILS	-8,200	5,529	148%	-10,657	7,975	134%	-10,048	9,241	109%	-28,906	22,746	127%
TOTAL INTEGRATED OILS	-137,839	156,520	88%	-191,817	235,652	81%	-190,468	234,118	81%	-520,124	626,290	83%
SUPER E&Ps	-27,061	16,567	163%	-32,666	21,604	151%	-43,727	26,619	164%	-103,454	64,791	160%
LARGE U.S. E&Ps	-5,543	2,600	213%	-10,282	4,946	208%	-17,281	7,944	218%	-33,106	15,490	214%
MID-SIZED U.S. E&Ps	-3,865	1,382	280%	-3,560	1,280	278%	-6,011	1,685	357%	-13,436	4,346	309%
SMALL U.S. E&Ps	-3,104	622	499%	-6,082	897	678%	-8,276	639	1294%	-17,461	2,159	809%
LARGE CANADIAN E&Ps	-908	258	352%	-777	544	143%	-942	699	135%	-2,626	1,501	175%
MID-SIZE & SMALL CANADIAN E&Ps	-3,864	1,701	227%	-6,284	3,425	184%	-8,210	3,794	216%	-18,359	8,919	206%
TOTAL NORTH AMERICAN E&Ps	-44,345	23,130	192%	-59,651	32,695	182%	-84,447	41,381	204%	-188,444	97,206	194%
OUTSIDE NORTH AMERICA E&Ps	-5,511	4,341	127%	-10,415	8,571	122%	-9,849	7,495	131%	-25,775	20,407	126%
TOTAL	-187,696	183,991	102%	-261,883	276,918	95%	-284,764	282,994	101%	-734,343	743,903	99%

Notes:
1. Capital Expenditures = Additions to Plant, Property & Equipment
2. Net Income = Net Income to Common Stock As Reported
3. Reinvestment % = Capital Expenditures/Net Income