TXOGA Comments

Prepared for
Texas Railroad Commission

Presented by
Todd Staples, Texas Oil & Gas Association President

April 8, 2020

Texas Oil & Gas Association

The Texas Oil & Gas Association (TXOGA) is a statewide trade association representing every facet of the Texas oil and gas industry including small independents and major producers. Collectively, the 2019 membership of TXOGA produced in excess of 90 percent of Texas' crude oil and natural gas, operated over 80 percent of the state's refining capacity, and was responsible for the vast majority of the state's pipelines. In fiscal year 2019, the oil and natural gas industry supported more than 428,000 direct jobs and paid more than $16 billion in state and local taxes and state royalties – the highest total in Texas history – funding our state's schools, roads and first responders.

The mission of the Texas Oil & Gas Association is to promote a robust oil and natural gas industry and to advocate for sound, science-based policies and free-market principles.

Founded in 1919, TXOGA is the oldest and largest group in the State representing petroleum interests and continues to serve as the only organization which embraces all segments of the industry.

Todd Staples, TXOGA President

Todd Staples was named President of the Texas Oil and Gas Association in November of 2014. As President of the state's oldest and largest trade association representing the industry, Staples has focused on expanding TXOGA's presence as the "go-to" source for reliable and credible oil and gas information. In order to continue a positive jobs and growth environment that oil and natural gas provides for Texas, TXOGA must be a modern-day voice for the industry.

Working with the TXOGA Board, Staples developed and implemented a multi-faceted approach to educate voters and elected officials on the industry's contributions to the state to ensure pro-energy policy decisions based on economic and scientific facts. This approach includes bi-partisan efforts to support passage of landmark legislation that provides cities with authority to reasonably regulate surface activity while affirming the regulation of oil and natural production is under the exclusive jurisdiction of the state and broad coalitions to ensure infrastructure needs of the state are met.

Prior to TXOGA, Staples served as the Texas Agriculture Commissioner, winning two statewide elections. He also served with distinction in the Texas Senate and Texas House of Representatives.

April 8, 2020

Chairman Wayne Christian
Commissioner Christi Craddick
Commissioner Ryan Sitton
Railroad Commission of Texas
1701 North Congress Avenue
Austin, Texas 78711

VIA EMAIL: RRCconference@rrc.texas.gov

RE: DOCKET NO. OG-20-00003167; IN RE: MOTION FOR COMMISSION CALLED HEARING ON THE VERIFIED COMPLAINT OF PIONEER NATURAL RESOURCES U.S.A. INC. AND PARSLEY ENERGY INC. TO DETERMINE REASONABLE MARKET DEMAND FOR OIL IN THE STATE OF TEXAS

Dear Chairman Christian, Commissioner Craddick and Commissioner Sitton:

Thank you for your service and for allowing the Texas Oil & Gas Association (TXOGA) the opportunity to comment regarding the issues surrounding the request that the Commission determine reasonable market demand for oil in the State of Texas. I would also like to present verbally at the April 14 meeting.

TXOGA is our state's oldest and largest oil and gas trade association whose membership includes every sector of the oil and natural gas industry: exploration and production, transportation and storage, refining, and a host of service companies. As with most organizations with broad, diverse membership, it is not uncommon to have differing opinions on a variety of issues, and we respect our members who may have a different view. The industry is in unified agreement that the current confluence of circumstances is nothing short of catastrophic.

On the issue of the Texas Railroad Commission and proration, our Association strongly opposes the idea of the Commission exercising proration in response to the current market dysfunction because of severe adverse consequences which we will define in our comments.

The Texas market is responding with greater efficiency than a government-controlled system can and with less damaging consequences than those we would experience from government-imposed controls.

We must not exchange the Texas model of success and try to solve a demand problem with a government forced supply solution, but rather work through the needed supply cuts in the same successful manner we have employed over the past half-century where individual operators make their own decisions.

We do, however, urge relief. We need regulatory certainty, and a return to a more stable economic environment, not a fundamental shift in our market-based system, regardless of the political and governing philosophy of other countries. We do not want to give up on the very market-based system that has unleashed innovation and technological advancements resulting in the most dynamic oil and natural gas industry in the world, headquartered right here in Texas.

We came to this conclusion through a great deal of research and conversation among active member companies and our governance process. TXOGA's position was determined by a wide variety of members, who overwhelmingly oppose proration as a remedy to the current situation.

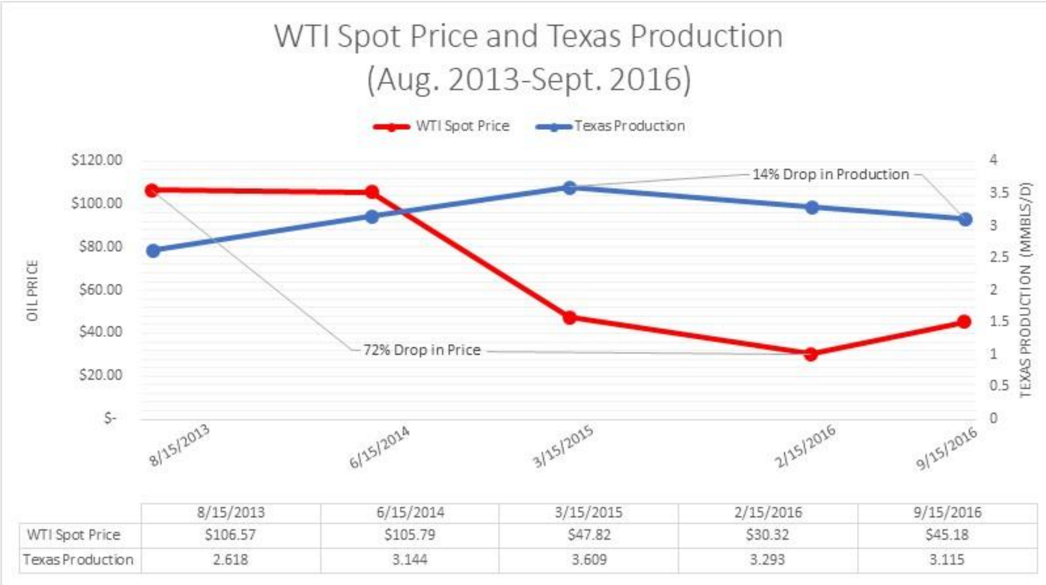
Our opposition to the Commission enacting a market demand order to curtail production, rather than allowing the market to make those decisions, is based on a variety of factors that I would like to share with you.

Market Reactions vs. Mandated Reductions

It is our belief the market can respond to necessary supply reductions more efficiently and effectively than government policy. While this is true in response to reductions, it will also be true when the recovery process begins.

The market without mandates has historically responded to other price shocks by reducing supply (Figure 1). Operators have not only reduced production but have also created operational efficiencies, enabling a more rapid recovery. We do recognize that past price shocks were not accompanied by a catastrophic demand shock. The fact that many efficiencies have already been instituted and demand has been decimated are just two factors that lead us to conclude that the production reductions are occurring more rapidly than in previous adjustment periods.

Figure 1



Source: U.S. Energy Information Administration

We also believe that these reductions are occurring the most efficient way possible because producers best determine how the market forces are impacting their individual business operations and can make business decisions to reduce production after careful review of their well portfolio. We do not know precisely what methodology would be employed by the Commission to accomplish oil production proration, but we strongly believe that it would not be as effective and efficient as allowing the market to govern. Notably, many companies are already making production decisions and added mandated proration could place additional, unnecessary burdens on those companies as well as disincentivize others from cutting production in anticipation of potential government intervention, further delaying the natural market response. This leads to government picking winners and losers rather than allowing the market to prevail.

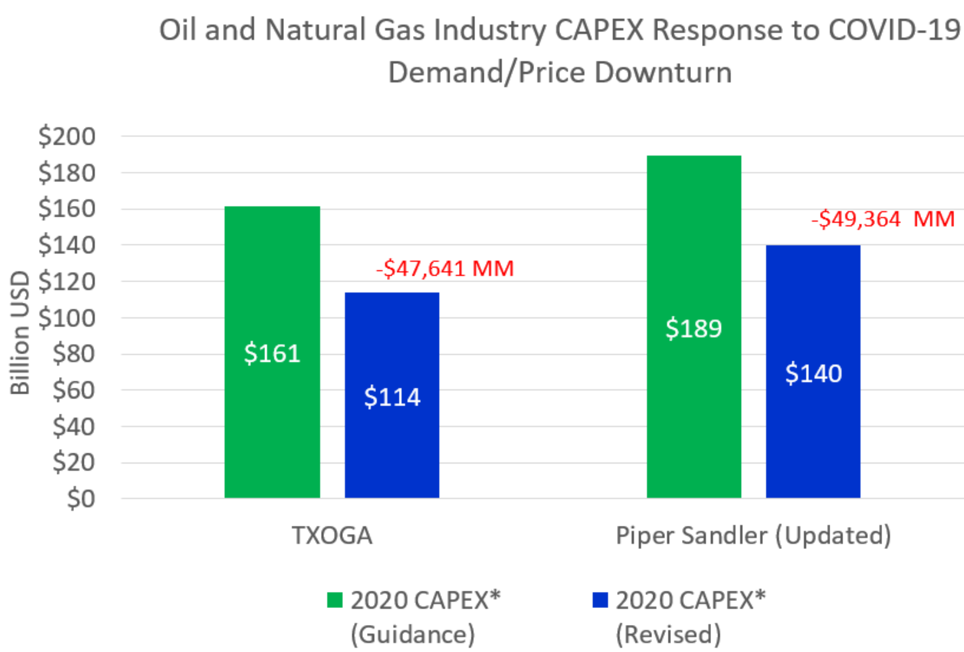
<u>Interference with Market-Based Operator Allocation of Necessary Reductions</u>

There is a tremendous amount of planning that operators are undertaking to determine which assets should be constrained in response to this crisis. The factors that operators are taking into consideration include the hydraulics of gathering systems, which wells need to be produced to avoid damage, production for lease maintenance, operations that are necessary to satisfy lease obligations or deadlines, and other contractual and legal requirements. This is an intricate balancing process to administer the range of curtailments industry is anticipating. If the RRC tries to overlay a curtailment on operations, it will be without regard and without understanding of these important operational considerations.

Market is Responding

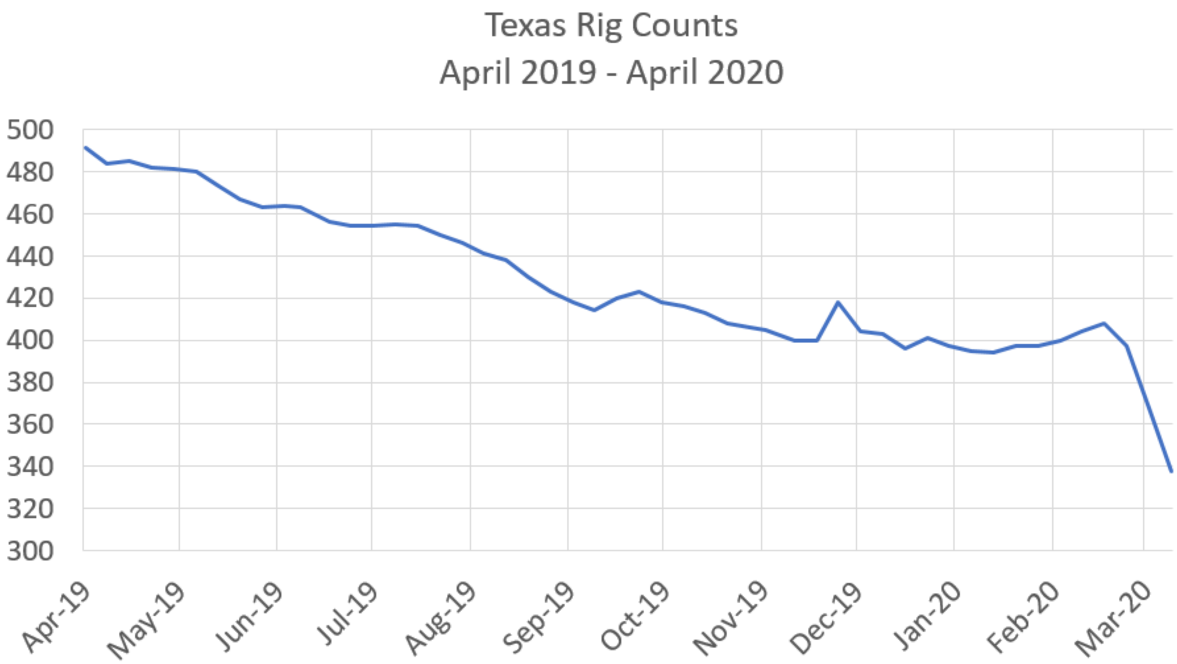
A review of announced capital expenditure reductions (Figure 2) and rig reductions (Figure 3) reveal clear indicators to state and global oil producers that Texas producers are reacting responsibly to market conditions through traditional market means. With almost $50 billion in announced CAPEX reductions this early in this current crisis, it is entirely unnecessary for the Commission to act in the market's stead in order to signal to other market participants that production from Texas or U.S. producers will decline.

Figure 2



TXOGA conducted a broad-based review of CAPEX reduction announcements publicly available and compared to other published analyses. The TXOGA analysis demonstrated similar reductions in CAPEX as the Piper Sandler analysis (updated with newly announced reductions). The similar analyses and outcomes clearly indicate the quick pace at which companies are making significant reductions to address the situation facing the industry. Of note, each analysis differed on specific companies, thus the difference in 2020 guidance.

Figure 3



Source: Texas Rig Counts via Baker Hughes

Clearly, production is going to drop precipitously on its own. There are four factors that are going to cause a drop in production.

First, purchasers are restricting volumes and forcing producers to curtail their production. Second, some producers cannot produce at current prices because the price is less than their lifting costs – they lose money producing. Third, many producers will choose to limit or shut-in their production in response to the low-price market based on their own economic criteria. All of these factors influencing production decline will lead to market-based well shut-ins and curtailment such that there will be no production in excess of transportation or market facilities or reasonable market demand under the Commission's waste statute, and thus no cause to enter a market demand order to limit production. Indeed, it is physically impossible for there to be such an excess.

Lastly, new drilling and completions are effectively curtailed. It is estimated about 50% of some operators' production comes from wells drilled within the last 12 months. Production capacity will fall off very quickly without new completions.

History Confirms Government Controls Do Not Work as Well as Market Participants

Case Study 1

President Nixon responded to a spike in the price of crude oil in the 1970s by imposing a price ceiling on gasoline in order to shield consumers from the full cost of gasoline (Attachment 1). Experience demonstrates blunt interventions lead to a series of unintended consequences as market participants react to new incentives. The government is then forced to constantly amend the policy to address unforeseen issues, which also has the effect of encouraging different industry players to focus more on seeking preferable policy changes than competing in the marketplace.

Case Study 2

Before 1978, the government alone determined whether a new airline could fly to a certain city, and what the prices were. Since there was limited competition, airlines were guaranteed a profit – for an expensive airfare, flyers experienced lavish services. The majority of Americans couldn't afford to fly at all. Three decades later, deregulation increased competition and led to a significant decrease in ticket price. In 1965, less than 20% of Americans had ever flown in an airplane. But by 2000, 50% of the country had taken at least one round-trip flight a year. This recent evidence our generation has experienced is a good reminder that the market is the best arbiter of market conditions, not government.

A Texas Approach Disadvantages Texans

Texas enacting prorationing would disadvantage Texas, its producers, mineral owners and taxing entities. If Texas limited production, even as a market leader in "hopes" to encourage others to do the same, investment would flee to other states. As a result, proration would punish royalty owners, operators and Texas taxing entities above and beyond the level at which they would otherwise be impacted by the current demand destruction and international interference on pricing. Additional restrictions would yield reductions on top of current business decisions to slow production. Further, any producer in another state or country could fill the void left by inaccurate allowable assignment or from actors saying they will reduce but do not follow through with their commitments.

Uncertainty is the Enemy of Recovery

Operators need regulatory certainty. While many operators have already publicly announced significant reductions, some are not taking final actions out of concern the Commission may be contemplating mandated proration policy. The mere fact this is continuing to be discussed is precluding some operators from making final or more aggressive reductions for fear of being caught in a regulatory trap and is further projecting uncertainty to market investors. The uncertainty surrounding market-based demand reductions versus government-based reductions is impairing the market.

Industry Alignment

While we recognize individual companies and different sectors may have differing views on the matter of proration, the vast majority of operators responsible for an overwhelming amount of upstream, midstream and downstream operations are very much aligned that the Commission should decline the motion to enter a market demand order before the Commission.

The industry has come together to develop proposals for regulatory and legal relief that would assist in operations during these perilous times and provide essential flexibility. The Commission has implemented many of those proposals and indeed acted quickly on its own accord to implement regulatory relief at the first opportunity. The industry is very much appreciative of the Commission's effort on this. There are other proposals, some of which are outside the purview of this Commission, that we believe the entire industry can rally around to further allow operators to adjust to market conditions based on their best judgment. Examples of these efforts are included as Attachment 2.

Conclusion

By dismissing the motion, the Commission will empower our free market system and allow individual companies to swiftly respond to these dire circumstances by taking the steps to continue to reduce production without the hinderance of our government altering the playing field that everyone understands and operates within today.

As an Association, we remain committed to working with you on and for solutions that will enable all producers to benefit and survive during these perilous times.

Thank you for your consideration, and we respectfully ask that you dismiss the motion for the market demand hearing and order.

Respectfully yours,

Todd Staples

Todd Staples
President
Texas Oil & Gas Association

Appendix

Attachment 1

Case Study: Failed Price Controls on Oil in the 1970s

Given the importance of energy to the economy and US consumers, policymakers have long sought to intervene in the market to encourage an optimal set price. Past experience shows blunt interventions lead to a series of unintended consequences as market participants react to new incentives. The government is then forced to constantly amend the policy to address unforeseen issues, which also has the effect of encouraging the industry to develop more energy into lobbying for preferable policies than competing in the marketplace.

- President Nixon responded to a spike in the price of crude oil in the 1970s by imposing a price ceiling on gasoline in order to shield consumers from the full cost of gasoline. Details of the controls were amended several hundred times through rulemaking, legislation, or interpretative guidelines while in effect from 1974-1981 to address various unforeseen issues with each regime.
- The policy was immediately problematic for US refiners who still had to buy oil at the global market price since they relied on foreign producers for part of their supply.
- To address this issue, the federal government limited the price control to only include mature oil wells from old domestic producers, while allowing new and foreign producers to sell at the market price. The updated policy was intended to target "windfall profits" which would have accrued to the old producers who made profitable investments earlier on when there was a lower price point.
    - The amendment was also made to discourage a disincentive for new production.
- The need to only fix the price for certain wells operated by established domestic producers immediately caused problems. For instance, some refiners struck deals to pay a premium for new oil in order to get guaranteed contracts for old oil.
    - To solve for this issue the government then froze supplier contract relationships, which arbitrarily advantaged older refiners who had contracts with older producers who were subject to the price control.
    - To solve for this issue the government created a complex entitlement program where refiners could sell entitlements amongst each other to equitably distribute the gains from artificially cheap old oil.
    - The entitlement resulted in a policy which subsidized newer domestic producers and foreign producers at the expense of the older domestic producers.

Broader unintended consequences:

1. Depressed oil prices fueled additional consumption.
2. Stifled domestic production from old producers who were disincentivized.
3. Supply disruptions caused by distorted incentives.
4. General manipulation by market actors looking to fraudulently profit off the complex regulations.

Lessons for Texas Railroad Commission

- Although the RRC is not seeking to set prices, it is trying to influence the price of oil by limiting production in the state.
- Like President Nixon, the RRC is not operating in a vacuum but still has to contend with production from foreign countries and even other states within the U.S. that will immediately muddle the effectiveness of the policy.
- The effectiveness of the policy will also be limited by supply chain constraints, which may also lead to other unforeseen consequences, for instance, refiners in the Gulf Coast will still rely heavily on imported oil because it is better suited to their facilities.
- Ultimately, the policy would exacerbate the Texas' competitive disadvantage in relation to Saudi Arabia and Russia by punishing the state's most efficient producers who can operate at a lower cost and would cut more than in market circumstances, in favor of less efficient producers who would cut less than in market circumstances, thereby weakening the state's industry.

Attachment 2

Substantive Enforcement Discretion Issues

Issue	**Description**
Additional time to respond to NOVs and Certified Letters Additional time for other permits, registrations and rule exemptions	Extension from due date on NOVs and Certified Letters
RRC Drilling Permits and MIPA Permits	Additional time for renewals
SWR 32	Extension of reporting and permitting deadlines
SWR 8 and 15	Additional time for closure deadlines for pits associated with drilling operations Additional time to meet inactive well surface equipment removal requirements and perform the work in the field
Email vs Hard copies	Allowing operators to email information rather than send hard copies Receiving notices electronically rather than in the mail Allowing for electronic signatures instead of wet signatures
RRC Inspections	Postponement of discretionary inspections
GLO/University Lands Relief	Relief from requirements of existing and new wells, as well as for certain surface requirements
Comptroller/CADs	Request to value minerals for property tax using 2020 market reality