

Oil and Gas Supply Module

The OGSM consists of a series of process submodules that project the availability of domestic crude oil production and dry natural gas production from onshore, offshore, and Alaskan reservoirs, as well as conventional gas production from Canada. The OGSM regions are shown in Figure 12.

The driving assumption of OGSM is that domestic oil and gas exploration and development are undertaken if the discounted present value of the recovered resources at least covers the present value of taxes and the cost of capital, exploration, development, and production. Crude oil is transported to refineries, which are simulated in the PMM, for conversion and blending into refined petroleum products. The individual submodules of the OGSM are solved independently, with feedbacks achieved through NEMS solution iterations (Figure 13).

Technological progress is represented in OGSM through annual increases in the finding rates and success rates, as well as annual decreases in costs. For conventional onshore, a time trend was used in econometrically estimated equations as a proxy for technology. Reserve additions per well (or finding rates) are projected through a set of equations that distinguish between new field discoveries and discoveries (extensions) and revisions in known fields. The finding rate equations capture the impacts of technology, prices, and declining resources. Another representation of technology is in the success rate equations. Success rates capture the impact of technology and saturation of the area through cumulative drilling. Technology is further represented in the determination of drilling, lease equipment, and operating costs. Technological progress puts downward pressure on the drilling, lease equipment, and operating cost projections. For unconventional gas, a series of eleven different technology groups are represented by time-dependent adjustments to factors which influence finding rates, success rates, and costs.

Conventional natural gas production in Western Canada is modeled in OGSM with three econometrically estimated equations: total wells drilled, reserves added per well, and expected production-to-reserves ratio. The model performs a simple reserves accounting and applies the expected production-to-reserve ratio to estimate an expected production level, which in turn is used to establish a supply curve for conventional Western Canada natural gas. The rest of the gas production sources in Canada are represented in the Natural Gas Transmission and Distribution Module (NGTDM).

Lower 48 Onshore and Shallow Offshore Supply Submodule

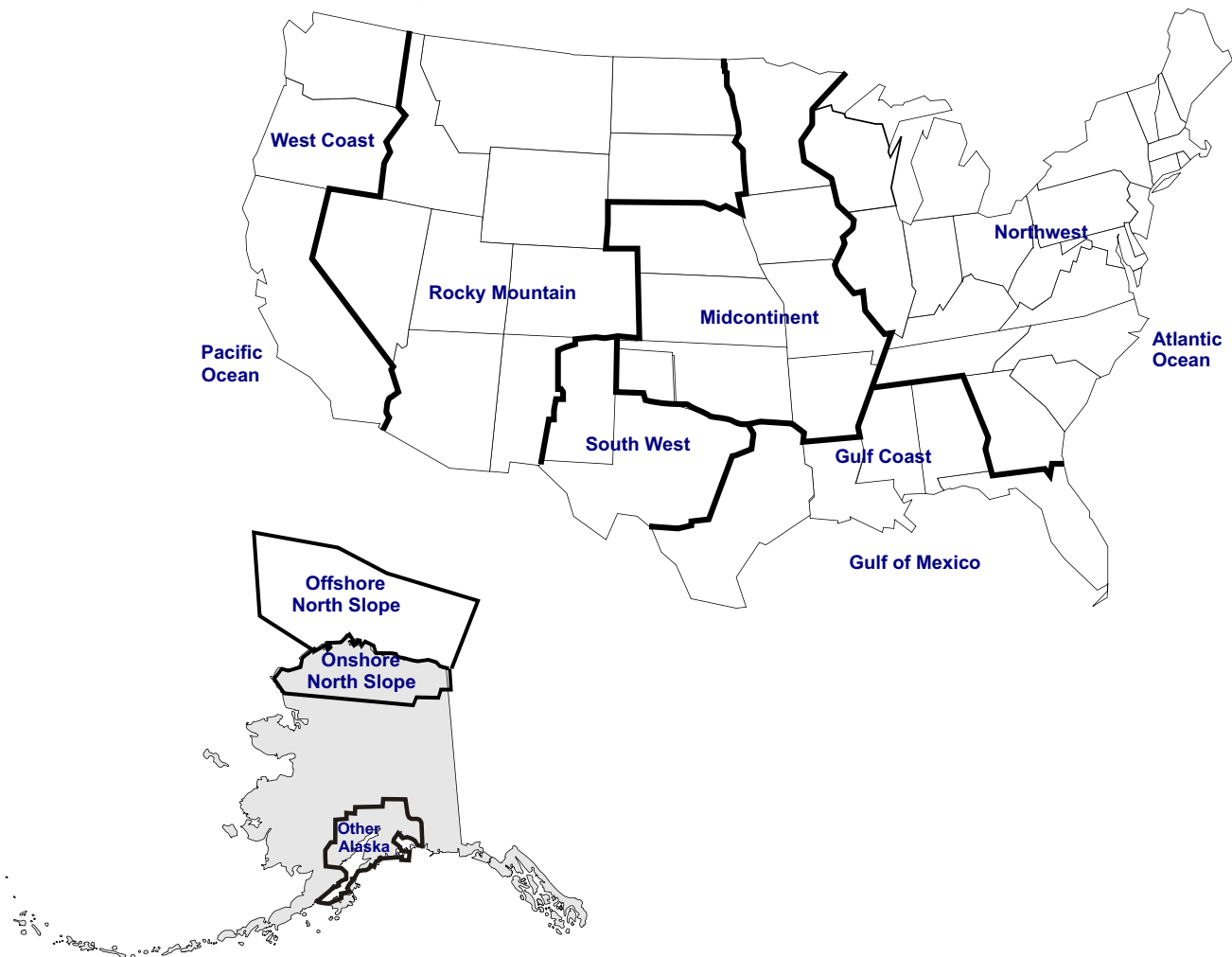
The lower 48 onshore supply submodule projects crude oil and natural gas production from conventional recovery techniques. This submodule accounts for drilling, reserve additions, total reserves, and production-to-reserves ratios for each lower 48 onshore supply region.

The basic procedure is as follows:

- First, the prospective costs of a representative drilling project for a given fuel category and well class within a given region are computed. Costs are a function of the level of drilling activity, average well depth, rig availability, and the effects of technological progress.
- Second, the present value of the discounted cash flows (DCF) associated with the representative project is computed. These cash flows include both the capital and operating costs of the project, including royalties and taxes, and the revenues derived from a declining well production profile, computed after taking into account the progressive effects of resource depletion and valued at constant real prices as of the year of initial valuation.
- Third, drilling levels are calculated as a function of projected profitability as measured by the projected DCF levels for each project and national level cash-flow.

OGSM Outputs	Inputs from NEMS	Exogenous Inputs
Crude oil production Domestic nonassociated and Canadian conventional natural gas supply curves Cogeneration from oil and gas production Reserves and reserve additions Drilling levels Domestic associated-dissolved gas production	Domestic and Canadian natural gas production and wellhead prices Crude oil demand World oil price Electricity price Gross domestic product Inflation rate	Resource levels Initial finding rate parameters and costs Production profiles Tax parameters

Figure 12. Oil and Gas Supply Module Regions



- Fourth, regional finding rate equations are used to project new field discoveries from new field wild-cats, new pools, and extensions from other exploratory drilling, and reserve revisions from development drilling.
- Fifth, production is determined on the basis of reserves, including new reserve additions, previous productive capacity, flow from new wells, and, in the case of natural gas, fuel demands. This occurs within the market equilibration of the NGTDM for natural gas and within OGSM for oil.

Unconventional Gas Recovery Supply Submodule

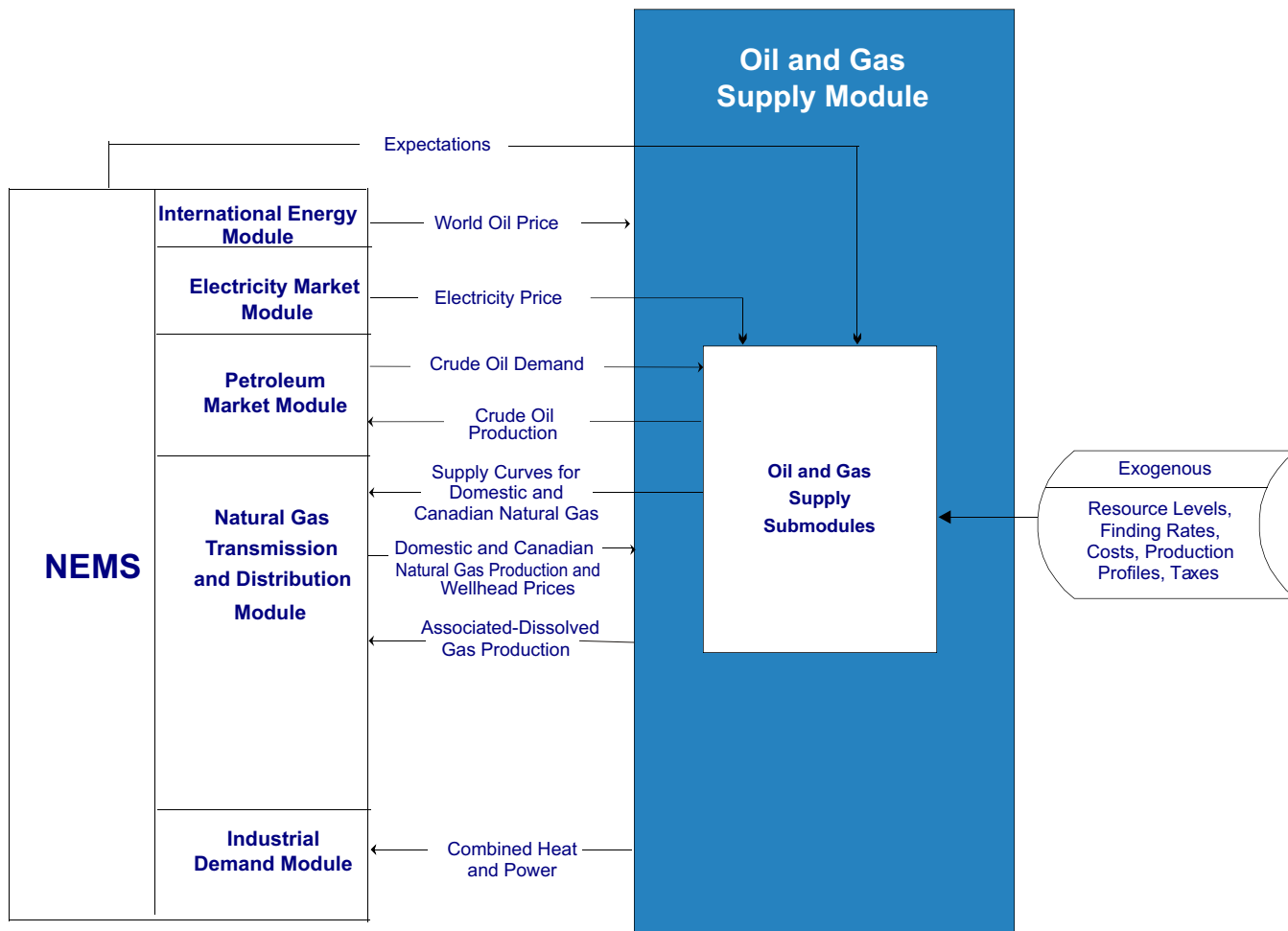
Unconventional gas is defined as gas produced from nonconventional geologic formations, as opposed to conventional (sandstones) and carbonate rock formations. The three unconventional geologic formations

considered are low-permeability or tight sandstones, gas shales and coalbed methane.

For unconventional gas, a play-level model calculates the economic feasibility of individual plays based on locally specific wellhead prices and costs, resource quantity and quality, and the various effects of technology on both resources and costs. In each year, an initial resource characterization determines the expected ultimate recovery (EUR) for the wells drilled in a particular play. Resource profiles are adjusted to reflect assumed technological impacts on the size, availability, and industry knowledge of the resources in the play.

Oil and Gas Supply Module

Figure 13. Oil and Gas Supply Module Structure



Subsequently, prices received from NGTDM and endogenously determined costs adjusted to reflect technological progress are utilized to calculate the economic profitability (or lack thereof) for the play. If the play is profitable, drilling occurs according to an assumed schedule, which is adjusted annually to account for technological improvements, as well as varying economic conditions. This drilling results in reserve additions, the quantities of which are directly related to the EURs for the wells in that play. Given these reserve additions, reserve levels and expected production-to-reserves (P/R) ratios are calculated at both the OGSM and the NGTDM region level. The resultant values are aggregated with similar values from the conventional onshore and offshore submodules. The aggregate P/R ratios and reserve levels are then passed to NGTDM, which determines the prices and production for the following year through market equilibration.

Offshore Supply Submodule

This submodule uses a field-based engineering approach to represent the exploration and development of U.S. offshore oil and natural gas resources. The submodule simulates the economic decision-making at each stage of development from frontier areas to post-mature areas. Offshore resources are divided into 3 categories:

- **Undiscovered Fields.** The number, location, and size of the undiscovered fields are based on the MMS's 2006 hydrocarbon resource assessment.
- **Discovered, Undeveloped Fields.** Any discovery that has been announced but is not currently producing is evaluated in this component of the model. The first production year is an input and is based on announced plans and expectations.

- **Producing Fields.** The fields in this category have wells that have produced oil and/or gas through the year prior to the AEO projection. The production volumes are from the Minerals Management Service (MMS) database.

Resource and economic calculations are performed at an evaluation unit basis. An evaluation unit is defined as the area within a planning area that falls into a specific water depth category. Planning areas are the Western Gulf of Mexico (GOM), Central GOM, Eastern GOM, Pacific, and Atlantic. There are six water depth categories: 0-200 meters, 200-400 meters, 400-800 meters, 800-1600 meters, 1600-2400 meters, and greater than 2400 meters.

Supply curves for crude oil and natural gas are generated for three offshore regions: Pacific, Atlantic, and GOM. Crude oil production includes lease condensate. Natural gas production accounts for both nonassociated gas and associated-dissolved gas. The model is responsive to changes in oil and natural gas prices, royalty relief assumptions, oil and natural gas resource base, and technological improvements affecting exploration and development.

Alaska Oil and Gas Submodule

This submodule projects the crude oil and natural gas produced in Alaska. The Alaskan oil submodule is divided into three sections: new field discoveries, development projects, and producing fields. Oil transportation costs to lower 48 facilities are used in

conjunction with the relevant market price of oil to calculate the estimated net price received at the wellhead, sometimes called the netback price. A discounted cash flow method is used to determine the economic viability of each project at the netback price.

Alaskan oil supplies are modeled on the basis of discrete projects, in contrast to the onshore lower 48 conventional oil and gas supplies, which are modeled on an aggregate level. The continuation of the exploration and development of multiyear projects, as well as the discovery of new fields, is dependent on profitability. Production is determined on the basis of assumed drilling schedules and production profiles for new fields and developmental projects, historical production patterns, and announced plans for currently producing fields.

- Alaskan gas production is set separately for any gas targeted to flow through a pipeline to the lower 48 States and gas produced for consumption in the State and for export to Japan. The latter is set based on a projection of Alaskan consumption in the NGTDM and an exogenous specification of exports. North Slope production for the pipeline is dependent on construction of the pipeline, set to commence if the lower 48 average wellhead price is maintained at a level exceeding the established comparable cost of delivery to the lower 48 States.