

Testimony of Guy H. Ausmus
Chairman, American Iron and Steel Institute Energy Subcommittee
to the House Energy Subcommittee
February 11, 2004

Gentlemen:

Thank for you for the opportunity to testify to the Subcommittee. I appear before you as the Chairman of the Energy and Climate Subcommittee for the American Iron and Steel Institute (AISI). AISI represents the steel industry on a number of industrial policy matters at the state and federal level.

Before I get to the substantive portion of my testimony, I'd like to spend a moment on my discussing my employment history and current responsibilities, as I believe that they qualify me as having a unique perspective on the topic of today's meeting.

Prior to employment in the steel industry, I worked for 10 years in various petroleum engineering and operating management positions for a major oil and gas producer, an independent oil and gas producer, a consultant to the E&P industry, and for the Federal Bureau of Land Management's Oil and Gas division. From this experience, I am fully aware of the nat. gas producing industry's structure, economics, risks, and motivations.

Presently, I am the Manager of Purchasing at Ispat Inland, Inc., which is part of The Ispat/LNM Group, the world's largest steel producer. Presently, Ispat/LNM has major steelmaking operations in 12 countries worldwide. It is one of the largest consumers of gas on the North American continent (+/- \$600 million/year) when Canadian, Mexican, and U.S. operations are aggregated. Part of my responsibilities is the development of energy strategies for Ispat Inland specifically, and the corporation generally. In the course of my employment with Ispat and its predecessor company, I have been exposed to the operating economics of steel manufacture in this country, as well as many countries in Europe and Central Asia.

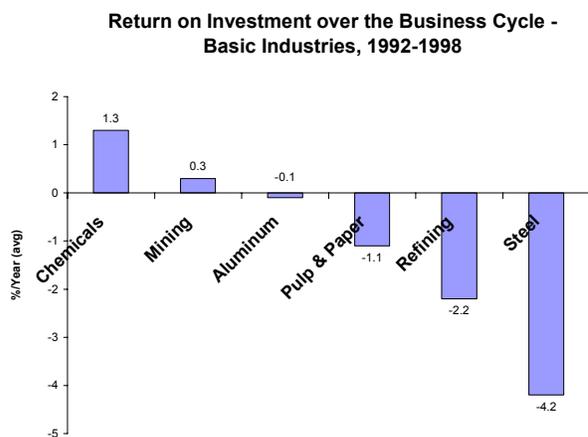
I am a keen student of the North American natural gas market. We have enormous exposure to this market, so we watch it with the ardor that you'd see in a Houston gas trader.

I've worked both sides of the street, so to speak. With large, direct commercial interests in the balance. I am not the "man on the street" on this issue.

From that perspective, I have four points of interest to review with the Subcommittee.

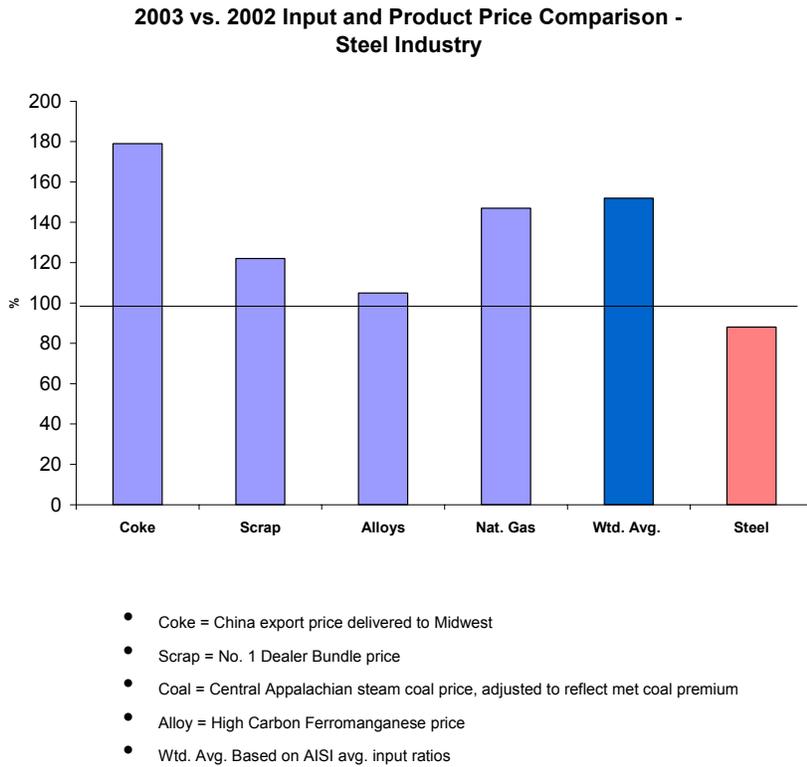
First - the U.S. Steel industry (as well as most basic manufacturing) competes in a global market, where we have no alternative but to manufacture product at a unit cost less than the market-clearing unit sales price. Recent natural gas market conditions represent a significant cost problem to healthy steel companies, and a potentially fatal problem to weak ones.

Fortunately for me, Ispat/LNM is among the former. Internally, we fight like cats and dogs for a 50¢/ton decrement in manufacturing costs, and gas has given us a \$5 to \$9/ton increase in cost.



Not surprisingly, the returns of basic industry in general and steel in particular have been very poor over the business cycle (see graph at left). As an industry, we're just not that healthy. Everybody that shows up here probably says they can't take the cost increase. Well, as an industry, we really can't!

Second - The U.S. steel industry is already in a tremendous raw materials cost squeeze. The next graphic shows the relative price increases in select commodities of interest to the steel industry, and compares them



to benchmark hot rolled sheet steel pricing. Fortunately, steel prices have begun to react to the cost pressures of manufacturers in early 2004 and are rallying, but there is a lagging effect.

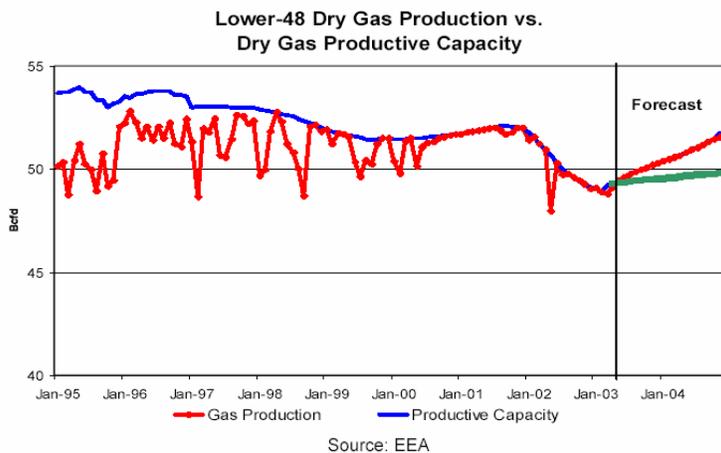
A side note: I visited Ispat's Kazakhstan operations last summer. Their gas prices are *an order of magnitude* less than ours. Steel price is about the same, however.

Third - Mr. Greenspan got it just about right when he sounded the alarm on gas supplies. North American natural gas supplies are in an extremely perilous state.

Consider what happened in 1969 when U.S. crude oil production peaked. Major oil companies began to abandon the North American continent as "financially uninteresting", and

the natural production decline was, to my mind, exacerbated by a lack of investment in the North American resource base.

But, there's one important difference between Nat. gas and Crude. There was and is an active and efficient supply network that brings oil from other regions of the world. Gas supplies from other parts of the world are hindered by what I will charitably call a nascent supply chain.



Reflect on that for a moment. From the supply side, the U.S. has no reasonable "Plan B" in place, and the clock is ticking. We do not, repeat, DO NOT have the luxury of time on this one, given the long lead times necessary to effect meaningful increments of natural gas supply. If you don't believe me, perhaps you'll believe this graphic from Energy & Environmental Analysis, Inc. (The Energy Information Agency website has the same data, but this is a cleaner presentation). It shows

that natural gas production has declined despite 100% utilization of effective gas production capacity AND very high natural gas prices. Note further the optimistic forecast - We've had 2+ years of very high gas prices. Where's the production response? What gives credence to a rapid change in the overall decline, absent new resource targets/sources?

Absent solutions on the supply side, the intermediate solution to the market balance is a decrement of demand. There is "good" decrementing (conservation), and "bad" decrementing (lowest economic utility uses cease). "Lowest economic utility" translates to manufacturing, generally speaking. There's been a lot of bad decrementing in the chemical, fertilizer, and metals industries, of late. This is very simple to demonstrate with Bureau of Labor Statistics - Industrial Productivity Index data. If you want the details, please contact me.

One other point on "bad" decrementing. The market will balance. That is, a supply constrained market will hunt down and kill the incremental demand necessary to balance. Price is an effect, not the cause. If \$47/MMBtu is what it takes to gain balance, well, that's what you'll see. New York City saw that for a few days this winter. I suspect that double-digit natural gas prices do not contribute to incumbency within the beltway.

Well, what to do? Some thoughts.

FOCUS ON THE NEXT BIG SUPPLY INCREMENT. LNG imports, Canada's Northwest Territories, Alaska, U.S. Rockies, and ESPECIALLY the subsalt and outer Continental Shelf plays in the Gulf of Mexico. Let's take a moment and be clear what the priorities are. UNLESS we really chase the Gulf of Mexico plays, you can't get the gas reserves AND production rate necessary to balance this market from the supply side in the near term. This is not meant to minimize the importance of other sources. I just saying that the Gulf is the first thing on our nation's natural gas supply "to do" list.

Regardless of the resource target, the prescription is the same: Break down barriers, and do it today! Drilling bans, leasing bans, pipeline bans and endless withholding of deep rights on HBP (held by production) acreage has just got to stop. We just don't have a lot of time to study this matter. Two points of detail:

- a) Look at all of the HBP leases in the Gulf of Mexico. Many explorationists have complained to me that, they have great deep drilling prospects, but they end up under existing shallower production. Those deep zone mineral rights are the common heritage of all U.S. citizens, and should be "up for grabs" if the incumbent lessee doesn't diligently pursue development. Give these lessees 3 more years and sever the deep rights.
- b) Take a look at what's happening with the siting of LNG terminals. I've seen siting plans for the Bahamas, Baja California, and offshore mooring with regasification on the LNG vessel. ALL of these schemes have, at their heart, a fundamental assumption: The U.S. Federal and State site permitting process is intractable, at least in a commercially reasonable timeframe. The U.S. will, at some point, be very dependent on these facilities. Isn't it better to have them inside our borders where reasonable environmental regulation can apply? Where OUR country provides the requisite site security? Where the we can impose stringent engineering and safety constraints?

PORTFOLIO APPROACH. Life is uncertain. Better to foster development of all fuel sources (Coal, Gas, Nuclear), if for no other reason than you can never tell when one of these may develop some type of problem. After all, why are we here today? Natural gas was given a preferred place in our economy, that's why. The "Hydrogen Economy" is great sound bite talk, but it dangerously ignores reality and isn't a part of the portfolio approach. Simple fact: You can't pick hydrogen off of a tree or get it from a hole in the ground. Some energy source has to be used to produce the elemental hydrogen touted as our savior by some.

FOSTER THE EXISTING RESOURCE BASE by streamlining the permitting processes for energy infrastructure. Give thought to limited term royalty holidays for new production from federal leases. Open

lands to development. Any thing that stands between a gas reservoir and a burner tip should be reviewed for efficacy and removed, if found wanting.

DEMAND SIDE can certainly be improved. Again, give thought to anything that stands in opposition to more efficient fuel use. Boiler upgrades that trigger "new source review" by the US-EPA seem a bit foolish in this context and time. Give improved tax treatment to energy efficiency projects.

And one thing not to do...

The shenanigans of Enron, et al notwithstanding, I do not believe that there is pandemic malfeasance in the energy industry. Nor are there plots and cabals that seek to prop the price. I do think gas traders are a rough and tough bunch. The consumer's defense lies in the fact that natural gas is produced and distributed in a very efficient manner. It's certainly much more efficient than the former regulated framework. A "many buyers - many sellers" market structure is a very good defense against price distortions. Solutions that "tar and feather the rascals" are singularly non productive, as they a) don't contribute to the production of gas and b) they give hesitancy to the average energy company that's just out there trying to make product and turn a buck. I'm waiting to see what California's going to do when they need the next increment of power generation. Where will they turn? Perhaps more to the point: What lender would capitalize a project with such regulatory and legal risk? I'm not saying there shouldn't be oversight. I'm just saying "enough, already! Can we get back to business now?"

In summary, energy needs are core to the steel industry's, and the nation's continued operation. We simply do not have degrees of freedom and the luxury of time. We have to act now.

Thanks again for your time.