

SB 209:

Strengthening Alaska's Oil and Gas Leasing Laws

Senate Resources Committee
March 23, 2012

The purpose of SB 209 is to encourage greater development of the state's oil and gas resources, consistent with Article VIII of the Alaska Constitution.

Section 8.1 of the Alaska Constitution states:

“It is the policy of the State to encourage the settlement of its land and **the development of its resources** by making them available for **maximum use** consistent with the public interest.”

SB 209 was developed in response to concerns that some oil companies are winning exclusive leases of petroleum-rich state lands, then sitting on those leases and warehousing Alaska's resources, while investing elsewhere.

Committee members are all aware of the Pt. Thomson case, in which state lands with vast quantities of oil and gas were leased more than three decades ago and have yet to be developed.

The sponsor's intent with SB 209 is to ensure that we don't have more Pt. Thomsons – to reform Alaska's leasing laws now to avoid spending millions of dollars 20 or 30 years from now to regain control over valuable state lands and resources.

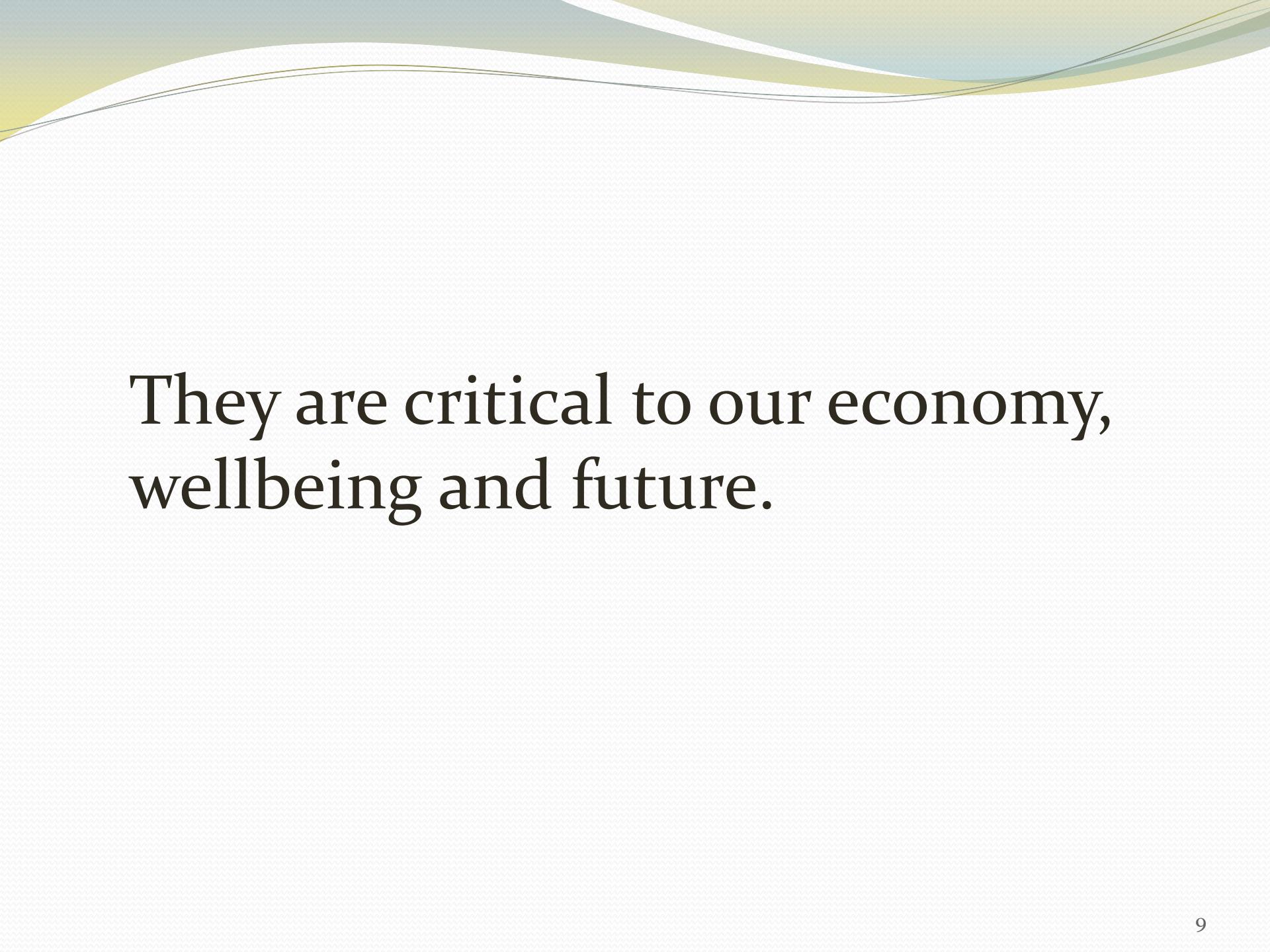
Of course, these are not any resources. They are the state's most valuable resources.

They are commonly referred to as our "lifeblood."

They provide:

- jobs for tens of thousands of Alaskans,*
- roughly 90% of our unrestricted state revenue, which pays for essential state services and infrastructure
- support for economic development in all other sectors of our economy from seafood to timber.

* Nearly 42,000 direct, indirect and induced jobs (or roughly 1/3 of the jobs within our economy), according to Dr. Scott Goldsmith at the Institute for Social and Economic Research.



They are critical to our economy,
wellbeing and future.

This importance clearly raises the stakes. It means we must exercise the greatest diligence when it comes to the management of our oil and gas resources.

So, just how bad is the problem
SB 209 seeks to address?

It could be significant, according
to the Department of Natural
Resources. More than 25% of
Alaska's existing oil and gas
leases could be sitting idle.

Last year DNR examined 1,320 leases.

- 578 were part of production units or were producing oil or gas,
- 404 had been sold in the preceding three years, so might still be in the planning stages, and
- 338 could be “idle,” as lessees had not applied for a single permit to explore or develop them.

What is the resource potential of these lands? Could they support production at some point? Could they help to fill the pipeline and provide jobs for Alaskans?

The answer is we don't know. Some company gave the state a bonus bid some years back and continues to pay rent (usually \$1/acre per month), indicating the land might have potential.

But that potential has never been explored or realized.

Alaskans have gained little from having taken these lands off the public rolls, putting them out of reach of other companies who may actually want to explore or develop them.

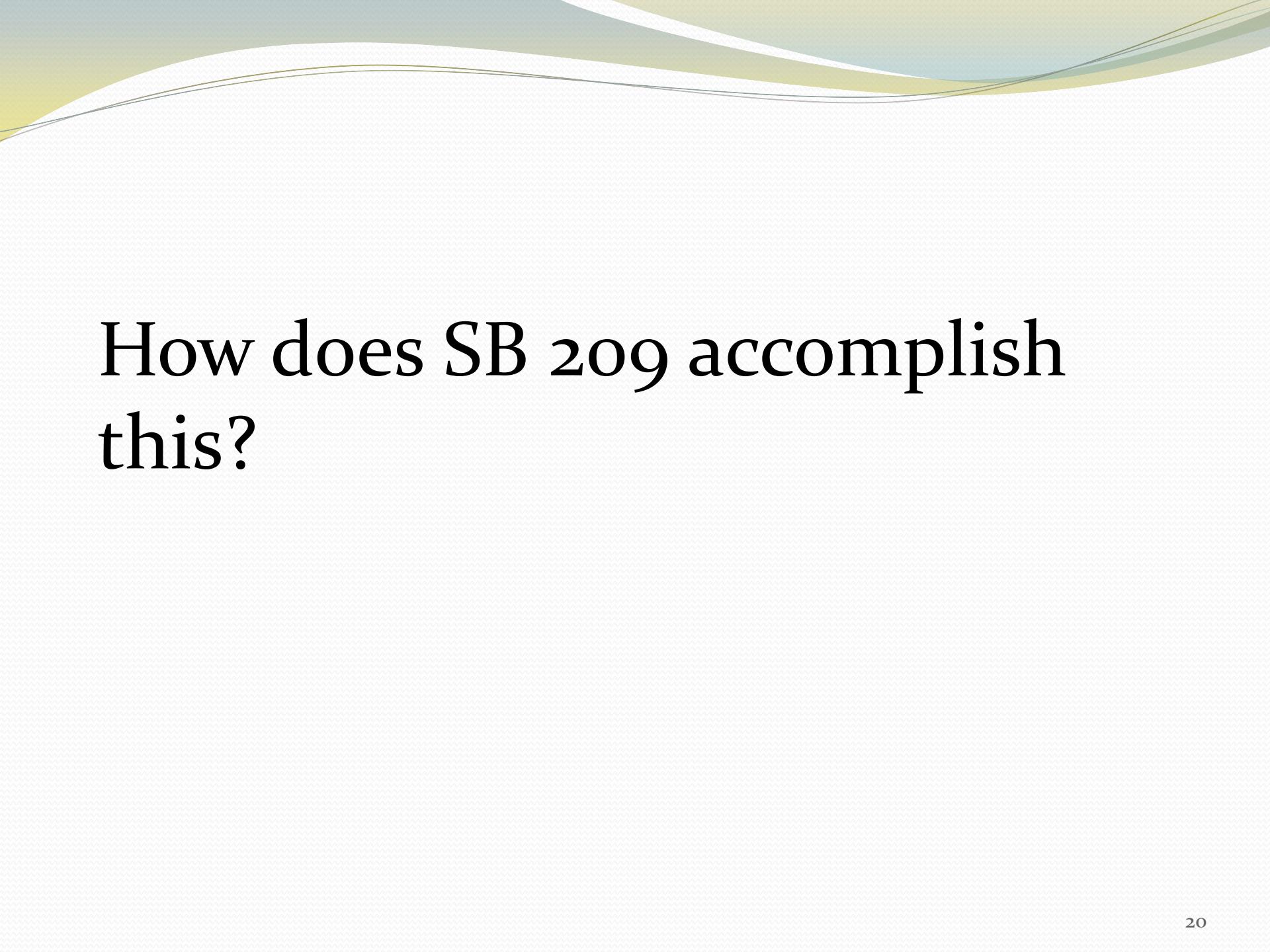
This is no way to ensure
“maximum use” of our resources,
especially as production in
Alaska’s largest fields declines,
pipeline volumes decrease, and
concerns over the state’s future
fiscal health intensify.

Regular litigation to take back idle leases is not the answer. It should be Alaska's last resort.

Carefully crafted laws that result in clear expectations about each party's responsibilities and intentions is the better way to go.

Alaskans deserve to know precisely what they are getting when they give exclusive 10-year leases, as was done recently on the North Slope, to resource-rich lands.

They deserve commitments they can count on, so 10 or 20 years down the road they don't feel misled or betrayed, ready to do battle against some of the world's most powerful corporations.



How does SB 209 accomplish
this?

1) It requires bidders for an oil and gas lease to submit a plan of exploration or, if appropriate, a plan of development for areas it seeks to lease, prior to submitting a formal bid.

The plan could outline seismic work that will be performed or exploration wells that will be drilled.

Actual production commitments would not, of course, be required if the tracts have yet to be adequately explored.

2) It requires the commissioner to review each bidder's plan to determine if it is "reasonably expected to develop the lease in the best interest of the state."

A company may not be qualified to bidder if the commissioner finds it has submitted a plan that is not in the state’s best interest or the bidder is not “reasonably capable” of implementing the plan.

While this “best interest” finding sounds vague and subjective, this terminology is used frequently in Alaska law and governs many state procedures.

It appears 131 times in our statute books. It is used to determine to what actions the state should take as well as to select among bidders and competing proposals.

3) SB 209 also requires that these plans be included in leases and requires DNR to review leases annually to ensure that plans are being implemented.

It allows the commissioner to waive a work commitment if conditions preventing drilling or exploration were beyond the lessee's reasonable ability to foresee or control.

It also allows for a waiver if the lessee demonstrates through good faith efforts an intent to drill or develop the lease in the following two years.

Under existing statutes, DNR has the option of including a minimum work commitment in a lease, along with penalties if the lessee does not fulfill the commitment.

This bill simply requires that work commitments, developed by bidders and approved by the state, be part of all future leases.

4) SB 209 also requires DNR to analyze the economics of each “participating area” (a unitized reservoir where sustained production is occurring) every five years to determine whether the area is capable of increased production.

There are 42 “participating areas” in Alaska. They are within the Badami, Colville River, Duck Island, Kuparuk, Milne Point, Nikaitchuq, Northstar, Oooguruk, and Prudhoe Bay units.

Knowing whether a prospect is reasonably economic matters, and the state currently lacks this knowledge.



It determines what lessees obligations are under contracts they have willingly signed.

The following slide contains language from new oil and gas leases which speaks to lessees' obligations to develop. (Form DOG 200204)

13 (b): Upon discovery of oil or gas on the leased area in quantities that would appear to a reasonable and prudent operator to be sufficient to recover ordinary costs of drilling, completing, and producing an additional well in the same geologic structure at another location with a reasonable profit to the operator, **the lessee must drill those wells** as a reasonable and prudent operator would drill, **having due regard for the interest of the state as well as the interest of the lessee.**

Language in old leases (referred to as DL-1 leases) addresses the same obligations.

18. OTHER WELLS. Upon discovery of oil and gas in paying quantities on said land, Lessee shall drill such wells as a reasonably prudent operator would drill having due regard for the interests of Lessor as well as the interests of Lessee.

As this contractual language makes explicitly clear, knowing whether a particular prospect is economic is key to enforcing the binding terms of leases Alaska has signed with our partners in the oil and gas industry.

The economic data we have today is limited, but indicates that Alaska remains a highly profitable place to do business.

We know that net income per BOE is nearly double in Alaska what it is elsewhere, at least for ConocoPhillips.

The information on the following slide is drawn from their SEC filings.

Table 2: ConocoPhillips: Net Income per Barrel of Oil Equivalent (BOE)

Jurisdiction	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average
Alaska	\$8.97	\$6.01	\$6.19	\$10.43	\$14.36	\$20.38	\$21.08	\$20.66	\$22.84	\$15.73	\$19.47	\$15.10
Lower 48	\$9.13	\$8.02	\$3.77	\$8.42	\$10.56	\$15.96	\$10.63	\$9.80	\$14.39	(\$0.20)	\$6.26	\$8.79
International	\$5.35	\$3.61	\$3.33	\$5.69	\$9.27	\$12.33	\$13.17	\$1.06	\$18.96	\$3.89	\$17.62	\$8.57
Global	\$7.54	\$5.62	\$4.43	\$7.32	\$10.75	\$14.79	\$13.73	\$7.02	\$18.26	\$4.39	\$14.86	\$9.88
Proportion of BOE Production												Average
Alaska	35.9%	47.6%	35.6%	23.6%	24.1%	22.0%	15.5%	16.6%	15.5%	11.9%	14.4%	23.9%
Lower 48	23.8%	19.6%	19.2%	18.8%	19.8%	19.1%	26.2%	30.9%	28.3%	22.2%	26.7%	23.1%
International	40.4%	32.7%	45.1%	57.6%	56.1%	59.0%	58.2%	52.5%	56.2%	65.9%	58.9%	53.0%

Notes: "Barrel of oil equivalent" expresses the amount of a given fuel required to equal the amount of energy contained in one standard U.S. barrel of crude oil (42 gallons). For instance, a generally accepted BOE approximation for natural gas is 5,800 cubic feet (5.8 Mcf). Please note, however, that the amount of energy provided by crude oil (or any fuel) varies by production location or, more precisely, the grade of oil produced. Therefore, BOE figures should be viewed as estimates. The figures in this table are the results of dividing net income by the aggregate BOE production of oil, natural gas, and natural gas liquids.

Source: Legislative Research calculations based on annual filings of form 10-K with the U.S. Securities and Exchange Commission posted to the EDGAR online database, <http://www.sec.gov/edgar/searchedgar/webusers.htm>.

We know that 2 of Alaska's three largest producers have made extraordinary profits in Alaska since ACES passed.

BP Alaska Net Income

(in billions)

2007: \$2.5

2008: \$2.0

2009: \$1.9

2010: \$2.3*

***minus \$1.5 billion in 2010 deducted for non-Alaska costs,
such as the Gulf spill**

\$8.7 billion in profits under ACES

ConocoPhillips

Alaska Net Income

(in billions)

2007: \$2.3

2008: \$2.3

2009: \$1.5

2010: \$1.7

\$7.8 billion in profits under ACES

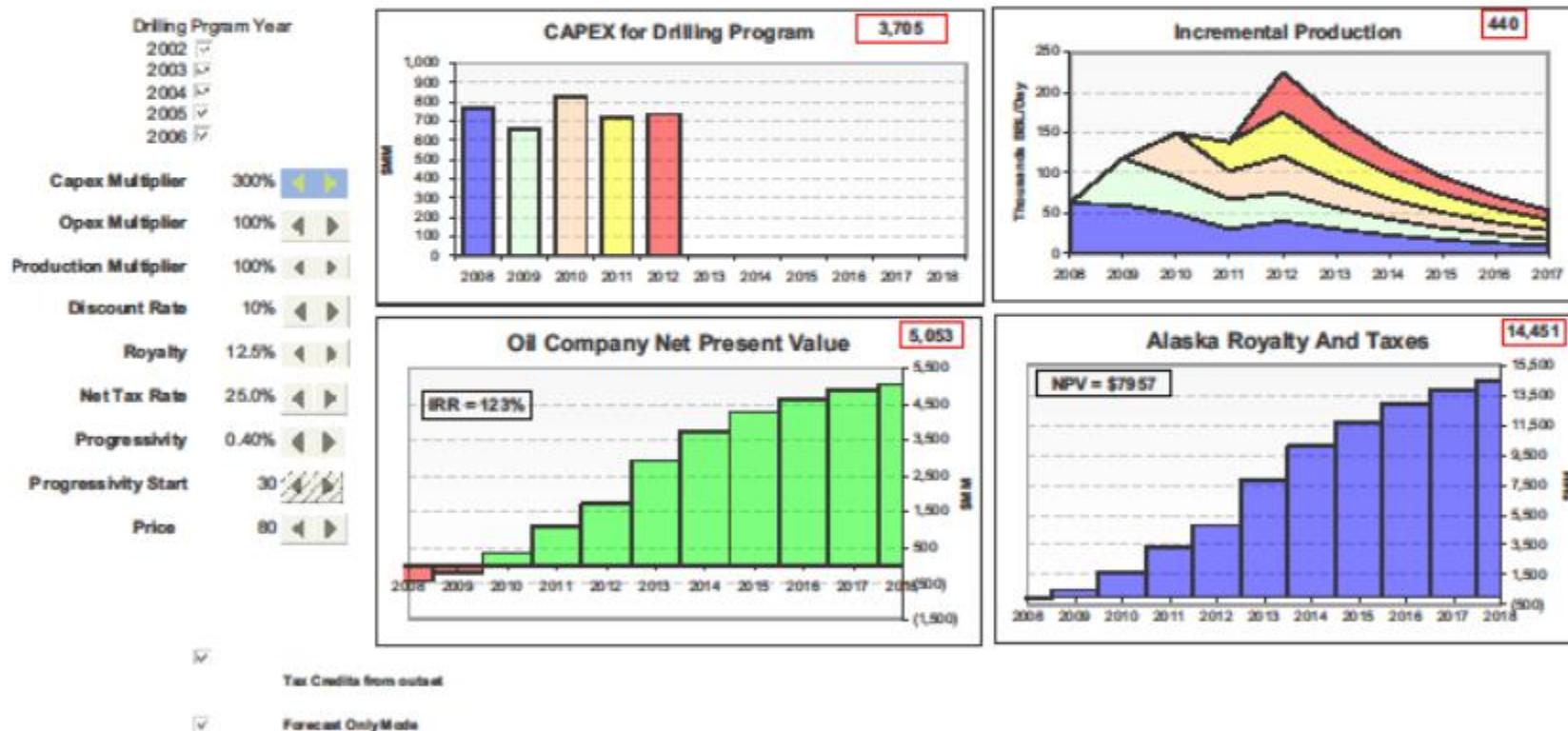
And we know what consultants retained by the Administration and Legislature have told us about the estimated rates of return an oil company would receive when further investing in Prudhoe Bay. The following slide estimates returns at 123% when oil sells at \$80 a barrel.



Senate CS – Forecast Mode, \$80 oil

- IRR = 123%, NPV10 = \$5.375 billion

Modeling the Prudhoe Success contained in AOGA/BP Testimony



There is one final provision in SB 209 the sponsor asked me to highlight. It requires DNR to annually submit a report to the legislature that lists each lease found to be out of compliance and the action taken by the commissioner to bring the lessee back into compliance.

DNR has expressed its view on timely lease development in a variety of public statements.

The following statements were made in the context of Point Thomson, but could apply to any lease on which no exploration or development has taken place over an extended period of time.

“The State and the public are primarily interested in **timely oil and gas production** from State leases. Every year that production is delayed costs the State millions of dollars in unrealized interest on production revenue...”

(Denial of the proposed plans for the development of the Point Thomson Unit, page 18)

“It is not in the public interest to grant a state lessee an indefinite extension on development merely because development in their view is not currently profitable enough or is too risky.”

(Denial of the proposed plans for the development of the Point Thomson Unit. Page 20)

“It is not in the public interest to change leasehold intent by **allowing a lessee’s parochial interests to supersede the State interest for orderly and reasonably prompt development.**”

(Denial of the proposed plans for the development of the Point Thomson Unit, page 20)

“... delaying timely production
also constitutes waste.”

(Denial of proposed plans for the development of the Point Thomson Unit, page 21)

“One of the state’s most significant interests in oil and gas leasing is production. The interest is realized by **compliance with the terms of the oil and gas leases...**”

(DNR Commissioner decision on appeal from DNR oil and gas Director’s October 27, 2005 decision on the 22nd PTU POD, page 15)

“The unitization scheme is intended to cause state leases to be developed efficiently. It is **not intended to allow lessees to simply hold oil and gas leases indefinitely until such time as the probable profit from a project meets their subjective and internal expectations** or the state agrees to modify its royalty or other contract rights or the state’s right to collect taxes.”

(DNR Commissioner decision on appeal from DNR oil and gas Director’s October 27, 2005 decision on the 22nd PTU POD, page 17)

This last slide is of particular interest in light of statements made by ConocoPhillips' Exploration Manager Michael Faust following Conoco's successful acquisition of 35 North Slope tracts this past December.

Faust said that exploration funding would depend in part on whether changes are made to the state's ACES production tax.

“One of the things that certainly weighs into that decision is the fiscal regime in Alaska.”

Michael Faust, Petroleum News, December 8, 2011

The sponsor believes this is an inappropriate approach to the development of leased state lands, which violates the terms of leases ConocoPhillips has signed.

“The state oil and gas leasing system is not intended to require DNR to engage in a murky subjective contest about a Lessees’ internal economics, development risk, or view of the difficult of developing the unit. One of the state’s primary interests is production. If production is not the plan, the state’s remedy is to terminate the unit and find another means to develop the unit.”

(DNR Commissioner decision on appeal from DNR oil and gas Director’s October 27, 2005 decision on the 22nd PTU POD, pg 17)

“Continuing this 30-year record of non-development and delay of an oil and gas lessee’s obligations to develop and produce its oil and gas leases **makes a mockery of the statutory, regulatory and contractual protections for the State as owner of the oil and gas estate.**”

(Denial of proposed plans for the development of the Point Thomson Unit, page 21)

As the legislature considers strategies to increase oil and gas production, the sponsor believes it's important to review and strengthen the state's leasing laws and commitment to lease enforcement.

Changing fiscal terms is not the only way to increase production.

As John Minge, the president of BP Exploration Alaska, recently said, “It’s not always only about taxes.”

During Alaska's constitutional convention, Bob Bartlett warned fellow delegates that outside interests might "attempt to acquire great areas of Alaska's public lands in order not to develop them until such time as ... they see fit." He saw this as a danger to our development as a state.

Senate Bill 209 attempts to pre-empt that danger by requiring the state to include meaningful work commitments in all state oil and gas leases and to enforce those leases to ensure our resources are developed for the maximum benefit of all Alaskans.