STATE OF ALASKA

DEPARTMENT OF NATURAL RESOURCES
550 W. 7th Avenue, Suite 1400
Anchorage, Alaska 99501

In re Remand Proceedings Pursuant to
December 26, 2007 Order of Superior Court
Regarding Point Thomson Unit Agreement

BRIEF OF ALASKA GASLINE PORT AUTHORITY ON REMAND BY SUPERIOR COURT ORDER DATED DECEMBER 26, 2007

The Alaska Gasline Port Authority ("Port Authority") hereby submits argument, pursuant to the Commissioners' determination to allow the Port Authority to file an end of hearing brief, in support of the decision of the Department of Natural Resources ("Department") to terminate the Point Thomson unit ("PTU").

INTRODUCTION

Bob Bartlett, Alaska's delegate in Congress, warned in his keynote address on the opening day of the constitutional convention of two different dangers that faced our fledgling State in relation to natural resource development.

> Two very real dangers are present. The first, and most obvious, danger is that of exploitation under the thin disguise of development. The taking of Alaska's mineral resources without leaving some reasonable return for the support of Alaska governmental services and the use of all the people in Alaska will mean a betrayal in the administration of the people's wealth. ***The second danger is that outside interests, determined to stifle any development in Alaska which might compete with their activities elsewhere, will attempt to acquire great areas of Alaska's public lands in order NOT to develop them until such time as, in the omnipotence and pursuance of their own interests, they see fit. If large areas of Alaska's patrimony are turned over to such corporations, the people of Alaska may be even more the losers than if the lands had been exploited.***[1]

[1] Vic Fischer, *Alaska's Constitutional Convention* 131 (1975) (quoting E.L. ("Bob") Bartlett, November 8, 1955) (emphasis added).

It does not take a student of Alaska history or of oil and gas law to recognize the working interest owners' lack diligence in pursuing a market and production for Point Thomson resources specifically, and off-slope gas sales in general, is a realization of our framers' fears. Oil and gas leases contemplate diligent development and marketing, a proposition that remains foreign even to the working interest owners' most recent proposed plan of development ("POD").

Put simply, forty years of speculation, broken promises, and refusal to aggressively market Point Thomson gas is long enough. The PTU working interest owners should not be allowed to continue to subjugate the State of Alaska's ("State") royalty interest to their own corporate purposes – or hold the State's own gas hostage as an inducement to gain royalty and tax concessions on a gas pipeline they may or may not one day build. The Commissioner should reject ExxonMobil Corporation's ("Exxon" or the "Unit Operator") newest proposed POD and affirm termination of the Point Thomson Unit Agreement ("PTUA").

I. MISCELLANEOUS OBSERVATIONS.

Before addressing why the unit is subject to termination under the habendum clause, and why past and the current Commissioners retain the power to cancel the unit under PTUA § 10 and for the lessees breach of the implied covenant to market product, the Port Authority would briefly like to address a few miscellaneous issues. These include (i) why the multi-year nature of the proposed November 2006 and February 2008 22nd PODs should result in their rejection; (ii) why, in oil and gas leasing, equity does not abhor a forfeiture; and (iii) the PTUA is structured such as to generally make the Unit Operator, not the other working interest owners, responsible to the State for in-unit decisions and obligations.

A. It Would be Improper for Past and the Current Commissioner to Accept a Multi-Year POD.

To the Port Authority's knowledge no seven to ten year POD has ever been approved by the Department for the North Slope, and in light of the Unit Operator's historic lack of willingness to delineate, develop, produce or market Point Thomson resources, the unit does not seem a fitting candidate. PTUA § 10 specifically contemplates a one-year POD,[2] and it is unreasonable for the Unit Operator to submit a long-term POD that would hamper the Commissioner's ability to maintain oversight, and if necessary, termination authority.

Additionally, acceptance of a multi-year POD would run afoul of the findings and stated policy rationale in the Commissioner's June 27, 2000 *Finding and Decisions* on Lessees' *Application for Change of [Prudhoe Bay] Unit Operator* (failure to have regular, periodic PODs – as opposed to annual reports – results in plans not being disclosed to or approved by the Commissioner). There is no part of the various proposed multi-year 22nd POD's that could not have been accomplished through a series of single-year PODs, and the newest POD should be rejected for the Unit Operator's fairly hollow attempt to use a long-term commitment to lock the unit up into yet another decade.

B. Equity Abhors a Forfeiture (Except in Oil and Gas Leasing).

Hornbook law tells us that "equity abhors a forfeiture," a proposition the Alaska Supreme Court has from time-to-time parotid.[3] But this principle does not hold in the unique body of oil and gas law where, although cases can be assembled to the contrary as done in the owners' pre-

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[2] The exact provision as PTUA § 10 under FMUA § 10 has historically been interpreted as requiring annual POD's. BLM Handbook (Unitization (Exploratory)) H-3180-1 at II.H. ("BLM Handbook") ("Prior to the expiration of the initial or nay subsequent plan of development and operation, a new plan covering the next period (the following calendar year) should be submitted on a calendar year basis not later than March 1 of each year, for the authorized officer's approval.").

[3] *See e.g., Strack v. Miller,* 645 P.2d 184, 187 (Alaska 1982).

hearing brief,[4] forfeitures are typically favored with a view towards protecting the lessor. "Although there is division of authority as to whether the equitable remedy of cancellation is favored, it is generally accepted with regard to oil and gas leases that forfeitures are favored."[5]

However, this area of case law and policy rationale behind it need not be explored in depth, because in Alaska this issue was squarely addressed – and decided – by the framers of our Constitution. Section 8 of the Natural Resources Article of the Alaska Constitution expressly mandates that State mineral leases and permits be subject to forfeiture. "Leases and permits shall provide . . . for forfeiture in the event of breach of conditions."[6] It would work an absurdity for the framers to mandate forfeiture for breach of conditions for leases, but to adopt a different policy for leases held by a unit (which is most producing State oil and gas leases except maybe a few in Cook Inlet[7]).

C. <u>The PTUA Generally Creates Obligations of Performance By the Unit Operator to the State, Not By the Other Working Interest Owners to the State.</u>

Under PTUA § 4, Exxon is the Point Thomson Unit Operator. Section 8 provides:

> [T]he exclusive right, privilege, and duty of exercising any and all rights of the parties hereto which are necessary or convenient for prospecting for, producing storing, allocating, and distributing the united substances are hereby delegated to and shall be exercising by the Unit Operator as herein provided. Acceptable evidence of title to said rights shall be depositing with said Unit Operator and, together with this agreement, shall constitute and define the rights, privileges, and obligations of the Unit Operator.

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[4] Owners Pre-Hearing Brief at 28-31.

[5] *Davis v. Cramer*, 837 P.2d 218, 225 (Colo. 1992). *See also Hiko Bell Mining & Oil Co.*, 100 IBLA 371 (1998) ("The courts have held that in connection with oil and gas leases, forfeitures are favored by the law so that such leases are to be construed liberally in favor of the lessor and provisions for forfeiture strictly enforced.").

[6] Alaska Const., art. XIII, § 8 ("Section 8. Leases. The legislature may provide for the leasing of, and the issuance of permits for exploration of, any part of the public domain or interest therein, subject to reasonable concurrent uses. *Leases and permits shall provide*, among other conditions, for payment by the party at fault for damage or injury arising from noncompliance with terms governing concurrent use, and *for forfeiture in the event of breach of conditions*.") (emphasis added).

[7] *See* Alaska Department of Natural Resources, *2007 Annual Report* §§ 1 and 2 <available at http://www.dog.dnr.state.ak.us/oil/products/publications/annual/report.htm (visited March 19, 2008)>.

The effect of this provision is that the working interest owners have delegated their rights to the Unit Operator to make just the Unit Owner, as opposed to all the working interest owners, answerable to the Department for performance of certain in-unit obligations established in the PTUA (but not out of unit obligations like marketing). As the Commissioner is no doubt aware, the PTUA is simply the federal model exploratory unit agreement ("FMUA") edited by the Department and working interest owners in the 1977 to account for the State, rather than the federal government, being the lessor.

"Under the Model Form Unit Agreement, the Unit Operator is delegated the exclusive authority to exercise all rights relating to prospecting for, producing, storing allocating, and distributing the unitized substances."[8] Thus the Unit Operator and government have final say on in-unit decisions such as prospecting, production rates and the size of participating areas under the PTUA § 8.

That is not to say that the working interest owners are without recourse if the Unit Operator makes poor decisions. Under the FMUA and PTUA it is pretty easy to remove the Unit Operator.[9] The Department of Interior has also allowed the working interest owners, but not royalty interest owners, to appeal certain Unit Operator decisions in limited circumstances.[10] However, the primary remedy that working interest owners have and are expected to exercise

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[8] 2 Kramer & Martin at § 16.02[2][d].

[9] Section 6 provides that Exxon may resign at any time, and "the owners of the working interests according to their respective acreage interests in all unitized land, shall by majority vote select a successor Unit Operator . . ." Additionally, under PTUA § 5, "The Unit Operator may, upon default or failure in the performance of its duties or obligations hereunder, be subject to removal by the same percentage vote of the owners of working interest determined in like manner as herein provided for the selection of a new Unit Operator." That is, because the PTU is in default, the working interest owners may – per PTUA §§ 5 and 6 – by simple majority vote on an acreage basis replace Exxon as Unit Operator (and if Exxon either resigns or is removed as Unit Operator by a majority vote, and a new Unit Operator is not selected and qualified, "the Commissioner at his election may declare this Unit Agreement terminated.").

[10] *See Stanley Mollerstuen*, 146 IBLA 1 (1998); *Chevron U.S.A. Production Co. Rio de Viento, Inc.*, 149 IBLA 374 (1999).

under the PTUA against poor unit operations and decision making are private suits against the Unit Operator for breach[11] of the Unit Operating Agreement.[12]

II. THE UNIT IS SUBJECT TO TERMINATION UNDER THE HABENDUM CLAUSE.

A. Commissioner Should Clarify for the Record that the Unit Terminated Automatically under PTUA § 20(c) and 11 AAC 83.336(a)(1) (if Applicable).

The Point Thomson unit has terminated automatically under the habendum clause provisions in PTUA § 20(c) and 11 AAC 83.336(a)(1). The termination of a determinable estate upon the occurrence of the special limitation (e.g., failure to have a well capable of producing in paying quantities or an approved POD) is not a forfeiture but merely the expiration of the estate in accordance with its terms.

> A habendum clause in an oil and gas lease (or other mineral lease) providing a short primary term and a secondary term for 'so long as' production in paying quantities or operations therefore continue, or similar language, conveys a 'determinable' interest, that is, an interest subject to a special limitation. Such an interest automatically terminates by its own terms upon the occurrence of the stated event, namely, expiration of the primary term without production or operations at such time, or the cessation of production or operations during the secondary term. Such a habendum clause does *not* convey an interest subject to a condition subsequent, with the lessor having the optionally exercisable power of declaring a forfeiture upon nonproduction or cessation of production. Instead, the lessor has a possibility of reverter and does not need to take any affirmative action for the lease to terminate.[13]

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[11] *See e.g., BHP Petroleum Co. V. Okie*, 836 P.2d 873 (Wyo. 1992).

[12] Under Section 7 the working interest owners must enter into a "Unit Operating Agreement." The Unit Operating Agreement ("PTUOA") must provide for allocation of benefits "and such other rights and obligations as between Unit Operator and the working interest owners as may be agreed upon by Unit Operator and the working interest owners . . ." The PTUOA had to be filed with the Director within 90 days of execution of the Unit Agreement (i.e., November of 1977) or the unit would terminate. Thereafter, "Any revision of the unit operating agreement must be submitted to the Director before it takes effect." The PTUOA cannot modify the Unit Agreement, and the Unit Agreement controls between any conflicts occurring between the State of Alaska and any working interest owner (including the Unit Operator).

[13] *McCullough Oil, Inc. v. Rezek, et al*, 176 W. Va. 638, 644-5 (W. Va. 1986) (internal citations omitted).

Common law makes clear that in agreements between private parties automatic termination happens without any notice being required, or action of any kind on the part of the lessor. Again, the West Virginia Supreme Court observed:

> A notice and demand clause in an oil and gas lease (or other mineral lease) has no effect upon the habendum clause or cessation of production clause of the lease. Ordinarily a notice and demand clause relates to express and implied contractual obligations (covenants) of the lessee under the lease and relates to forfeiture of the lease for a default, that is, for a breach of these obligations; the notice and demand clause does not relate to termination or expiration of the lease upon the occurrence of the estate limiting event stated in the habendum clause or cessation of production clause.[14]

However, in the administrative context, when the Department or Bureau of Land Management (the "BLM") are acting as both regulator and lessor, it is common practice for the agency to give notice of expiration after it makes appropriate administrative findings.[15] For instance, before the FMUA is held to have automatically terminated, BLM makes legal and factual findings and then gives notice of the expiration.[16] BLM can even backdate the date it determines automatic termination occurred from the date of its findings, thus reducing the amount of time leases formerly committed to a unit will have before themselves expiring.[17] It should be recognized that this administrative action does not turn automatic termination into administrative cancellation that requires a finding of default or breach and subsequent forfeiture.

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[14] *Id. See also Renner v. Huntington-Hawthorne Oil and Gas Company, et al,* 39 Cal. 2d 93, 96-8 (Cal. 1952)("A determinable fee terminates upon the happening of the event named in the terms of the instrument which created the estate; no notice is required for, and no forfeiture results from, such termination.").

[15] *Kirkpatrick Oil & Gas Company, v. United States of America, et al,* 675 F.2d 1122, 1123 (10th Cir. 1982)("The initial terms had all expired by December 31, 1975. On November 26, 1976, the United States informed Kirkpatrick that its oil and gas leases were terminated for lack of paying production.").

[16] *Oronegro, Inc.*, 156 IBLA 170 (2002) ("By decision dated October 21, 1999, the . . . BLM, notified appellant that the North Kern Front Field Unit Agreement had terminated effective February 28, 1998, because of the cessation of unit production during that month and because diligent operations to restore production or discover new production had not been undertaken in the ensuring 20 months."); *D.L. Cook*, 144 IBLA 63 (1998) (because the three wells in the unit were not able to produce in paying quantities, and the unit operator had not commenced sufficient reworking or drilling operations within 60 days, the unit agreement is invalid under Section 9).

[17] 2 Kramer & Martin at § 16.02[6] ("Terminations can be retroactively determined as in the case of *Oronegro, Inc.*, where BLM sent out a notice of termination in October 1999, declaring that a particular unit had terminated February 28, 1998.") (citing *Oronegro, Inc.*, 156 IBLA 170 (2002)).

As an analogy, think of it like a one year lease expiring at the end of 12 months. At the end of the year when the landlord asks the tenant to move out, no forfeiture has occurred. The lease has simply ended as agreed by the parties when they entered into it. The fact that the lessor may be the government, and for whatever reason an administrative agency reviewing the lease makes a finding that 12 months has passed, does not turn the agency's action in forfeiture proceedings.

This distinction between automatic termination (also called expiration or termination by operation of law) and forfeiture or cancellation for breach has been long recognized in oil and gas law and is briefed in detail in the Port Authority's amicus brief before Judge Gleason. Although Judge Gleason ruled automatic termination did not occur (because the State did not assert the 20(c) argument and in the Court's view 11 AAC 83.336(a)(1) was inconsistent with the PTUA), it is extremely important that the Commissioner rule for the record that: (i) the unit terminated automatically under PTUA § 20(c); and (ii) under 11 AAC 83.336(a)(1) – if applicable – the unit would have terminated automatically upon the Unit Operator's failure to have an approved POD. As to the latter, the Port Authority is very confident that the Alaska Supreme Court can be convinced 11 AAC 83.336(a)(1) applied, and consequently all the hullabaloo about whether the Department should or is required to accept the newest 22nd POD is irrelevant because the estate has already expired.[18]

[18] And we even know from federal precedent such as *Oronegro, Inc.*, 156 IBLA 170 (2002), that regardless of when the Supreme Court makes that finding, termination of the Unit will be back dated to the fall of 2005. That will mean all the leases will have long since terminated as well because that will be when the 90 day period in 11 AAC 83.140 and Clause 5 of the DL-1 lease form began to run.

B. The Unit is Subject to Termination under Discovery Jurisdiction Habendum Clause Case Law Regardless of Whether there is a Capable Well or a POD was Rejected.

Even if the courts ultimately hold that the unit cannot be terminated under the habendum clause for not having a well capable of producing in paying quantities, or for the Unit Operator's failure to submit an acceptable POD, the unit is still subject to termination under the habendum clause (not PTUA § 10) because an unreasonable amount of time has passed without the owners having marketed product.

The majority of jurisdictions, under typical habendum clause language (e.g., "the lease shall continue so long thereafter as oil and gas or either or any of them are produced in paying quantities"), have adopted the rule that if actual production stops, or does not commence, then the lease terminates automatically at the end of the primary term.

> In a few states there is authority for another theory, namely that habendum clause requires merely discovery rather than production in paying quantities. . . In 'discovery' jurisdictions, the habendum clause is read to require the lessee to attempt to market the natural gas within a reasonable time. Failure to do so will lead to lease termination.[19]

Essentially this distinction comes down to whether marketing is a necessary incident of production. In most jurisdictions it is held there cannot be production without disposition so if product is not being marketed at the end of primary term the estate terminates under the habendum clause. Marketing in most states is consequently considered a special limitation to the determinable estate.

> In a jurisdiction where marketing is an essential part of production, an habendum clause which provides for a fixed term and so long thereafter as oil or gas is 'produced' will not be satisfied unless the oil or gas is actually removed from the earth which necessarily involves marking in the case of gas. In this context, marketing the product is a special limitation and a failure to market gas will result

[19] 3 Williams & Meyers at § 604.1.

> in an automatic termination of the lease unless termination is prevented by some other provision. On the other hand, in a jurisdiction where marketing is not an essential part of production, an habendum clause such as the one just described will be satisfied by commercial discovery without marketing the product.[20]

Thus discovery jurisdictions are more lessee friendly because a lessee's rights do not automatically terminate if product is not being marketed when the primary term ends. Rather in discovery jurisdictions if there is a lack of market the court will allow a lease to be held under the habendum clause into the secondary term so long as at the conclusion of the primary term there has been a valuable discovery and the acreage contains a "well capable of producing in paying quantities."

> In these states the discovery of gas (and perhaps oil) in commercial quantities during the primary term or an extension thereof satisfies the thereafter provision of the habendum clause, at least for a period of time, and thereby extends the lease into the secondary term.
>
> After the mineral is discovered the lessee has a duty to use due diligence to market the product, and the failure to do so will result in termination of the lease, under the habendum clause, after the primary term has expired.[21]

However, unlike in a case claiming a breach of the implied covenant to market, in a discovery jurisdiction habendum clause case the courts will terminate the unit after a reasonable amount of time *even if the lessee has continued to market with diligence.* [22]

> Here we find the breakdown of the conceptual distinction between the implied marketing covenant and the [discovery jurisdiction] habendum clause. However, the marketing covenant and the habendum clause are not completely assimilated: Satisfaction of the implied marketing obligation through continuing efforts to market the product will not satisfy the habendum clause indefinitely. At some point, even though there has been no breach of the covenant, the lease will expire if there is no production.[23]

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[20] 5 Kuntz at § 60.1.
[21] 5 Williams & Meyers at § 855.
[22] *See e.g.*, *Somont Oil Co., Inc. v. A & G Drilling, Inc.*, 49 P.3d 598 (Mont. 2002); *Fisher v. Grace Petroleum Corp.*, 830 P.2d 1380 (Ok. Civ. App. 1991).
[23] 5 Williams & Meyers at § 855.

If the Alaska courts refuse to apply the special limitations in the PTUA § 20(c) and 11 AAC 83.336(a)(1) then for purposes of interpreting the PTUA (and maybe all units) Alaska is a discovery jurisdiction and the unit is subject to termination if: (i) the operator did not exercise diligence at any time in finding a market, even if a market is not readily available; or (ii) after a reasonable amount of time no market is available even if the lessee exercised diligence in attempting to find one. Thus under discovery jurisdiction law either a lack of diligence or market can ultimately terminate the unit. This is because failure to acquire a market results in termination under the habendum clause, not the implied covenant to market. Under such a standard the PTU owners' interests are unquestionably subject to termination given 30 years has passed since unitization and no market has been secured.

III. THE UNIT IS SUBJECT TO TERMINATION UNDER PTUA § 10; THE REASONABLY PRUDENT OPERATOR STANDARD IN PTUA § 10 REQUIRES THE UNIT OPERATOR AND WORKING INTEREST OWNERS TO MARKET WITH DILIGENCE.

A. The Department has "Broad Authority" to Approve, Modify and Terminate Units, which Includes the Inherent Authority to Terminate the Unit for the Unit Operator's Failure to Submit an Acceptable POD under PTUA § 10.

Substantial energy has been expended arguing that the unit agreement is a private contract between the working interest owners and the State, and that the Department does not have the authority to unilaterally terminate it. However, federal case law demonstrates a government/lessor can do just that. In addition to the now well briefed holding in *Boesche v. Udal*, 373 U.S. 472 (1962), that the government has the inherent power to administratively terminate an oil and gas property interest when such power is not specifically withheld, IBLA decisions relating to the FMUA support that conclusion as applied to units.

In *Chevron U.S.A., Inc.*, 111 IBLA 96 (1989), after reviewing applicable provisions of the Mineral Leasing Act,[24] the leases, and the FMUA § 2 (almost identical to the PTUA § 2), it was determined that – so long as he considers the "reasonableness" of a plan – the Secretary of the Interior has broad authority to approve unit plans, including ratifying and expanding units, over the objection of the working and royalty interest owners.

> As can be seen, 30 U.S.C. § 226(j), the lease terms, and the MDUA all give the Secretary broad authority to approve any unit plan 'he may deem necessary or proper to secure the proper protection of the public interest,' to mandate unitization, and to prescribe a plan 'which shall adequately protect the rights of all parties in interest, including the United States.'[25]

Relying on this decision, the most learned of commentators, Professors Bruce Kramer and Patrick Martin, noted in their treatise on unitization that a government's sweeping authority under these provisions to approve and dictate unit plans extends to forced termination of units. "The broad authority to approve any unit plan that the Secretary deems reasonable or proper is sufficient to cover the forced termination and/or expansion of existing federal exploratory units."[26]

In short the Department – like the Department of the Interior – is not just any other lessor. Broad, inherent authority to approve, modify and terminate units is typically reserved to the overseeing agency on leased government land under statute, regulation and the leasing documents (i.e., leases and unit agreements).

[24] 30 U.S.C. § 226(j) (1988).
[25] *Chevron U.S.A., Inc.*. 111 IBLA at 104 (quoting *Celsius Energy Co.*, 99 IBLA 53, 68 (1987)).
[26] 2 Bruce M. Kramer & Partrick H. Martin, *The Law of Pooling and Unitization* § 16.02[2][d] (2005 ed.).

B. The Implied Covenant to Market as a Reasonably Prudent Operator under PTUA § 10.

Lessees do not have a legal choice about whether to explore for, develop, produce and market hydrocarbon resources from Point Thomson. American courts since early in the 20th century have read into oil and gas leases a series of implied covenants in order to assure that a lessor's rights are protected, covenants which are extended to units upon unitization.[27] Courts use implied covenants to ensure a lessee does not act opportunistically towards a lessor whose interests might otherwise be held hostage by a lessee holding the land for speculation,[28] and in fact they are so important in protecting a lessor against a lessee's speculative behavior that many jurisdictions hold they are integral parts of the written contract and implied in fact rather than implied in law.[29]

In oil and gas leases and unit agreements, such as PTUA § 10, the duty to develop and/or produce as a reasonably prudent operator is often express. When not expressly provided for by the parties, as noted by the Alaska Supreme Court, courts imply such obligations.[30] Similarly,

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[27] *See Parkin v. State Corp. Comm'n of Kansas,* 677 P.2d 991 (1984) (implied covenants extended to units).

[28] *Amoco Production Co. v. Douglas Energy Co.*, 613 F.Supp. 730, 733 (D. Kan. 1985) ("[H]olding leases for speculative purposes is condemned. Leases of this kind contemplate exploration and development, and not the bottling up of land for speculative or other purposes or the postponement of reasonable development. . ."); *Carter v. United States Smelting, Refining and Mining Co.*, 485 P.2d 748, 752 (Okla. 1971) (condemning holding a lease for "sheer speculation and without any purpose for further development"); *Garcia v. King*, 164 S.W.2d 509 (Tex. 1942) ("The lessors should not be required to suffer a continuation of the lease after the expiration of the primary period merely for speculation purposes on the part of the lessees.").

[29] *Smith v. Amoco Production Co.*, 31 P.3d 255 (Kan. 2001) (implied covenants in an oil and gas lease are implied in fact, rather than in law, in *inter alia* Kansas, Oklahoma, Texas and Montana).

[30] *Baxley v. State of Alaska,* 958 P.2d 422, 427 (1998) (Noting in passing that the State's oil and gas leases contain an implied covenant for lessees to "diligently explore and develop their leases."). *See also* Richard W. Hemingway, *The Law of Oil and Gas* § 8.3 (3d ed. 1991) ("All jurisdictions impose a prudent operator rule to determine whether lease development satisfies the implied covenant of further development. . . Within such relationship the lessee has an implied duty, after production is acquired, to develop the lease to its fullest extent."); *Meaher v. Getty Oil Co.*, 450 So.2d 443, 446 (Ala. 1984) ("[I]mplied covenants to reasonably develop the leased lands, recognized to exist in every oil and gas lease, continue to obligate the lessee to develop all the leased lands. . ."); *Byrd v. Bradham*, 280 Ark. 11, 14, 655 S.W. 2d 366, 367 (1983) ("In oil and gas leases where royalties constitute the chief consideration, an implied covenant exists that the lessee will explore and develop the property with reasonable diligence."); *Olson v. Schwartz,* 345 N.W.2d 33, 38 (N.Dak. 1984) ("It is well settled that the lessee of an oil and gas lease has an implied obligation to the lessor to do everything that a reasonably prudent operator would do in operating,

regardless of whether the duty to develop and produce as a reasonably prudent operator is express or implied, courts will additionally imply a duty to market oil and gas from the lease as a reasonably prudent operator.

> In the absence of such a duty, the courts, on the same theory that they imply covenants to test and develop, imply a covenant on part of the lessee to market the oil and gas produced. It would be of little benefit to the lessor to have express or implied covenants on part of the lessee to test, develop, and protect the land by drilling wells, if the lessee might cap them and refuse to market the product.[31]

The duty to market lies at the heart of the parties' purpose since without it the lessor does not receive royalty. The Texas Supreme Court long ago explained:

> Under the ordinary oil and gas lease, the lessee is not required to market the yield of the leased land at any certain time for any certain price. When the lease is silent on the subject, the lessee's duty is to exercise ordinary or reasonable care. . . Without the exercise of reasonable care to market the gas, there could be no compliance with the assignee's obligations to proceed with the development reasonable and necessary to bring the lease to a normal stage of production.[32]

The New Mexico Supreme Court put it a bit more succinctly:

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developing, and protecting the property, with due consideration being given to the interests of both the lessor and the lessee, if there is no express clause in the lease relieving the lessee of this implied duty.").

[31] 2 W.L. Summers, *The Law of Oil and Gas* § 400 (1959 ed. and 2004 Supp.). The case law supporting the implied duty to market is legion. *See e.g., Wolfe v. Texas Co.,* 83 F.2d 425, 432 (10th Cir.), *cert. denied,* 299 U.S. 553 (1936) ("In the absence of an express provision in an oil and gas lease with respect to marketing the production there is an implied duty on the part of the lessee to make diligent efforts to market the production in order that the lessor may realize on his royalty interest."); *Davis v. Cramer,* 808 P.2d 358, 361 (Col. 1991) (*en banc*) ("Embodied in the covenant to operate diligently and prudently is the implied covenant to market."); *Tana Oil & Gas Corp. v. Bates,* 978 S.W.2d 735, 739 (Tex. App. 1998) ("Oil and gas law in Texas recognizes an implied covenant in gas leases such that a lessee must use due diligence to market the oil or gas produced within a reasonable time and at a reasonable price…[t]he behavior of a lessee in this regard must conform to the standard of a reasonably prudent operator."); *Gilmore v. Superior Oil Co.,* 192 Kan. 388, 392, 388 P.2d 602, 606 (Kansas 1964) ("Kansas has always recognized the duty of the lessee under an oil and gas lease not only to find if there is oil and gas, but to use reasonable diligence in finding a market for the product, or run the risk of causing the lease to lapse…"); *Townsend v. Creekmore-Rooney Co.,* 358 P.2d 1103, 1104 (Okla. 1960)("Where the oil and gas lease does not, in express terms, provide for the marketing of production discovered under the lease, the lessee is under an implied covenant only to market production within a reasonable time. In complying with said covenant the lessee must exercise due diligence in securing a market or a new market, if the one secured proves unsatisfactory. The matter of whether the lessee exercised due diligence in obtaining a satisfactory market within a reasonable time depends upon the facts of each case."); *Severson v. Barstow,* 103 Mont. 526, 63 P.2d 1022, 1024 (Mont. 1936) ("Where, as here, the principal consideration for a lease is the payment of royalty, the lease carries an implied covenant to use reasonable diligence to market the product when produced, although the lease is silent on the subject, and whatever is implied in a contract is as effectual as what is expressed…").

[32] *Cole Petroleum Co. v. United States Gas & Oil Co.,* 41 S.W.2d 414 (Tex. 1931).

> Obviously production without disposition of the product is futile. Thus the courts have developed the implied covenant ‘to make diligent efforts to market the production in order that the lessor may realize on his royalty interest.’[33]

The Port Authority does not believe termination of the PTUA must be contingent on a finding that the November 2006 or February 2008 proposed 22nd PODs do or do not comply with the reasonably prudent operator standard. However, if such a proposition were correct it is not sufficient to inquire whether the Unit Operator’s prior and promised development conduct alone complies with the reasonably prudent operator standard as expressly stated in PTUA § 10. The owners and Unit Operator’s production and marketing efforts must likewise be measured against a hypothetical reasonable third party producer in order for the proposed PODs to comply with such a standard. Additionally, the Unit Operator and owners’ breach of the implied marketing covenant provides independent grounds for forfeiting the unit outside of the Unit Operator’s obligation to submit an acceptable POD under PTUA § 10 (with is also grounds for termination under PTUA § 10).

C. The Prudent Operator Standard as Applied to Oil and Gas Marketing.

The prudent operator standard has the same function in oil and gas law as the reasonable man standard has in negligence law. Thus to comply with this standard, Exxon (and the other owners) must act with regards to duties owed under implied covenants, including the duty to market oil and gas, as a prudent third party operator would under similar circumstances.

The standard against which a producer’s marketing efforts must be measured has been summarized by Professor Kramer as follows:

[33] *Darr v. Eldridge*, 346 P.2d 1041 (N.M. 1959).

> [T]he lessee in any given case is compared to a hypothetical reasonable person engaged in oil and gas operations. Under such an objective standard, the lessee cannot justify his wrongful act or omission on the grounds that his course of action was reasonable based on circumstances peculiar to himself. Rather, the lessee's marketing activities are compared to those that would have been carried on by a reasonably prudent operator under similar circumstances. Where it is found that the lessee failed to meet this standard of conduct he will be liable for breach of the implied marketing covenant.[34]

Additionally, in relation to marketing Point Thomson product, there are at least four relevant corollaries to the duty of care owed by Exxon and the other working interest owners to the State as lessor.

First, a reasonably prudent operator will act if and when there is a "reasonable expectation of profit."[35] Second, the reasonableness of the acts of the lessees in marketing oil and gas cannot be measured in light of a lessee's individual circumstances, such as available financial resources, corporate objectives or self interests, a desire to favor development of another property, or an overall North Slope development strategy.[36]

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[34] Bruce M. Kramer and Chris Pearson, *The Implied Marketing Covenant in Oil and Gas Leases: Some Needed Changes for the 80's*, 46 La. L. Rev. 787, 810-11 (1986) (notes omitted).

[35] *See e.g., Whitman Farms, v. City of Longmont*, 97 P.3d 135, 137-8 (Colo. Ct. App. 2003) ("When, as here, there is a proven field of oil or gas, courts have held that a lessee is required to further develop the lease when there is a reasonable expectation that one or more new wells would generate enough revenue to cover the cost of development and return a reasonable profit. Thus, when a prudent operator would have a reasonable expectation of such economic viability and a lessee is not developing the field, it is proper to conclude that the lessee has breached the covenant of reasonable development and to grant an equitable termination to the lessor.").

[36] *Shelton v. Exxon Corp.*, 719 F.Supp. 537, 549 (S.D. Texas) (Exxon's failure to market gas from leasehold to meet certain corporate warranties without having to purchase gas on the open market "completely subordinated the rights of the mineral interest owners to Exxon's financial gain. Exxon's acts and omission in so doing were not those of a reasonable, prudent operator having its own and the plaintiff's interest in mind."), *rev'd on this point*, 921 F.2d 595 (concluding that the imprudent marketing claim had been released by a 1980 settlement). *See also Newell v. Phillips Petroleum Co.*, 144 F.2d 338, 339 (10th Cir. 1944) ("It was the duty of Phillips to operate this well prudently and with reasonable diligence… It's duty in that respect was not affected in any manner by its ownership of other wells in the vicinity. And its failure to discharge that duty, whether motivated by its interest in wells located lower on the structure, or otherwise, would render it liable in damages for any injury suffered by the owner of the royalty interest."); *Smith v. Amoco Production Co.*, 272 Kan. 58, 31 P.3d 255, 272 (Kan. 2001) ("Amoco admits that its obligations as lessee apply independently to each lease. The independent duty principle is applied to prevent Amoco from making the management of a given lease dependent upon the management of another lease."); *Amoco Production Co. v. Alexander*, 622 S.W.2d 563, 569 (Tex. 1981) ("The reasonably prudent operator standard is not to be reduced to the Alexanders because Amoco has other lessors in the same field. Amoco's status as a common lessee does not affect its liability to the Alexanders."); Pearson and Dancy, "Negotiating and Renegotiating the Gas

> The prudent operator . . . is a hypothetical oil operator who does what he ought to do not what he ought not to do with respect to operations on the leasehold. Since the standard of conduct is objective, a defendant cannot justify his act or omission on personal grounds or by reference to his peculiar circumstances. . . In short, the question is not what was meet [sic] and proper for *this* defendant to do, given his peculiar circumstances, but what a hypothetical operator acting reasonably would have done, given circumstances generally obtained in the locality.[37]

Third, diligence in marketing is a prerequisite to the working interest owners' standard of care given it is they – not the lessor – that are in the position to secure a market for the product.

> The covenant to market requires that the lessees exercise reasonable diligence to market the products. Reasonable diligence is whatever, in the circumstances, would be reasonably expected of all operators of ordinary prudence, having regard to the interests of both lessor and lessee. . .[38]

Fourth, a reasonably prudent operator's interaction with a nearby or prospective pipeline will recognize the economic realities of the industry are such that pipelines must secure long-term shipment commitments from either the gas producer or purchaser.

> [G]as normally is marketable only when the reserves in the field where the lease is situated justify the sizeable capital expenditure necessary to construct and lay a pipeline capable of transporting the gas to its market destination. Pipeline systems, of course, are complex creatures and are quite expensive to construct. Investors traditionally have not been willing to build pipelines unless gas is available in a sufficient quantity and has been committed to the pipeline for an adequately long period, thereby providing the investors with reasonable assurance that they will make a profit on their investment. Thus, the justification for the capital expenditure necessary to construct the pipeline usually comes in the form of long-term gas sale contracts which effectively commit the volume of gas to be sold to the purchaser who will transport the gas through its pipeline to the point of consumption.[39]

Contract: Producer Duties to Third Parties," 56 Okla. B.J. 2181 at 2182 (1985) ("lessee cannot justify his actions merely on the grounds that his course of action was reasonably based on circumstances peculiar to himself.").

[37] 5 Williams & Meyers at § 806.3 (emphasis in original).

[38] *Davis v. Cramer*, 808 P.2d 358, 363 (Colo. 1991).

[39] Holliman, *Exxon Corp. v. Middleton: Some Answers but Additional Confusion in the Volatile Area of Market Value Gas Royalty Litigation*, 13 St. Mary's L.J. 1, 6 (1981). *See also Panhandle Eastern Pipe Line Co. v. The United States*, 187 Ct. Cl. 129, 170 408 F.2d 690 (Ct. Cl. 1969) ("Since pipelines are expensive to construct, pipeline companies have been required to insure for themselves long-term supplies of natural gas in order to amortize their investments…"); *The Superior Oil Co. v. Western Slope Gas Co.*, 549 F.Supp. 463, 469 (D. Colo. 1982) ("Because gas purchasers must make substantial capital outlays in order to move the gas product to the retail consumer, they require same assurance that sufficient long-term supplies of gas will be available to them.").

Consequently, a reasonably prudent operator must act to diligently secure a pipeline connection,[40] include making necessary long-term gas sale or pipeline shipment commitments.[41] Even in the cases where the courts have found the implied covenant to market was not breached, they have nevertheless emphasized the diligence that operators showed with respect to trying to secure, and in some cases actually securing, pipeline connections.[42] In each of these cases the courts recognized that the producers' attempts to and actually contracting with a pipeline were central to the issue of whether reasonable diligence in marketing had been shown.

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[40] *See Crain v. Hill Resources, Inc.*, 972 P.2d 1179, 1181 (Okla. Ct. App. 1998) (The "wells were never hooked up to a pipeline," and the court found that therefore the "lessees failed to comply with the implied covenant to market the gas and cancelled the lease."); *Davis v. Cramer*, 837 P.2d 218 (Colo. Ct. App. 1992) (When the well was completed in 1972 and the pipeline was completed near the well in 1975, but product was not marketed until 1978, the implied covenant to market had been breached.); *Barby v. Cabot Corp.*, 550 F.Supp. 188, 190 (W.D. Okla. 1981) ("Defendant's breach of its duty to diligently market the gas produced . . ." resulted from fact that "[d]efendant was dilatory in renegotiating" expired gas contracts.); *Cole Petroleum Co. v. United States Gas & Oil Co.*, 41 S.W.2d 414 (Tex. 1931) ("The jury found that reasonable care was not used by the assignee to connect the gas wells with a pipe line nor to sell the gas to the advantage of the parties. Without the exercise of reasonable care to market the gas, there could be no compliance with the assignee's obligation to proceed with the development reasonably necessary to bring the lease to a normal stage of production.").

[41] *See Hillard v. Stephens*, 276 Ark. 545, 550, 637 S.W.2d 581, 583-4 (Ark. 1982) ("Once the lessee-producer drills a well resulting in the commercial production of natural gas on the leased premises, the lessee-producer has the immediate duty to market the gas. In order to market such gas effectively, it is the custom in the industry and is usually necessary for the lessee-producer to sell the gas under a long-term gas purchase contract."); *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269, 1273 (Okla. 1981) (footnotes omitted) ("Once a producing well is drilled, a producer has a duty to market the gas. In order to market gas it is usually necessary to enter into a gas purchase contract – frequently a long term one. . . We have recognized this necessity of the market, and we believe that lessors and lessees know and consider it when they negotiate oil and gas leases.").

[42] *See e.g., Christianson v. Champlin Refining Co.*, 169 F.2d 207, 210 (10th Cir. 1948)(In determining whether an operator had "exercise[d] due diligence" the court emphasized the defendants "secure[d] within a year the construction of an expensive pipe line and made it possible to market the gas which was an inferior quality, which in itself, entailed additional difficulty, and were actually marketing the gas from the well within fifteen months from the date of completion."); *Tate v. Stanolind Oil Co.*, 172 Kan. 351, 358 240 P.2d 465, 470-71 (Kan. 1952)(In deciding whether marketing had occurred "within a reasonable time," the court considered that the pipeline "refused to take the gas," and the producer "proceeded before the commission to compel" the pipeline to take it and the pipeline "then agreed to do so."); *Fey v. A.A. Oil Corp.*, 129 Mont. 300, 320 285 P.2d 578, 588 (Mon. 1955) (In determining "[w]hether due diligence [in marketing] has been exercised," the court emphasized that "[t]he record is replete with the efforts of defendants to procure a pipe line company that would take the gas at the profit to lessors and lessees."); *Commissioners of the Land Office v. Carter Oil Co. of W. Va.*, 336 P.2d 1086, 1096 (Okla. 1958) (In determining whether "due diligence was exercised in the seeking and obtaining of a market" the court considered the fact that "[c]ontinued negotiations were carried on with other [potential buyers] and the operator found a buyer "taking the gas from the well head.").

Thus a general statement of the relevant marketing duty of a working interest owner as a party to the PTUA is as follows: upon discovery of oil or gas, an owner is under an implied duty to use diligence to market product and secure pipeline connections as a reasonably prudent operator, which includes marketing the product if there is a reasonable expectation of profit and a willingness to enter into necessary long-term gas sale or shipping commitments.

IV. THE UNIT OPERATOR HAS BREACHED THE IMPLIED COVENANT TO MARKET GAS, FOR WHICH TERMINATION IS A PROPER REMEDY.

A. Elements of Breach of the Implied Covenant to Market as a Reasonably Prudent Operator.

The easiest way to show the Point Thomson owners have not behaved as reasonably prudent operators in relation to marketing as required under PTUA § 10 – and to separately make the case that violation of the marketing covenant justifies forfeiture in its own right outside of the obligations in PTUA § 10 to submit an acceptable POD – is to demonstrate breach of the covenant. The elements of the cause of action for breach of the implied covenant to market are: (i) discovery of oil or gas on the leasehold; (ii) failure to sell the product so discovered; (iii) ability of a prudent operator to sell the product through the exercise of reasonable diligence; (iv) and damage to the lessor as a result of the failure to obtain a market.[43]

Of the four elements necessary for the State to prove a prima facia case of breach, only element (iii) is not facially met for the Point Thomson unit. Consequently the Port Authority will explore it further, explaining that: (a) in these circumstances it need not be shown that a prudent operator could have sold product (or at least the owners bear the burden to demonstrate a prudent operator could not have sold product); and (b) the owners have not acted with diligence in attempting to market product.

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[43] 5 Williams & Meyers at § 855.

B. <u>The Unit Operator and Other Owners Bear the Burden of Proof to Demonstrate Their Diligence in Marketing Product form the Unit.</u>

In a case claiming a breach of the implied covenant to market, the lessor normally bears the burden to prove the ability of a prudent operator to sell the product through the exercise of reasonable diligence. But what happens if the lessor cannot meet this burden and substantial time passes? Should the lessee continue to maintain the right to produce and market the leasehold indefinitely notwithstanding his continuing inability to so?

The Port Authority has already explained this problem is resolved in discovery jurisdictions, not through a claim of the breach of the implied covenant to market, but in the rule that a failure to market product after a reasonable period of time results in forfeiture of the lease under the habendum clause regardless of diligence.

However, what happens in non-discovery jurisdictions when substantial time passes without marketing, yet the habendum clause is satisfied into the secondary term because there is either: (i) a habendum clause that requires the “capability of production” (such as PTUA § 20(c)) rather than “actual production;” or (ii) a habendum clause that requires “actual production” but the lease contains a shut-in royalty clause that allows payment of shut-in royalties to act as constructive production after the primary term?

> That the lessor must prove that diligence would have secured a market in a covenant case but need not make such proof in a habendum clause case suggests the possibility that the lessor may be favored with the lighter burden in pure covenant cases when the lease is being held under a shut-in royalty clause. Suppose the lessee drills a commercial gas well but no market is immediately available. He shuts the well in, commences shut-in royalty, and forgets the well. Some years later the lessor sues to cancel the lease for failure to market the gas. Should he bear the burden in such a case of showing that a market was available and could have been secured through due diligence?
>
> The [discovery jurisdiction] habendum clause cases are not controlling on this point, because the issue arises under the implied marketing covenant, not the

> habendum clause. Payment of the royalty is production for habendum clauses purposes. Nevertheless, if no efforts to market the gas are made by the lessee, or if his efforts fall below the standard of prudent operation, a court could properly grant cancellation for breach of covenant without proof that a market for gas existed. The ground for cancellation would be to prevent the lessee from holding the land for speculative purposes.
>
> A court reluctant to forfeit the lease where the lessee is paying shut-in royalty (although these sums are usually nominal) should at least shift the burden of proof to the operator to show that a market could not be obtained, even if the exercise of reasonable effort. A shut-in gas clause should not hold a nonproducing lease indefinitely in the absence of the exercise of due diligence to market the product. It is difficult to know whether a market could have been obtained unless efforts have been made to do so; the absence of effort implies a desire by the lessee to hold the land for speculation contrary to the base purposes of the lease.[44]

First, the Port Authority has already suggested that if the courts or Department refuse to give effect to the special limitations in PTUA § 20(c) and 11 AAA 83.336(a)(1), then Alaska is a discovery jurisdiction in this context and the unit is subject to termination under the habendum clause for a reasonable amount of time passing and marketing not having occurred. Second, if the unit is not subject to discovery jurisdiction rules, then for units held indefinitely by shut-in savings provisions, or a "can be produced" habendum clause where there is maintained a well capable of producing in paying quantities (the rationale is identical), it is proper if product has not been marketed with sufficient diligence for the Department under the implied marketing covenant to: (i) rule the unit cancelled for breach of the covenant without proof that a market existed, or (ii) at least shift the burden of proof to the Unit Operator and owners to show that a market could not be obtained, even if the exercise of reasonable effort.

[44] 5 Williams & Meyers at § 856.3.

C. The Unit Operator and Other Working Interest Owners Have Not Marketed Point Thomson Gas with Diligence.

The duty of care the lessees owe the State to find a market for gas is one of diligence. To even suggest the owners, in 43 years since the first lease sale or 31 years since unitization, have acted diligently to bring product to market is farcical. That is because not only have the Point Thomson working interest owners not diligently sought a market, they have used Point Thomson as a chess piece in their ongoing corporate strategies relating to the construction of a gas pipeline. The Port Authority respectfully submits that the Commissioner would be woefully ignoring his obligations as trustee of our people's resources if he did not focus these termination proceedings on the working interest owners' refusal to market gas from the Unit.

Exxon, BP and ConocoPhillips have not even been coy about their respective positions on North Slope gas development. Time and time again these owners have beat the refrain that they will not sell gas from Point Thomson until an off-slope pipeline gets build, they will not commit gas to a pipeline until the State makes royalty and tax concessions, they will not enter into gas purchasing agreements to allow a downstream gas purchaser to make shipping commitments on an independent pipeline, and they will not enter into firm transportation commitments to ship their own gas down a third party pipeline. Each one of these positions is a direct breach of the marketing covenant and will be addressed individually below.[45]

[45] In its September 16, 2006 Agency Demand letter to Director Myers ("Agency Demand"), PTUR 000001, and in the pleadings leading up to and argument at the November 20, 2006 hearing before Commissioner Menge, the Port Authority detailed and incorporated into the record many of the violations of the producers' obligations to market Point Thomson gas diligently. However, a brief recap of some of those arguments and producer statements is useful.

1. The Unit Operator and Working Interest Owners Have Not Been Willing to Develop Point Thomson Resources Until There is an Off-Slope Gas Pipeline.

The State should not be distracted by the most recent POD proposal to undertake a relatively small gas cycling project. As the Unit Operator testified before the Commissioner, Point Thomson is predominately a gas field.[46] That is why, starting in 1983, the Unit Operator repeatedly took the position in PODs for almost twenty-five years that only a major off-slope gas sale would economically justify development of the unit, with the crux of its justification for non-development and for not marketing unitized substances being a lack off-slope gas transportation facilities.[47] The newest version of the 22nd POD, a minimal development commitment to get around negotiating gas sales with a third party pipeline operator, is hardly a meaningful departure from this strategy.[48]

2. The Unit Operator and Working Interest Owners Will Not Commit Gas to a Pipeline Until the State Makes Royalty and Tax Concessions.

As has been addressed, lessees must undertake development and marketing if they have a reasonable expectation of profit. Yet irrespective of the level of profitability the various working

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[46] "Gas is our predominant resource. It's over 90 percent of the hydrocarbons at Point Thomson . . . And we will be pursuing . . . the ultimate development of Point Thomson . . . to commercialize that gas, but as we're – as we know we're currently await a pipeline." Testimony of Craig Haymes, Hearing Transcript at 98-99 (February 27, 2008).

[47] 7th POD (1983) ("Sufficient drilling has been accomplished to establish within reason the area and potential commerciality of the field. Further development prior to commencement of construction of a pipeline to market would constitute economic waste through premature expenditure of funds which otherwise could be utilized for exploratory or development activity on other Alaska areas and leases."). *See also* 11th POD (1994) ("Exxon believes that the most likely way to commercialize ANS gas, other than the relatively small volume of gas for local sales, will be through a large scale delivery system, to an off-slope market."); 15th POD (1998) ("[H]urdles to economic development remain; particularly, high well and facilities costs, lack of a gas market and transportation system, and the unique technical challenges associated with high pressure gas cycling. Consequently, development of the Thomson Sand gas is not economically justified at the present time.").

[48] Cycling out 10,000 bbl/d, or about 3 to 4 mmbbl/y, of condensates in a field with know resources of several hundred million barrels can hardly be considered preparing for a major gas sale. Such a small amount of condensates will be cycled out in the next few years that if a major gas sale were to occur in the near future it would still be a gas blowdown.

interest owners and independent consultants are actually projecting from gas sales,[49] it has been repeatedly stated that major off-slope gas sales will not occur without fiscal concessions from the State.

Consider the 15th POD where the Unit Operator stated unit development was not commercially viable, and instead hinted that development might be appropriate upon a change in the State's royalty and tax structure.[50] The alluded to Stranded Gas Development Act ("SGDA"), AS 43.82, ultimately culminated in the SGDA negotiations fiasco where the producers used their stranglehold on Alaska's gas resources to extract sickening tax and royalty concessions in the Murkowski Administration contract. The very point of the implied covenant to market is to force lessees to live up to the spirit of the lease by requiring that they exercise diligence to try and produce and market product. For a lessee to demand renegotiation of fiscal terms (e.g., waiver of lessor's right to take gas in value) in order to take known resources to a profitable market is a gross violation of the implied marketing covenant and the State should not continue to tolerate it for Point Thomson.

And of course the Unit Operator and working interest owners continue to maintain this position. ConocoPhillips's AGIA filing, as well a litany of radio advertisements and legislative testimony, makes clear that that company expects the State to change its tax and royalty structure before it will consider marketing gas.[51]

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[49] Consider, for instance, the Econ One findings and Green Gate LLC calculations included in the record with the Port Authority's "Appeal Letter" before the November 20, 2006 hearing.

[50] 15th POD (1998) ("Additionally, three of the PTU Owners (Exxon, BP and Phillips) have worked with the State of Alaska's North Slope Gas Commercialization Team which has recommended that changes be made to the State's tax and royalty structure to improve the economic feasibility of a North Slope gas project. This work culminated in the Governor's introduction of Stranded Gas legislation (HB 393) earlier this year. . . Future fiscal legislation will continue to be monitored for applicability to PTU resource commercialization.").

[51] *See* Attachment B.

Unbelievable, just a few weeks ago, Exxon filed comments on TransCanada's application under the Alaska Gasline Inducement Act ("AGIA"), AS 43.90, taking just that position. "An appropriate fiscal regime must be negotiated between the State and the ANS producers."[52]

> ExxonMobil considers the foregoing to be a fundamental condition to achieving commercially viable Alaska gas pipeline project under any legislative regime. Consistent with EM's testimony during the AGIA hearings, EM reiterates its offer to engage in substantive fiscal discussions with the State with a goal of developing a fiscal regime which can lead to a viable pipeline project.[53]

But even more telling are Exxon's multiple comments before the legislature on April 12, 2007 that Exxon will not be involved with a North Slope gas project if the State does not lock in fiscal terms.

> [I]ncreases in taxes and oil and gas related activities during the life of the project could significantly impact the commercial viability of the project and offset the benefits of taking on a project of this magnitude. Because fiscal terms could be modified under the proposed AGIA legislation, it dos not provide the fiscal stability necessary to ensure a commercially viable project.[54]

Exxon even hinted it may insist on fiscal certainty before marketing product even if such fiscal certainty is potentially unconstitutional under the Alaska Constitution.[55]

3. The Owners Are Not Diligently Seeking Pipeline Connections for Off-Slope Gas Sales, Either by Selling Gas on the North Slope or by Agreeing to Make Shipping Commitments on an Independent Pipeline.

Above numerous cases were cited to demonstrate that a reasonably prudent operator must act to diligently secure a pipeline connection, include making necessary long-term gas sale or pipeline shipment commitments. But the difference between the PTU working interest owners' behavior, and their legal obligations under the PTUA to market with diligence, is remarkable. It

[52] Attachment B at 1.
[53] *Id*. at 14 (referring to Attachment C, Exxon's testimony to Alaska House Resources Committee, April 12, 2007).
[54] Attachment C at 16.
[55] *Id*. at 19.

is worth focusing on two specific aspects of that behavior, the owners' lack of diligence in finding a party that will purchase gas on the North Slope, and their lack of diligence in encouraging the construction of or making gas commitments on an independently owned pipeline.

a. The Owners Will Not Enter into Gas Purchasing Agreements to Allow a Downstream Gas Purchaser to Make Shipping Commitments on an Independent Pipeline.

A fundamental disconnect between the North Slope producers' actions with Point Thomson, and their legal obligations, is their unquestioned supposition that they will under all circumstances retain title to unitized substances past the point of production. That is, the owners are behaving as if they do not have to diligently seek and ultimately sell to a party that would purchase the gas on the North Slope.

It is customary that a lessee will sell its gas to a third party and the gas purchase contract will determine the price the working and royalty interest owners receive for their gas. Because of this disputes dealing with a producer's obligation to market product tend to deal with gas sale contracts as opposed to a producer's direct participation in a pipeline open season and requisite firm transportation commitments. In fact marketing covenant cases have held that when a lessee sells gas to an affiliated company, the potential of a lessee acting opportunistically towards the lessor (on pricing for instance) make such arrangements "inherently suspect."[56]

Thus producers have a duty of care to diligently seek to sell gas through a gas sales contract.[57] Although the largest North Slope gas reserves holders (BP, Exxon and

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[56] "Although the sale of gas by the lessee to a subsidiary is 'inherently suspect,' it does not [necessarily] constitute a breach of the covenant to market . . ." 5 Kuntz § 60.3 (quoting *Parker v. TXO Production Corp.*, 716 S.W.2d 644 (Tex. App. 1986)).
[57] "[E]ntering into a long term gas purchase contract will discharge the obligation to market the gas where the sale is for the best price obtainable at the time." 5 Kuntz § 60.3.

ConocoPhillips) no doubt find the idea anathema, other producers that do not have an interest in Trans Alaska Pipeline System currently undertake on-slope oil sales,[58] and the major North Slope producers could do so for gas.

However, in Alaska the major producers have made it clear there preference for integrated ownership of the value chain means they will not ship down someone else's pipeline, much less transfer title to the gas via a gas purchase contract that would, for instance, allow a downstream distributor, consumer, or even pipeline company to take title and make shipping arrangements from the unit boundary or the gas conditioning facilities. This is true even though such an arrangement could significantly reduce, and even eliminate, the risk the Point Thomson working interest owners would have if they themselves made firm transportation commitments and took their own gas to market.

As with their demand for fiscal concessions, Exxon is frank in its comments on the TransCanada AGIA application that they demand integrated ownership.

> [A]s explained in ExxonMobil testimony to the Alaska Legislature during April, 2007, because AGIA disconnects the upstream and the midstream aspects of the business, ExxonMobil's participation in an AGIA-related project would be difficult. Notwithstanding this situation, ExxonMobil believes it is important to offer the following comments on TransCanada's Application from the perspective of a possible 'owner-shipper' that expects to have both those roles in the project that is ultimately constructed.[59]

And the producers' behavior evidences their refusal to consider major on-slope gas sales. For instance, shortly after formation the Port Authority in 1999 made its first formal offer to purchase North Slope gas.[60] On April 1, 2005, the Port Authority in conjunction with Sempra

[58] Anadarko sells to a third-party upstream of Pump Station No. 1, and Pioneer has recently agreed to do so. Prior to merger with Unocal, Chevron sold to a third-party upstream of Pump Station No. 1 and has continued that practice on a limited basis after the merger.
[59] Attachment B at 5.
[60] Attachment D at ¶ 2.

LNG made a much more formal and detailed offer to purchase gas on the North Slope and transport it to market.[61] The offer was distributed to Exxon, ConocoPhillips, BP, ChevronTexaco and others. On May 27, 2005 Sempra LNG and the Port Authority had their first substantive discussion with Exxon about that offer, and the tone of the Unit Operator and its obvious unwillingness to commit gas to a project led to Sempra LNG pulling out of the project four hours later, even though in the months prior Sempra LNG had spent millions of dollars on project development.[62]

During the several months that followed, the major Point Thomson working interest owners declined to sell the Port Authority North Slope gas, or even to discuss prices or terms.[63] As of today, the Port Authority still labors to develop its project, but is prevented from moving the project forward by the unwillingness of the working interest owners to provide terms for the sale or shipment of North Slope gas.[64] This is notwithstanding the record established before Commissioner Menge at the November 20, 2006 hearing unquestionably demonstrated the working interest owners would have a reasonable expectation of profit if they pursued a Port Authority project.

Finally, although counsel for the Port Authority has not reviewed its AGIA application, it has heard that Sinopec has expressed interest in making gas purchase commitments that would have characteristics similar to an on-slope gas sale (e.g., Sinopec would absorb shipping commitment risk). If true, it is likely the PTU working interest owners have refused to take such an idea seriously, much less diligently pursue it.

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[61] *See* Agency Demand at Exhibit 65.
[62] Attachment D ¶ 4.
[63] *Id*. at ¶ 4-7.
[64] *Id*. at ¶¶ 8-9.

b. The Unit Operator and Working Interest Owners Will Not Enter Into Firm Transportation Commitments to Ship Gas Down an Independent Pipeline

A lessee is not typically viewed by the courts as obligated to construct expensive pipeline facilities to comply with the duty to market.[65] Rather courts expect a lessee to work diligently towards finding a gas purchaser and to secure pipeline connections from existing or proposed third party pipelines. But in Alaska the Point Thomson working interest owners have turned this expectation on its head, instead demanding they own the pipeline facilities before gas will be marketed form the unit.

In all of the various PODs over the years Exxon consistently speaks in terms of the producers eventually building a gas pipeline to bring Point Thomson gas to market. Nowhere in the record can the Port Authority find evidence that the Unit Operator or other working interest owners seriously discussed or considered a third party building a line in which Point Thomson gas could be transported. Yet there is a long history of capable, qualified parties seeking to build an off-slope gasline, and numerous parties have sought Point Thomson gas from the owners. The owners have demonstrated a long history of refusing to diligently attempt to commit Point Thomson gas to qualified parties seeking to build an Alaska gas pipeline, regardless of such projects' economics.

For instance, in the 1980s and 1990s Yukon Pacific Corporation ("YPC"), a subsidiary of CSX Corporation, which because of its acquisition of Texas Gas Resources Corp. in 1983 was at the time one of the largest natural gas pipeline operators in America, sought to build a gasline from the North Slope to Valdez to allow delivery of liquefied natural gas to market in Asia. By

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[65] *See e.g.*, Richard W. Hemingway, *The Law of Oil and Gas* § 8.9 (3d ed. 1991) ("Although the lessee has an obligation to market the products from the wells, it has been repeatedly held that he does not have to stand the expense of a long and costly gathering system to transport the products to the nearest market.").

at least 1989 YPC had attempted to purchase the necessary natural gas,[66] efforts that obviously did not come to fruition.

As discussed above since its inception the Port Authority has tried everything in its powers to engage the working interest owners in the hope of either purchasing or shipping Point Thomson gas. The Port Authority is right now able and willing to enter into long-term gas sale contracts or shipping commitments that would allow it to construct pipeline facilities to bring Point Thomson gas to market, but Exxon and the other owners have refused to provide terms of sale or shipment. No doubt such other third party project sponsors as the Alaska Natural Gas Development Authority and TransCanada have experienced a similar frustration.

That is because the Point Thomson working interest owners are not only not acting diligently in pursuing pipeline connections they are, to the detriment of the State's royalty interest, unequivocally warehousing Point Thomson gas until such time as they decide to undertake their own project.

Consider the comments on May 30, 2005, while Exxon was engaged in negotiations with the State under the SGDA, the Chairman and Chief Executive of Exxon, Lee Raymond, stated this fact with chilling clarity in an interview with National Gas Weekly.

> NGW: Will political problems seem to be popping up in Alaska and Canada affect the proposed gas pipelines?
>
> Raymond: There is not a mechanism in Canada to deal with all of the local, provincial and federal issues all in a consistent, timely manner. . . My friends at the International Energy Agency talk about developing more upstream resources, but they don't have a clue as to what it takes to do that. They think it just takes money. There isn't going to be an Alaska gas pipeline before there is a Canadian gas pipeline. I know some people in Alaska don't like to hear it, but Canada is a sovereign country, and the pipeline does have to go through Canada. Then you have these competing pipeline proposals, which is fine if that's what you want to

[66] *See* Agency Demand at Exhibit 71.

> do. But the reality is, nobody is going to build a pipeline without the producers. You and I know how pipelines get built. The pipeline goes to the bank. The guy at the bank says, what are you going to put in your pipeline? Gas. Do you own the gas? No. I don't own the gas. Well, who does own the gas, and do you have a commitment from them that they are going to put it through the pipeline? Well, no, we don't have that. Then I don't think I'm going to give you much money to build a pipeline.

Just consider the number of ways this statement violates the implied duty to market as a reasonably prudent operator. By its Chief Executive's own admission Exxon has followed a policy that an Alaskan North Slope gas pipeline will be built when and if Exxon chooses to do so, and until such a time it plans to sit on Point Thomson and other North Slope gas reserves.

On the night of Governor Palin's election, ConocoPhillips made a similar assertion:

> Jack Griffin, ConocoPhillips Alaska Inc.'s vice president for external affairs, predicted that no matter how many new proposals Palin solicits, she will end up negotiating with the three major oil produces, just as Murkowski did.
>
> 'There's only one proposal from the resource owners, and no project can move forward without the resource owners,' said Griffin.[67]

Even Exxon's recent comments on TransCanada's AGIA application are unequivocal in this regard, stating that Exxon's lack of desire to participate in the AGIA process that disconnects the upstream and midstream aspects of the business, and that Exxon expects to hold an equity interest in any project equivalent to its portion of gas being treated and shipped.[68] And if there were any doubt, Exxon's April 12th testimony before the legislature again made it clear that not only is its participation necessary, but so is BP and Exxon's. "[I]t will take ExxonMobil, BP, ConocoPhillips, and the State of Alaska. 'Until we are all aligned on this project it just is not going to happen,' he said."[69]

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[67] Reuters, "Incoming Alaska Gov to Consider New Pipeline Deals," Wed. Nov. 8, 2006 (8:49 p.m. ET).
[68] Attachment B at 5.
[69] Attachment C at 11.

Although this position may be reasonable when measured against the working interest owners' corporate profit motives, it is not reasonable when measured against their legal obligations under the implied marketing covenants in the State's leases and units.

D. <u>The Working Interest Owners' Marketing Commitments in the Newest Proposed POD do not Satisfy Their Legal Obligations Under the Unit Agreement.</u>

The final issue the Port Authority would like to highlight in light of the Point Thomson working interest owners' refusal to market Point Thomson gas as a reasonable prudent operator is the following statement in Exxon's February 10, 2008 transmittal letter sending the most recent proposed POD to the Commissioner. The below is actually quite remarkable, because it is the first time the Port Authority is aware of that ANY Point Thomson working interest owner has ever shared terms under which it would consider marketing Point Thomson gas.

> In addition, necessary engineering work will be completed to allow individual PTU working interest owners to participate in an open season for a gas pipeline. Each owner must individually decide whether to participate in a specific gas sales opportunity. ExxonMobil, as an individual owner, will fully participate in and make commitments for its Point Thomson gas in an open season for a gas pipeline (producer owned, third-party owned, or some other combination) in that pipeline's open season on terms and conditions no less favorable to ExxonMobil than those upon which other shipping commitments are made.

Essentially Exxon is suggesting it will sell Point Thomson gas if it can do so on parity with the best deal any other shipper gets (although it is unclear how this statement meshes with various other recent Exxon statements about gas development in Attachments A and B). But even taken on its face, this position is woefully below what the law expects.

First, this commitment is expressly limited to Exxon. **<u>The Commissioner should demand to know under what terms the other working interest owners are willing to market Point Thomson gas.</u>**

Second, Exxon's obligation is to seek a market with diligence. It should be beating the pavement trying to find a market for its gas, not begrudgingly offering conditional terms of sale because it fears losing the property interest.

Third, Exxon conditions its willingness to sell gas only if it can do so "on terms and conditions no less favorable to ExxonMobil than . . . other shipping commitments." The gamesmanship is just palatable. A reasonable prudent operator does not play games, it diligently seeks a market, and courts recognize that what a lessee covenants is to "obtain the best price and terms available."[70] "[E]ntering into a long term gas purchase contract will discharge the obligation to market the gas where the sale is for the best price obtainable at the time."[71] Why would Exxon believe it has the legal right to warehouse gas if it has a reasonable expectation of profit, just because some other shipper was able to negotiate a slightly better deal?

V. <u>CONCLUSION</u>

In conclusion, the Port Authority respectfully requests the Commissioner affirm or make the following findings of law and fact (many of which have already been made in Director Myers's Amended Decision, Commissioner Menge's Decision, and/or the Acting Commissioner Rutherford's Decision on Reconsideration). As a general rule cites are only provided if the point of law was not addressed elsewhere in the brief, although a few cites were included to clarify which portion of the brief the suggested finding relates.

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[70] *Texaco Inc. v. Duhe*, 274 F.3d 911 (5th Cir. 2001) (the obligation of the implied covenant is to use "reasonable diligence" to get the "best price reasonably possible," but "while royalty owners legitimately cannot expect the highest rates of return from their mineral or natural gas interests, they can expect returns consistent with the bargains-for exchange: reasonable rent for the intended use of land.").

[71] 5 Kuntz at § 60.3. These cases normally arise when a lessor accuses a lessee of selling for too low a price, but the principle is still the same. The lessee's duty under the marketing covenant is to sell gas at the best price currently available, or the prevailing market rate. *See e.g., Cabot Corp. v. Brown*, 754 S.W.2d 104 (Tex. 1987); *Yzaguirre v. KCS Resources, Inc.*, 53 S.W.3d 368 (Tex. 2001).

A. **Habendum Clause.**

1. The lessee's failure to have a well capable of producing in paying quantities meant the special limitation in the "can be produced" habendum clause in PTUA § 20(c) was triggered, and the unit is subject to automatic termination. For a well to be capable and to meet this requirement, it must be able to be turned on and product flow without additional equipment and repairs, [72] and plugged and suspended wells cannot meet this definition because: (i) 11 AAC 83.361 did not adopt a fiction that a certified well would be treated as capable even though not equipped; (ii) if 11 AAC 83.361 did create a fiction that a certified well would be treated as capable even though not equipped, then 11 AAC 83.361 is inconsistent with the known meaning of the PTUA § 20(c);[73] and/or (iii) when the Department revoked well certification the owners no longer met the special limitation in PTUA § 20(c).

2. Although Judge Gleason determined 11 AAC 83.336(a)(1) does not apply to the unit because it is inconsistent with the PTUA, it should be clarified for record that if 11 AAC 83.336(a)(1) does apply, then the unit would be subject to automatic termination upon the occurrence of the special limitation of not having an approved POD for a unit not in production.

3. If the courts or Department refuse to terminate the unit for the triggering of the special limitations in either PTUA § 20(c) (e.g., effect is not given to the "can be produced" requirement because of, for instance, 11 AAC 83.361) or 11 AAC 83.336(a)(1) (e.g., it is inconsistent with PTUA § 20(c)) then Alaska is a *de facto* discovery jurisdiction because, upon valuable discovery, a unit survives into its secondary term without marketing product. In such jurisdictions the habendum clause will be satisfied after the primary term without marketing product unless: (i) the operator did not exercise diligence at any time in finding a market, even if a market is not readily available; or (ii) after a reasonable amount of time no market is available even if the lessee exercised diligence in attempting to find one.

4. A reasonable amount of time to obtain a market had passed when Director Myers and Commissioner Menge rejected the original proposed 22nd PODs, and thus under law applicable to discovery jurisdictions the Unit was properly terminated under the habendum clause.

B. **PTUA § 10.**

5. The rejection of the all the proposed 22nd PODs under PTUA § 10 and 11 AAC 83.343 was consistent with the provisions of 11 AAC 83.303.

6. The Commissioner has inherent authority under PTUA § 10 to cancel the unit administratively for the Unit Operator's refusal to submit an acceptable POD since such authority was not withheld by applicable statute, regulation, or the PTUA.[74]

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[72] *See e.g., Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550 (Tex. 2002).
[73] *Merrion Oil & Gas Corp.*, 169 IBLA 47 (2006).
[74] *Boesche v. Udal*, 373 U.S. 472 (1962).

7. In addition to the power of the Commissioner to administratively cancel an oil and gas lease or unit agreement when that power is not specifically withheld, the Commissioner's broad express authority under applicable statute, regulation, and PTUA to approve any unit plan that the Commissioner deems reasonable or proper is sufficient to cover the forced termination of the former Point Thomson unit.[75]

8. PTUA § 10 conditioned the existence of the Unit on the Unit Operator's submitting an acceptable plan of development; the Unit Operator's refusal to do so is a breach of a condition that subjects the unit to forfeiture.

9. The Unit Operator not only expressly covenanted in PTUA § 10 to develop the unit as a reasonably prudent operator, the Unit Operator and other working interest owners impliedly covenanted in PTUA § 10 to produce and market product from the unit as a reasonably prudent operator.

10. The Unit Operator and other working interest owners' past marketing activities and proposed terms of marketing (e.g., Exxon's terms of marketing) do not meet the reasonably prudent operator standard requirement of PTUA § 10.

C. <u>Breach of the Implied Covenant to Market.</u>

11. As to the first element of a cause of action for breach of the implied covenant to market, there has been discovery of oil and gas on the leasehold.

12. As to the second element of a cause of action for breach of the implied covenant to market, there has been a failure to sell the product so discovered.

13. As to the fourth element of a cause of action for breach of the implied covenant to market, there has been damage to the State of Alaska as lessor as a result of the failure to obtain market, including *inter alia* the failure to receive royalties from the sale of unitized substances.

14. As to the third element of a cause of action for the breach of the implied covenant to market, if an operator has not acted diligently in marketing product, it need not be shown that a market existed. Alternatively, the burden of proof should be shifted to the operator to show that a market could not be obtained.

15. As to the third element of a cause of action for the breach of the implied covenant to market, the Unit Operator and other working interest owners have not acted diligently in marketing product from the Unit.

16. The Unit Operator and other working interest owners breach of the implied covenant to market product is independent grounds for terminating the Unit.

[75] *See e.g.*, 2 Kramer & Martin at § 16.02[2][d]; *Chevron U.S.A., Inc.*, 111 IBLA 96 (1989) ("The broad authority to approve any unit plan that the Secretary deems reasonable or proper is sufficient to cover the forced termination and/or expansion of existing federal exploratory units.") (discussing *Chevron U.S.A., Inc.*, 111 IBLA 96 (1989)).

DATED this 21st day of March, 2008.

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By [signature]
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Certificate of Service:

I hereby certify that on the 21st day of March, 2008, I caused a true and correct copy of the foregoing document to be served upon each of the following:

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Exhibit B