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VIA EMAIL TO SENATOR_HOLLIS_FRENCH@LEGIS.STATE.AK.US
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The Honorable Hollis French
Alaska State Legislature
716 W. 4th Avenue, Suite 420
Anchorage, AK 99501-2133

Re: Point Thomson Settlement Agreement

Dear Senator French:

Thank you for this opportunity to explain certain aspects of the settlement of *Exxon Mobil Corporation v. State, Department of Natural Resources*, 3AN-06-13751 (consolidated), the litigation that arose after DNR terminated the Point Thomson Unit. During the Senate Judiciary Committee hearing on April 27, 2012, Mr. William Walker, Mr. Craig Richards, and Dr. Mark Myers raised questions and concerns about the settlement agreement. Many of these points relate to technical issues that are best addressed by DNR, and I defer to that agency on these matters. I would like to discuss the legal allegations that Mr. Richards has made on behalf of Mr. Walker, however.

Mr. Richards and Mr. Walker argue that the settlement agreement violates Alaska law, citing several reasons for their allegations. They are incorrect on the law—as I explain below—but even more fundamentally, they misunderstand the authority of the Attorney General to settle the cases. Alaska's Attorney General has broad authority to enter into any agreement to settle litigation that he or she believes is in the best interest of the State.[1] The exercise of this authority is not subject to legislative approval or administrative review, and requires no prior public notice or comment. Settling litigation is an executive branch function, and a legislative role would violate separation of powers principles.[2]

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[1] *See, e.g., Public Defender Agency v. Superior Court*, 534 P.2d 947, 950-51 (Alaska 1975).

[2] *See, e.g., Bradner v. Hammond*, 553 P.2d 1, 5 (Alaska 1976) (separation of powers doctrine prohibits "encroachments upon the executive by the legislative branch" in

Aside from the question of the Attorney General's authority, Mr. Walker and Mr. Richards make five allegations about the legality of the settlement agreement. They argue that the settlement should have been subject to public notice and comment because (1) it is a disposal of an interest in state land; (2) it is subject to the material amendments doctrine; and (3) it impermissibly disposes of state royalty gas. They also allege that the agreement (4) unlawfully attempts to restrict the State's future ability to tax Point Thomson gas, and (5) contracts around DNR's regulations, running afoul of the Alaska Supreme Court's 2001 decision in *Exxon v. State*.[3]

I will address each point in turn.

1. *The Agreement is not a "Disposal" of State Land.*

The Alaska Constitution provides that "[n]o disposals or leases of state lands, or interests therein, shall be made without prior public notice and other safeguards of the public interest as may be required by law."[4] A "disposal" is the transfer of an "interest" in state land, which includes the sale or leasing of land, mineral leasing, and right of way permits and licenses.[5]

The Point Thomson settlement agreement does not dispose of an interest in state property. The disposal occurred many years ago when the leases were issued. The settlement agreement addresses DNR's administration of these leases and the Point Thomson Unit Agreement. The State did not transfer any additional interests by entering into the unit agreement, approving Plans of Development ("PODs"), or forming participating areas under the unit agreement.

2. *The Agreement Does Not Amend Any Leases and Thus Does Not Implicate the Material Amendments Doctrine.*

The "material amendments" doctrine applies to competitively bid contracts, *e.g.*, leases. Unit agreements, in contrast, are not competitively bid. In general, "competitively

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confirmation of executive appointments); *Public Defender Agency*, 534 P.2d at 950 ("When an act is committed to executive discretion, the exercise of that discretion within constitutional bounds is not subject to the control or review of the courts. To interfere with that discretion would be a violation of the doctrine of the separation of powers.").

3 40 P.3d 786 (Alaska 2001).

4 Alaska Const. art. VIII, sec. 10. This requirement is codified in the Alaska Lands Act at AS 38.05.035.

5 *See Northern Alaska Environmental Center v. State, Dep't of Natural Resources*, 2 P.3d 629, 636 (Alaska 2000).

bid contracts involving state resources cannot be materially amended."[6] The rationale behind this judicially created rule is that an amendment effectively produces a new contract, which the State should award only after a new round of public bidding.[7]

Here, DNR has not amended the lease terms. Mr. Walker and Mr. Richards point to no provisions in any of the Point Thomson oil and gas leases that have been amended, nor could they. Because the settlement agreement addresses only the terms of the unit agreement, the sole case cited by Mr. Walker and Mr. Richards, *Baxley v. State*, is inapplicable.[8]

3. *The Agreement Does Not Dispose of State Royalty Gas.*

In the settlement agreement, the State has committed to take its royalty in-kind only if the working interest owners complete a project injecting Point Thomson Gas into Prudhoe Bay in order to enhance oil recovery at Prudhoe Bay, while awaiting a potential subsequent Major Gas Sale project.[9] The agreement provides that the State's in-kind Point Thomson gas will be injected into Prudhoe Bay alongside the working interest owners' produced Point Thomson gas where it will both aid in enhanced oil recovery and be available for later withdrawal at the State's discretion for in-state use.[10] In the event there is a later Major Gas Sale project, the State may elect to have the working interest owners sell the gas that was previously taken in-kind and injected into Prudhoe Bay and instead take its royalty in-value based on the Major Gas Sale price.[11]

Agreeing to take royalty in-kind in this manner is consistent with the applicable leases that grant DNR discretion to take its royalty in-kind or in-value. In these circumstances, DNR regulations provide that royalty must be taken in-kind according to the lease terms.[12]

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6 *Kenai Lumber Co. v. LeResche,* 646 P.2d 215, 221 (Alaska 1982).

7 *McKinnon v. Alpetco Co.,* 633 P.2d 281, 287 (Alaska 1981); *Baxley v. State*, 958 P.2d 422, 433 (Alaska 1998).

8 958 P.2d at 433.

9 *See* Section 4.16.2.

10 *See* Section 4.16.2.2; 4.16.2.4.

11 *See* Section 4.16.2.4(c)(i) ("For gas produced from Point Thomson after Project Start-up of a Major Gas Sale, the State from time to time may elect to take its royalty share in-value or in-kind pursuant to the Point Thomson leases, other applicable agreements and applicable State law.").

12 11 AAC 03.015.

The legal provisions that Mr. Walker and Mr. Richards cite on the topics of addressing public notice, royalty board submittal, and legislative approval all address state *disposals* of its royalty in-kind oil or gas, by sale or otherwise.[13] Here, there is no disposal because DNR has not agreed to sell or otherwise transfer its interest in any gas taken in-kind under the agreement. Rather, DNR will retain full title and control to all royalty in-kind gas injected into Prudhoe Bay. The State would potentially trigger the procedural requirements referenced by Mr. Walker and Mr. Richards only if it subsequently withdrew its gas to sell.

The terms of the agreement require only that the Commissioner determine in writing that taking in-kind is in the best interests of the State.[14] Section 5.8 of the Agreement makes this express finding.[15]

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[13] *See, e.g.*, AS 38.05.183 ("Sale of Royalty); AS 38.06.050 (providing for Royalty Board Review for "proposed sale, exchange, encumbrance, or other disposition . . ."); AS 38.06.055 (providing for legislative approval of a "sale, exchange, or other disposition of oil or gas . . ."); 11 AAC 03.020 ("Procedures to be followed for dispositions").

[14] AS 38.05.182 ("any royalty . . . may be taken in kind rather than in value if the Commissioner determines that the taking in-kind would be in the best interests of the state."); 11 AAC.03.010(b) ("Before taking royalty oil, gas, or associated substances in-kind, the commissioner will determine in writing that taking in-kind will be in the best interests of the state.").

[15] DNR agreed to take its royalty in-kind under these circumstances in order to maximize royalty value to the State. Under this development scenario, Point Thomson gas is transported to Prudhoe Bay and injected into that reservoir to enhance oil recovery. Any gas that leaves the Point Thomson Unit boundary triggers the working interest owners' royalty obligations. But if the State were to take its royalty in-value at that time, the value would be minimal because the gas is not being sold by the working interest owners, but is instead being injected into Prudhoe Bay to aid enhanced oil recovery, and potentially for later withdrawal and sale as part of a Major Gas Sale project. If the gas injected into Prudhoe Bay is later sold as part of a Major Gas Sale project, its value will be higher than when it was initially produced from Point Thomson and injected into Prudhoe Bay. The agreement entitles the State to take payment in-value from the Point Thomson lessees after project start-up of a Major Gas Sale for the State's Point Thomson in-kind gas that had been injected into Prudhoe Bay. If there is not a pending Major Gas Sale, however, the State's injected gas in Prudhoe Bay is available for withdrawal at the State's discretion for in-State use. By negotiating these options with respect to royalty, the State ensured that it would derive greater royalty value than if the State had taken its royalty in-value when the gas was first produced from Point Thomson for injection into Prudhoe Bay.

4. *The Agreement Contains No Future Tax Commitments.*

The settlement agreement does not impermissibly bind future legislatures on tax issues. The tax provision in Section 4.16.1 makes no commitments at all about the future state of the law; it only articulates the current state of the law that permits deferral of taxation in certain circumstances, citing 15 AAC 55.151(c) .[16] To the extent Mr. Walker and Mr. Richards are arguing that the agreement's statement in Section 4.16 (Point Thomsen gas injected in to Prudhoe Bay is only subject to tax and royalty once) wrongfully limits the legislature's taxing authority, this argument is meritless.

5. *The Agreement Is Consistent with DNR's Regulatory Authority.*

Finally, Mr. Walker and Mr. Richards argue that DNR has contracted around its regulations providing for unit management, including POD review and the formation of participating areas.[17] To the contrary, the agreement represents an appropriate exercise of DNR's regulatory authority. The recognition in Section 5.1.3 that the agreement is a contract simply makes clear that parties have negotiated a binding agreement (just as oil and gas leases and unit agreements are binding contracts).

Under DNR's regulations,[18] a unit operator must submit a POD that commits to diligent development of the unit resources and sets out a long-term plan for future work activities. After reviewing the POD and considering the criteria set out in 11 AAC 83.303, DNR may approve or deny the POD. If DNR approves the POD, it must monitor activities to ensure that the unit operator complies with the plan.

Mr. Walker and Mr. Richards misunderstand how the POD process will work in conjunction with the agreement. First, the agreement does not eliminate the requirement to have a POD for the Initial Production System; the agreement itself serves as the Initial Production System POD. It sets forth the key work activities and timelines required for the Initial Production System, and it has other requirements that complement the POD.

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16 Section 4.16.1 provides: "The Parties recognize that Alaska law regarding oil and gas production tax provides that gas produced from the Point Thomson Unit that would be used according to 15 AAC 55.151(e) in effect as of the Effective Date, and that would be injected into a reservoir within the Prudhoe Bay Unit in the course of operations of a Point Thomson Gas Development/Prudhoe Bay Enhanced Recovery Project for purposes of repressuring, including enhanced recovery, would be exempt from taxation at the time of its production from the Point Thomson Unit and would be subject to tax only at the time the gas would be ultimately produced for sale from the Prudhoe Bay Unit."

17 Walker Letter at 7-12.

18 11 AAC 83.343.

In addition, before moving forward with the Initial Production System POD and future PODs, the working interest owners must secure DNR's approval for their plan of operations under 11 AAC 83.158. Second, for development beyond the Initial Production System, the agreement expressly requires the submittal of PODs for both development planning and the development itself.[19]

Likewise, the agreement is consistent with DNR's participating area regulations. DNR's regulations require the creation of a participating area for acreage "reasonably estimated through use of geological, geophysical, or engineering data to be capable of producing or contributing to production of hydrocarbons in paying quantities."[20]

The agreement does not abrogate this important management authority. With participating areas, as with PODs, the agreement looks to the future in providing that participating areas will be formed if production actually commences at levels required by the agreement. Addressing participating areas in advance of production is consistent with DNR's regulations and, if the participating area is to be formed, the agreement[21] requires submission of the same supporting technical data that is currently required by DNR regulations.[22]

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[19] *See* Section 4.6. The agreement provides that these PODs will be approved only if they are consistent with the specific development requirements set forth in the agreement *Id.* DNR agreed to place its imprimatur on the post-Initial Production System development scenarios set forth in the agreement after engaging in an extensive diligence and review process. Determining that these development paths are in the public interest, and that any POD that conforms to these development requirements will be approved, is a reasonable and authorized exercise of DNR's POD review discretion.

[20] 11 AAC 83.351(a). Further, the regulations provide that the unit operator must apply for the creation of a participating area "at least ninety days before sustained production."

[21] *See* Sections 4.3.1; 4.4.1; 4.4.2; 4.4.5 and Ex. F.

[22] Because the agreement works within DNR's regulations, the discussion in *Exxon v. State,* 40 P.3d 786 (Alaska 2001) cited by Mr. Walker regarding DNR's authority to enter into contracts that violate its regulations is inapplicable. Walker Letter at 10-12. Further, the facts of that case have no application to the agreement. There, ExxonMobil argued that a provision in the Prudhoe Bay Unit agreement expressly abrogated DNR's regulatory discretion to evaluate whether expanding the unit was in the public interest and instead made expansion mandatory should certain geologic criteria be satisfied. *Id.* at 794-95. The Court rejected ExxonMobil's reading of the Prudhoe Bay Unit agreement. *Id.* at 795. The Court concluded that its interpretation of the Unit agreement was bolstered by the general principle that DNR could not agree to contract terms that violate its regulations. *Id.* at 796-97. Here, DNR is not contracting away the requirement

Mr. Walker and Mr. Richards also argue that the agreement impermissibly alters DNR's dispute resolution procedures by agreeing to arbitration and to superior court jurisdiction.[23] But the Commissioner and the Attorney General have flexibility when settling litigation to negotiate terms, including dispute resolution mechanisms. DNR's appeal regulations do not prohibit it from agreeing to arbitration or other dispute resolution procedures.[24] And agreeing to superior court jurisdiction for certain disputes is not a novel concept; DNR's regulations currently provide for judicial proceedings in certain circumstances.[25]

Finally, Mr. Walker and Mr. Richards misread DNR's regulations in asserting that DNR was required to provide public notice and issue written findings prior to entering into the agreement.[26] They are incorrect on both counts. DNR is required to issue written findings only when disposing of interests in state lands.[27] As discussed above, the agreement does not effect a disposal. In contexts other than disposals, DNR does not have to issue public interest findings in writing, or in any other particular form.

Nor was DNR required to provide for public notice and comment for the agreement. DNR regulations require notice and comment for approvals of a unit agreement, expansions of an approved unit, and extensions of the unit term.[28] But the agreement did none of these things and therefore did not trigger any of the conditions in 11 AAC 83.311 that require public notice and comment.

In conclusion, we fully stand behind the decision to settle the Point Thomson litigation. The settlement agreement secures the State's goal of settling this protracted

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that PODs be submitted with certain information and approved by DNR, or the requirement that acreage must be in a participating area if it is contributing to production. Rather, DNR has agreed that it will approve future PODs *if* they are consistent with all of the conditions set out in the agreement. And DNR has agreed to what participating areas will form *if* production commences and the appropriate information is submitted to DNR.

23 Walker Letter at 10.

24 The State demanded that the agreement include an expedited arbitration provision to deal with an abandonment dispute because the State did not want to waste years in court litigating over whether the working interest owners had abandoned the Initial Production System. Arbitration does not apply to any other dispute.

25 11 AAC 83.374.

26 Walker Letter at 11.

27 *See* AS 38.05.035(e).

28 11 AAC 83.311.

and uncertain litigation, and advances the State's interest in the commercialization of Alaska's natural gas It is not a perfect settlement—no settlement achieves that standard—but the agreement unquestionably is in the public interest. I appreciate this opportunity to supplement the record and would be happy to answer any additional questions by the committee.

Sincerely,

Michael C. Geraghty
Attorney General

cc: Commissioner Dan Sullivan, Department of Natural Resources