Funding for DNR Royalty Valuation Initiatives

Reopeners-Arbitration-Litigation-Valuation and Royalty Disposition

February 25, 2013

Presentation to the House Finance Sub-Committee

Department of Natural Resources

DNR Funding Requirements

- The value of the State's royalty share is a key feature in our relationship with industry.
- Over the years DNR's management of royalty revenue has evolved:
  - To strike a balance between achieving the right amount for its royalty oil and gas and promoting production.
  - To achieve our fair share of the benefits of the production of our oil and gas with minimal conflict with the lessees.
- DNR needs to be proactive to effectively strike this balance.
  - Be well-informed, agile, and responsive to changes in the oil and gas markets.
  - Meet future royalty value challenges with existing and new producers.

DNR Funding Requirements

- DNR requires funding to maintain the effectiveness and efficiency of our royalty revenue management, by:
  - Monitoring external market changes that affect value.
  - Enforcing the State's rights to conduct royalty and net profit share audits.
  - Responding to and initiating "reopeners" and other opportunities to re-negotiate definitions of royalty value
  - Responding to and initiating legal proceedings if necessary when royalty value disputes cannot be otherwise resolved.
  - Seeking innovative solutions to achieve the right royalty value, and effectively and efficiently minimizing future disputes.
    - Interpretation of lease value terms
    - Disposition of royalty in-value and royalty in-kind

DNR FY 14 Funding Request

- $500.0 currently part of the Division of Oil and Gas base operating budget, for:
  - In-house and expert analysis and monitoring of market and cost components of the royalty value calculation.
  - “Routine” or predictable reoccurring reopener/renegotiations.
  - Audit enforcement beyond normal audit administrative process.
- $300.0 increase to Division of Oil and Gas base operating budget
  - Extraordinary reopener events, e.g., the “limited” reopener.
  - New royalty value initiatives.
- $500.0 CIP request for unpredictable multiple value disputes/settlements.
  - Contingency funding should an unresolved royalty value dispute go to full arbitration or court.

Royalty Value Defined by Lease

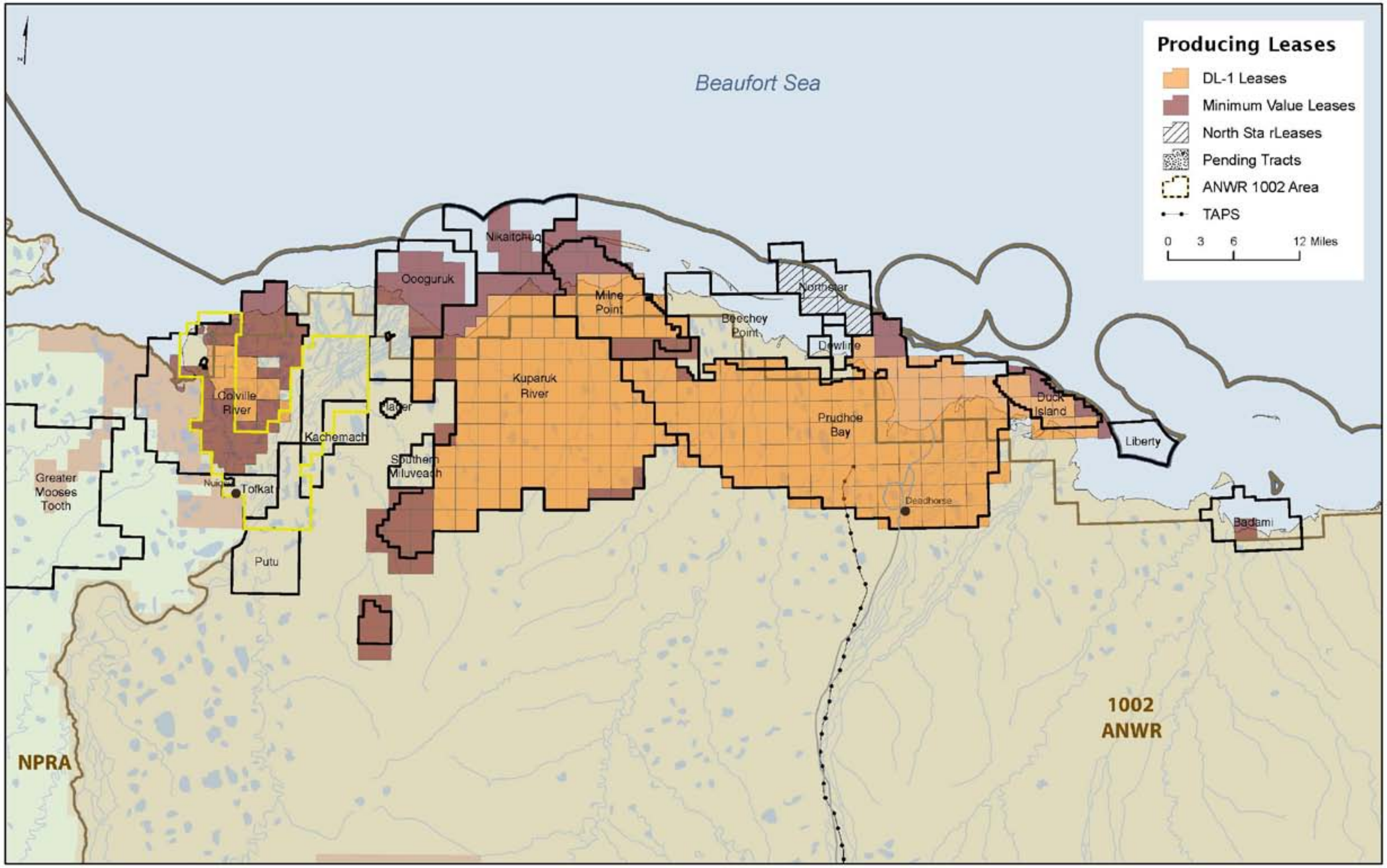
- All state oil and gas leases include provisions that define the cash amount the state should receive for its royalty share when the state takes its royalty in-value.
- Over the years the state and lessees have disputed the meaning of these provisions.
- As various disputes have been resolved over the years, the state and lessees have entered into royalty settlement agreements (RSAs) that modified and simplified the lease value provisions.
- RSAs and other statutory changes govern the calculation of royalty value for most of the oil and gas production from state leases.

Royalty Value Defined by Lease

- All state oil and gas leases define the lessees' obligation to pay using the "higher-of" different measures of value.
  - DL-1 Leases (issued before 1979) effectively require a comparison of:
    - The actual price paid to the lessee
    - The prevailing price received by other producers in the field
    - The market price or value
  - New Form Leases (little changed since 1979) effectively require a comparison of:
    - The field price received by the lessee
    - The volume-weighted average of the three highest field prices received by other producers in the same field or area
    - The state may establish minimum values for the purposes of computing royalties on oil, gas and associated substances

Royalty Value Defined by Lease

Current North Slope Production from DL-1 and New Form Leases



Royalty Value Defined by Lease

- Royalty Value is set by a "netback" formula.
  - As per court rulings on the meaning of the DL-1 Lease and adoption of the concept in the New Form Lease.
  - Royalty Value is set at the point of production, i.e., where oil and gas leaves the lease property and delivered to a pipeline.

Example Calculation of Royalty Value	
Destination Value	$110.00
- Marine Cost	$2.50
= Valdez Value	$107.50
- TAPS Tariff	$5.00
± Quality Bank Adjustment	$1.00
= Value at Pump Station No. 1	$103.50

  - Destination Value: most of the North Slope oil is delivered for sale and prices set at the US West Coast.
  - Marine Cost: depending on the specific wording of the lease, the lessees are entitled to "actual and reasonable" transportation costs to deliver North Slope oil to the US West Coast.
  - TAPS Tariff: Deductions are allowed for tariffs paid on TAPS and upstream pipelines.
  - Quality Bank Adjustments: Oil from different fields affect the market value; the Quality Bank makes sure that producers get reimbursed or paid when oil is mixed together.

Royalty Value Defined by Lease

- Lease Value provisions as modified by RSAs
  - ANS Royalty Litigation:
    - Huge settlements with the major producers applicable to DL-1 leases were finally concluded in 1980 (field costs); 1991-92 (oil); 1995 (gas sold on the North Slope).
    - About 83 percent of current North Slope royalty production is governed by RSAs.
  - Cook Inlet Gas RSAs
    - Resolved disputes in the late 1970's.
    - Non-arms length deliveries destined for LNG export and the now-shuttered fertilizer plant.
- Lease Value provisions modified by statute
  - AS 38.05.180(aa): Cook Inlet gas sold to utilities
  - AS 38.05.180(ee): Cook Inlet gas sold to the now shuttered fertilizer plant.

SOA Benefit of Funding

- North Slope RSAs provide opportunities to renegotiate; these are called “reopeners” which are triggered by:
  - Changes in published oil price reporting or the Destination Value no longer measures the correct royalty value
  - Government action
  - Changes in direct marine costs not reflected in the royalty value formula
  - Under certain circumstances, a reopener may be initiated when a party feels that any aspect of the royalty value formula does not yield a correct royalty value

Examples of Benefits of Funding

- If RSA reopener negotiations are unsuccessful, the RSAs call for "baseball" arbitration.
  - A three-person arbitration panel must choose just one of two proposals submitted by the State and the lessee.
  - The State has only had to resort to full arbitration once in 20 years.
    - The State initiated the reopener and won in arbitration
    - The difference between the two initial positions was a $27 million retroactive adjustment for the period in dispute (total retroactive payment = $44 million)
    - New destination value established prospectively.
- Baseball arbitration is an incentive for reasonable negotiations
  - Sizable DNR expenditures in FY 2012 paid for its share of an RSA reopener initiated by the lessee: DNR and the lessee eventually negotiated a settlement.
    - As the parties moved closer to arbitration, DNR estimated that the difference between the lessee's initial proposal and final proposal was equal to about $8 million per year to the State's benefit.

Budget Funding History
Capital Budget FY 2008-2013

- CIPs in FY 2008 and FY 2011 established a \$2.0 million budget.
- Total Expended to date = \$1.2 million.
- Often supplemented by Department of Law's funds.

Royalty Settlement Agreements			
(Reopeners-Arbitration-Litigation-Valuation)			
	(AR# 40758:\$1,500,000)	(AR# 40783:\$500,000)	TOTAL CIP
FY 2008	19,525		19,525
2009	0		0
2010	313,081		313,081
2011	200,000	45,113	245,113
2012	437,604	48,823	486,427
2013	100,000		100,000
Total	1,070,210	93,936	1,164,146

Funding History
Operating Budget FY 2008-2013

- CIP converted to OTI in FY 2009.
- OTI converted to part of operating "base" in FY 2013.
  - FY 2012: $486.0 expended on a "limited" reopener to reset Destination Value.
  - When combined with operating funds that year, total expended was $712.0.
  - FY 2013 shows operating expenditures to date.

OTI Royalty Reopener/Royalty Valuation		
(AR# 37403)		
	Authorized	Expended
FY 2008		
2009	500,000	362,353
2010	500,000	122,595
2011	200,000	225,000
2012	500,000	226,446
2013	500,000	24,350
Total		960,744

- Industry is completely aware of the amounts of DNR's operating and capital budgets and may factor this information in their decision to challenge the DNR over royalty value.