ALASKA STATE LEGISLATURE
JOINT MEETING
LEGISLATIVE BUDGET AND AUDIT COMMITTEE
SENATE RESOURCES STANDING COMMITTEE
April 20, 2005
3:38 p.m.

MEMBERS PRESENT

LEGISLATIVE BUDGET AND AUDIT COMMITTEE

Senator Gene Therriault, Chair
Representative Ralph Samuels, Vice Chair
Senator Ben Stevens
Senator Bert Stedman
Senator Lyda Green
Senator Lyman Hoffman
Senator Gary Wilken, alternate

Representative Mike Chenault
Representative Mike Hawker
Representative Beth Kerttula
Representative Kevin Meyer, alternate

SENATE RESOURCES COMMITTEE

Senator Tom Wagoner, Chair
Senator Fred Dyson
Senator Kim Elton
Senator Gretchen Guess

MEMBERS ABSENT

LEGISLATIVE BUDGET AND AUDIT COMMITTEE

Representative Pete Kott
Representative Reggie Joule, alternate

SENATE RESOURCES COMMITTEE

Senator Ralph Seekins, Vice-Chair

OTHER LEGISLATORS PRESENT

Senator Hollis French
Representative Jay Ramras
Representative Mike Kelly

Representative Harry Crawford
Representative Jim Holm
Representative Eric Croft
Representative Nancy Dahlstrom
Representative Vic Kohring

COMMITTEE CALENDAR

INFORMAL WORK SESSION ON ANS GAS LESSEES

PREVIOUS COMMITTEE ACTION

No previous action to record

WITNESS REGISTER

SPENCER HOSIE, Attorney at Law
Hosie McArthur;
Consultant, Department of Law
San Francisco, California
POSITION STATEMENT: Offered testimony on the ANS gas lessees' obligations.

RICK HALFORD, Governmental Relations
Alaska Gasline Port Authority (AGPA)
Eagle River, Alaska
POSITION STATEMENT: Offered testimony on behalf of Alaska Gasline Port Authority (AGPA).

W. MARK COTHAM, Attorney at Law
Cotham, Harwell, & Evans
Houston, Texas
POSITION STATEMENT: Speaking as counsel for the Alaska Gasline Port Authority (AGPA), offered testimony on the ANS gas lessee's obligations.

ACTION NARRATIVE

CHAIR GENE THERRIAULT called the joint meeting of the Legislative Budget and Audit Committee and the Senate Resources Standing Committee to order at 3:38:50 PM. Senators Therriault, Hoffman, Stedman, Green, Wilken, Elton, Guess, Dyson and Representatives Samuels, Chenault, Hawker, Kerttula, and Meyer were present at the call to order. Senator Ben Stevens arrived as the meeting was in progress.

INFORMAL WORK SESSION ON ANS GAS LESSEES

3:39:22 PM

CHAIR THERRIAULT related the committee would be hearing presentations from outside counsel providing background information on the existing oil and gas leases and language contained in the leases regarding the duty to produce and market the resource.

3:40:18 PM

SPENCER HOSIE, Attorney at Law, Hosie McArthur; Consultant, Department of Law, related his background and work in and for Alaska, which first began in 1984 with the State v. Amerada Hess, et al. 1 JU-77-847 Civ. (Superior Court, First Judicial District) case that grew into the ANS [Alaska North Slope] royalty litigation. He relayed that because of his work specializing in energy and antitrust cases, he has had the opportunity to review many of the producers' documents. The aforementioned provided a "deep intricate knowledge" of how the oil industry thinks about royalties, royalty owner relations, capital budgeting, and project finance. The aforementioned, he opined, is why the Department of Law asked his firm to review the following closely related questions regarding North Slope stranded gas: what the duty is under Alaska law to market or develop the stranded gas; and if there is such a duty, what that might mean vis-à-vis the stranded gas. Mr. Hosie stated, without equivocation, that there is a duty under Alaska law to market and develop hydrocarbons, which relates to the Division of Lands 1 Lease Form (DL1) in which the state contributed the land with the prospect of mineral resources and the oil companies promised to use their expertise to develop, produce, and market the hydrocarbons. As a consequence of those commitments, the oil companies have received the "lion's share" of the value of the hydrocarbons produced, which is 87.5 percent, while the state has received 12.5 percent under the DL1 Lease Form. As a consequence of the lease there is a relationship between the state as a royalty owner and the oil companies as producers. The oil companies are not a fiduciary to the state; however, there is a relationship of mutual benefit, which means the oil companies cannot make decisions in their unilateral best interest without due regard to the interest of the royalty owner, the State of Alaska. Therefore, the oil companies can never treat the state any worse than they would themselves. The aforementioned relationship is referred to by some as a "cooperative venture," and it governs the

conduct between the two parties. He commented that problems in the relationship can arise when the economic interest of the producers diverge from the economic interests of the royalty owner, specifically in the situation of further development.

MR. HOSIE explained that the law addresses the aforementioned situation through the creation of what are known as "implied covenants". Although the covenants aren't explicitly in the text of the lease, they are real concrete obligations. The "covenant to market" and "covenant to develop" are important issues regarding the DL1 lease form, he added. The implied covenants exist under the DL1 lease form and have been litigated in the Amerada Hess case between the state as royalty owner and the oil companies as producers. He recalled that in 1988 to 1989, the State of Alaska filed a summary judgment motion asking Judge Walter Carpeneti to rule that the producers serve as fiduciaries. Although Judge Carpeneti declined to do so, in his ruling he said even though the producers aren't fiduciaries there is a relationship of mutual trust and cooperative venture; and he ruled that under Alaska law and the DL1 lease form the implied duties are fully present in the DL1 lease form. The aforementioned decision is the law of this state, and therefore it's binding on the state and it's no less binding on the producers.

MR. HOSIE relayed that the law obligates the producers to make economic decisions with due regard to the interests of the royalty holders, which is the State of Alaska. With regard to what that means for the duty to market rule, Mr. Hosie explained that it means that if an Alaska gas project is reasonably profitable measured on its own merit, the producers have a duty to go forward with that project. The aforementioned is an objective test. Although Exxon may have an internal rate of return for upstream projects of 25-30 percent, that's a "subjective hurdle rate" and isn't necessarily the objective test of what a reasonably profitable project might be.

MR. HOSIE turned to the concept of gasline development, and offered that Alaska does not need to prove gas projects in Alaska are as economical here as elsewhere in the world. Furthermore, it's not the state's obligation to go head-to-head with international projects and give concessions until the project becomes as economical. He related that the state, given this lease form and this relationship, should simply ask whether the gas projects are reasonably profitable on their own merits. He highlighted that the aforementioned question is appropriate because it goes back to the basic bargain of the lease form

signed by the producers to take on obligations, such as the obligation to produce to market. He reiterated that as a consequence of the aforementioned obligations, the producers received the "lion's share" of production. He alluded to the idea that investment has never been risk free and the producers aren't entitled to a risk-free deal. He reiterated that under the cooperative relationship and release form the question is whether this is a reasonably profitable project.

MR. HOSIE explained that in order for the state to determine whether a particular project is reasonably profitable, the courts look at the economics of the individual project, which includes the following factors: whether other oil companies expressed interest or tried to develop; what the rate of return is that these same companies have accepted in past projects elsewhere; and, "most importantly," the producers' own internal economic analysis of project profitability. The ANS producers have done detailed economic analysis of various gasline projects dating back 15 years and have analyzed natural gas liquids (NGLs), gasline projects, and different combinations of projects. The internal economic analysis of [the ANS producers] will detail the producer's true thoughts about the projected rate of returns, cost of debt, and value of equity. The state needs the aforementioned documents in order to have informed negotiations with the producers. The state is entitled to the documents under the lease form, which gives the state, as the royalty owner, the right to inspect the producers' records. Furthermore, under the Stranded Gas Act the state has the right to ask any applicant to produce documents germane to the economics of the proposed project. He related that he cannot overemphasize the importance of review of the producers' actual economic analysis. He related his understanding that the producers have asked for concessions, and opined that the state has the right and the obligation to look at the companies' internal documents to assess those requests in an informed manner.

3:53:51 PM

MR. HOSIE suggested that the aforementioned documents should also be reviewed for hidden reasons why the oil companies may not think the Alaska gas project is economic right now. For instance, the [documents] may specify artificially high rates of return, 25-35 percent, on equity. He highlighted a recent Wall Street Journal article that focused on ExxonMobil Corporation (Exxon), which was negotiating a large project in Saudi Arabia and was demanding a very high rate of return. The Saudi

government rejected Exxon's offer and decided the internal hurdle rate of 25 to 30 percent [was too high]; instead it divided the project and set it out to bid with smaller companies with different risk "calculus" for the necessary rate of return. According to the Wall Street Journal, that has been very successful. The aforementioned project has gone forward with companies such as Amerada Hess Corporation and Occidental Petroleum, which work with a 15 percent rate of return. He emphasized that it's essential that the state understand that neither the state nor the producers write on a blank slate because there's a preexisting relationship under a lease from which the producers have benefited "enormously." Therefore, the negotiations have to be viewed in that context. He said this is not a situation in which the producers can come to the table, put forth the most aggressive offer, and be free to walk away if they don't obtain the deal on which they insist. The aforementioned circumstance would be the case if there wasn't a preexisting relationship or there weren't obligations under the lease form. However, that's not the case and the producers have an obligation to develop and market [gas] if they can do so in a "reasonably profitable way," because that is the basic bargain [agreed upon] and under which they produced tens of billions of dollars worth of oil.

3:56:56 PM

MR. HOSIE suggested the state should not have to compete with projects elsewhere. He said the state should ask for, receive, and review the producers' internal economic analysis. The producers cannot say "no" to an offer, such as the Alaska Gasline Port Authority (AGPA) offer, or a binding shipment commitment so that the [state] can build the infrastructure and get the gas to market. The law is clear in that the producers cannot warehouse hydrocarbons merely because it makes sense from their perspective. Mr. Hosie related that from Exxon's perspective, it probably doesn't make sense to produce gas in Alaska today because it has more [lucrative] projects. However, the oil companies must take into account Alaska's interests, as the royalty owners, which lay in having a gasline and turning gas into a financial stream for the state, he opined. Under Alaska law, if the gasline is an "economic measure objectively standing-alone," the producers have a duty to go forward.

4:00:04 PM

REPRESENTATIVE SAMUELS inquired as to the definition of "reasonably profitable."

MR. HOSIE answered that the definition of "reasonably profitable" is extremely fact specific. He suggested that the state should review the rates of returns the producers have accepted in past projects. For example, the economic return the producers expected and received when they built the North Slope central gas facility that closed in 1986 or when they invested in natural gas straddle plants in the Gulf of Mexico. Defining "reasonably profitable" has to be answered in the context of the existing ANS business, the money the company has already made on the oil, and the company's obligation to the state to develop reasonably.

4:02:00 PM

CHAIR THERRIAULT inquired as to Judge Carpeneti's decision and the discussion on the duty to produce.

4:02:16 PM

MR. HOSIE said:

> It came in the context of a long and protracted fight about the right way for the producers to calculate and pay royalties to the State of Louisiana. The case was first filed in Juneau by the attorney general's office in 1977. It went through various phases; the first phase dealt with field costs and then it ripened into questions of valuation. In the course of the case, the question arose: What relationship exists between the producers and the State of Alaska -- are they arms-length third parties fighting with bare knuckles in the hurly burly of the commercial market place; that was the producers' perspective. They [the producers] said ... this is just a commercial relationship .... The state disagreed, and argued that they were fiduciaries, which meant they had to treat the state with the utmost care and confidence. Judge Carpeneti disagreed with us, but he also disagreed with them. And he said that in Alaska, which is true in every other oil producing state that I know of ... , the basic lease, the basic bargain where you tender your land and they develop it for their interest and your interest, that that relationship creates this obligation ... to operate the property for the mutual benefit of both the oil companies and the state.... And so, in ... 1989,

> Judge Carpeneti issued a decision where he talked about the implied duties, including the duty to develop and duty to market, where he found that those duties were present in the DL1 lease form. That issue has been litigated here, that is the law today. The producers were party to that case or their predecessors were, and that decision is as binding on them as it is on the state. There is this relationship of mutual benefit. ... Nothing I have just said in any way is controversial or stretches the law, ... that is crystal clear in this state given this decision and in other states given parallel decisions. And it's important because if you think about the basic bargain, you really have to trust the producers on some level.... [The producers] control the process, they get to decide ... what gets developed when and how, and they do have substantial authority to do those things. But with that right comes a concomitant obligation to make those decisions with your interests in mind, as well.... Here, unlike [Kazakhstan], they have a preexisting relationship with a lease form ... under which they have derived enormous benefit. ... This was the kind of thing that Judge Carpeneti thought about and wrote about that is explicit in the record here, and it is binding on the parties.

4:05:57 PM

CHAIR THERRIAULT asked if the current hydrocarbon production satisfies the duties set forth in the lease agreement.

MR. HOSIE related that plans for development don't take away from the larger obligations to market and develop the product, but a specific development plan entered into between the state and a company is a deal. The state needs to be aware of its previous agreements because if it explicitly agreed with a plan of development then a "deal is a deal." The previous agreements don't detract from the state's right to say, as the royalty owner, that producers need to invest in Alaska because the gasline project is reasonably profitable.

4:08:40 PM

CHAIR WAGONER inquired as to what Mr. Hosie would consider a reasonable amount of time to wait for the producers to provide

their economic analysis documents on the profitability [of a gas pipeline] project once the state requests such documents.

MR. HOSIE replied that it would be reasonable to insist on production of the documents in four weeks time. He surmised that the producers are probably "surprised" that the state hasn't already requested these documents. He predicted that there will be "boxes" worth of documents.

CHAIR THERRIAULT asked if, under the Stranded Gas Act, the state has the right to discontinue negotiations if the aforementioned documents, due under the law, are not delivered.

MR. HOSIE said, "I believe that's right." He related his belief that, aside from the Stranded Gas Act, it’s a matter of negotiating morality. If the producers are asking for concessions because they say the project is uneconomic, the state should be entitled to make those decisions in an informed way and thus review the documents supporting such beliefs. He added that there is an underlying economic reality to which the producers subscribe and have an obligation, under the lease and under the Stranded Gas [Act], to share the aforementioned documents, he opined. He suggested that it will help both parties during the negotiation process.

4:10:46 PM

REPRESENTATIVE SAMUELS inquired as to the state's options, beyond litigation, if the state is convinced that the standard presented by Mr. Hosie is the law and the producers won't sell or ship the gas. He also inquired as to a timeline with regard to the type of litigation that could occur.

MR. HOSIE said if Alaska is convinced, after considerable review, that the project is economic and the producers refuse to go forward, the state has the options to either accept the producers' refusal or file a lawsuit. He opined that litigation is never a good solution because it's guaranteed to be slow, expensive, and unpredictable. However, sometimes there is no other option, he commented. Although a duty to develop case is far simpler than an ANS royalty case, it would still take years, possibly two to three years, to conclude, he noted. In further response to Representative Samuels, Mr. Hosie said that Alaska is not unusually litigious. With regard to the ANS royalty litigation, the state sued because it wasn't being paid royalties fairly. The oil companies paid more in royalties because they owed more. Furthermore, the state wasn't the only

entity to sue these companies on the basis of underpaid royalties. In fact, the federal government filed a fraud case against 24 of the largest oil companies in Texas and many other states filed lawsuits to establish that the oil companies were underpaying them, and all those cases, save one, were successful.

4:14:33 PM

SENATOR DYSON asked if the state, in the case in which the state has decided that it's a profitable project, could tell the producers to "sell" or a reserves tax will be instituted.

MR. HOSIE replied, "Absolutely." In further response to Senator Dyson, Mr. Hosie answered it's inevitable that the oil companies will try to refute a reserves tax and go to court over it. He related his belief that the lease agreement doesn't limit the state's chances [of instituting a tax]. He highlighted that the lease agreement doesn't address the aforementioned issues, so it wouldn't preclude a reserves tax. However, should the matter be stalemated, a reserves tax would be an impetus [to develop]. He related his personal belief that the producers will acknowledge they have a duty to develop in Alaska, "it's just a question about how much money gets pushed to their side of the table versus left on [the state's] side of the table." In such debate, it's important to focus on the preexisting obligations and the amounts of ANS gas. He concluded that no matter the situation, warehousing the hydrocarbons because it's in the economic best interest [of the producers] is not an option for the producers.

4:17:03 PM

REPRESENTATIVE HAWKER asked whether Mr. Hosie believes it's possible to compel the sale of the product at an unreasonably low purchase offer or even one that's below the cost of production.

MR. HOSIE replied no. If the sales price tendered is uneconomic, then there's no obligation to sell under the basic test measurement of "reasonable profitability measured objectively." In the case in which the purchase offer is "commercially reasonable," the producers can still refuse, but it increases their duty to provide an alternative. He related his belief that the producers want to hold the reserves and profitability upside. He relayed that the AGPA's offer shows commercial interest from third parties to try to find a way to

commercialize ANS gas. In the case where the producers continue to say "no" to offers without due reason, then it seems that they really don't want to develop the gas but rather want to warehouse it.

4:20:06 PM

CHAIR THERRIAULT asked whether the industry can continue to say "no" and provide the reasoning that it is working on another project that will benefit the industry and the state, as its partner, "to a higher degree."

MR. HOSIE said the industry could say that and he opined that it would be great if it did because if the industry is moving forward and willing to do so on commercially reasonable terms, that would satisfy the obligation. He related that the sequential series of "no" responses is problematic for the industry because it proves they're warehousing and looking for reasons not to build the gasline. He opined that $20 billion is a lot to [invest in a gasline project]; however, 35 trillion feet worth of stranded gas is enormous, and therefore it's difficult to fathom how this project couldn't be economic "measured on its own merits." In further response to Chair Therriault, Mr. Hosie responded that the duty to develop obligates those with existing production to seek out additional production. However, that's not the situation in Alaska because here there are already discovered reserves. Therefore, the question is in regard to the duty to market. He reiterated that the state has to look at the full array of economic consequences, including accounting for any potential degradation in oil production resulting from significant gas blow down. He highlighted that the industry will have reviewed that in its internal documents. However, he highlighted the Point Thompson reservoir, and related his belief that before gas is sold from Point Thompson there will need to be a cycling operation in effect for some period of time. If the aforementioned isn't done and the project moves into a gas blow down phase, about 30 percent of the otherwise recoverable hydrocarbons will be left in the formation. The aforementioned underscores the importance of obtaining the producers' own internal economic analysis.

4:23:27 PM

MR. HOSIE, in response to Representative Croft, related his belief that there wouldn't be an antitrust implication if the industry decides to work together on a development project. In terms of a remedy, he offered that courts like to issue a

"conditional remedy." For instance, if the state, against its will, is ultimately forced to file a lawsuit that it ultimately wins, he said he believes the state would ask the court to order that a development go forward on a particular schedule. The consequence for not meeting that schedule is that [the producers] would have to let the gas go, a "conditional forfeiture." The aforementioned is fair because if the producers aren't going to develop the gas, then they should let it go so that the state can see if another company views the project differently. He noted that there is a cost to Alaska to delay, although there may be a benefit to [the producers] to delay. He indicated that the state may be at cross purposes with the oil companies on this development issue, which is why the state's rights under the covenants are important.

4:25:37 PM

REPRESENTATIVE KERTTULA posed a situation in which a project is deemed profitable but the [companies] won't develop it or sell it, and agree with the other oil companies to do that. She asked if the aforementioned could have antitrust implications that [the oil companies] were closing down that market because of that activity.

MR. HOSIE, drawing on his antitrust experience, suspected that the industry would claim to be in the aforementioned "deal" together and that there's an agreement [based on cooperation].

REPRESENTATIVE KERTTULA asked whether the aforementioned scenario requires the remedy of conditional forfeiture or legislative action.

MR. HOSIE responded that the remedy is either instituting a reserves tax or filing a lawsuit. He highlighted that the issue for a jury in Alaska is whether the project, with a 15-17 percent rate of return, is a reasonable profit margin to obligate the companies to [develop] as opposed to merely warehousing the hydrocarbons.

4:27:38 PM

MR. HOSIE, in response to Senator Ben Stevens, clarified that his firm was hired as an outside contractor by the Department of Law in order to analyze the duty to develop and the duty to market. In further response to Senator Ben Stevens, Mr. Hosie said he has not been in contact with the Stranded Gas Act negotiation teams occurring within the [Department of Law]. He

explained that he has reviewed the record in the ANS royalty litigation for which he produced a long memo regarding the decisions and precedents that may be of great value for the state going forward. The aforementioned led to requests for follow-up work specific to the duty to develop and the duty to market. He specified that he has had no role in any negotiations. However, he informed the committee that he has been extensively briefed by the Department of Law and the Department of Natural Resources because of the importance to his work to have a concrete sense of what has and is about to happen. He noted that most recently he has carefully read the AGPA purchase offer.

4:29:49 PM

RICK HALFORD, Governmental Relations, Alaska Gasline Port Authority (AGPA), explained that Alaska doesn't have the "myriad" of royalty owners like other states; thus, many of these oil and gas issues come from out of state. Therefore, AGPA hired the out-of-state firm of Cotham, Harwell, & Evans, who has over 70 years combined experience in resolving commercial oil and gas issues.

4:30:45 PM

W. MARK COTHAM, Attorney at Law, Cotham, Harwell, & Evans, representing the Alaska Gasline Port Authority (AGPA), related that the oil and gas law, as put forth by Mr. Hosie, is not controversial. He offered that his testimony on the legal duties and obligations the producers have with respect to ANS gas is based on case law and his experience as a lawyer, and is not intended to reflect any statement of position by the AGPA. Upon reviewing the general discourse over Alaska natural gas development, he said he was struck by the lack of any discussion regarding the producers' obligations in these circumstances. There has been a lot of discussion about the federal loan guarantee and how it might be important in getting the pipeline built. Furthermore, the producers have been very outspoken about insisting on royalty and tax concessions. In order to analyze the legal duties that he saw, Mr. Cotham addressed the following five misconceptions:

> MISCONCEPTION NUMBER 1: The oil companies "own" the ANS gas.

MISCONCEPTION NUMBER 2: The oil companies have complete legal control over if and when the ANS gas is marketed.

MISCONCEPTION NUMBER 3: The oil companies can choose how much profit they want and not market the ANS gas until their profit goals, through State concessions or otherwise, are met.

MISCONCEPTION NUMBER 4: The oil companies, by virtue of owning the ANS leases, have the legal right to dictate the location, ownership, and structure of the pipeline.

MISCONCEPTION NUMBER 5: The State is in a relatively weak negotiating position with the oil companies.

MR. COTHAM began by addressing Misconception Number 1. He related his belief that the reality is that the producers' leases, just as Mr. Hosie indicated, give them the right to develop and market the gas. However, that right has corresponding responsibilities and if those responsibilities aren't met, those leases can be cancelled. Therefore, the State of Alaska would become the owner of that gas if the oil companies refuse to adhere to their duties. He recalled a question last fall from former Senator Ogan: "How [does] one get past the [reality] that the guys with the gas make the rules." Although Mr. Cotham sympathized with the aforementioned sentiment, he emphasized that the fact is that the producers do not own this gas as a matter of property law or any type of oil and gas law. He explained that an oil and gas lease conveys first, an exclusive right to explore and produce. The aforementioned right is how the oil companies have produced 14 billion barrels of oil in Prudhoe Bay. On the other hand, the oil companies give back a bonus, which is determined by a competitive bid, a royalty, which in this instance is 12.5 percent, and finally they give back a commitment to develop, produce, and market the gas. He offered an analogy comparing a single individual owner of a hamburger stand to the owner of a McDonald's franchise:

Single Owner of Hamburger Stand	McDonald's franchise

The owner holds 100 percent.	Many incidents of ownership, all subject to a franchise agreement.
Owner runs it however he or she pleases.	Must run it according to standards established in a franchise agreement.
No matter how it is run, the owner will remain the owner.	Failure to meet the franchise standards will lead to forfeiture of the franchise.

MR. COTHAM contrasted the aforementioned example with the state's oil and gas lease situation. An owner of the minerals would have the same basic incidents [as the single owner of a hamburger stand] they would hold 100 percent of the title, run the lease however they desired, and no matter what they would remain the owner of that property. However, the producers have none of the aforementioned rights, instead they have a specific contractual duty, which is spelled out in their leases, such that they must diligently develop and produce the gas. The producers don't have the rights that a normal owner would to develop or not, instead they have to develop as a matter of law and likewise must diligently market that gas, he said. The lease specifically provides that if the producers do not meet the terms of the lease, the lease is subject to cancellation. Therefore, the notion that ANS is owned by the oil and gas companies is a fundamental misconception, he concluded.

MR. COTHAM turned to Misconception Number 2. Upon understanding that the oil and gas companies don't own the gas, the question becomes whether the oil companies can control if and when the gas is self-produced. He related that the law is a "two way street" with respect to rights and responsibilities. The companies are subject to very specific duties to develop and market the gas. He turned to the modern form lease, which in part reads:

> The lessee shall exercise reasonable diligence in drilling, producing, and operating wells on the leased area .... The lessee must drill those wells as a reasonable and prudent operator would drill, having due regard for the interest of the state as well as the interest of the lessee.

MR. COTHAM noted that the DL1 form has similar language. The second duty the producers have is "reasonable diligence" being required in marketing. As in the case of the covenant to

produce, the lessee is also under implied obligation to market with due diligence the products that are produced. He opined without the aforementioned happening the lessor receives no benefit. With respect to diligence, as far as the pipeline is concerned, there has been inaction on the level that no pipeline has been built and there has been no acceptance of any offer to purchase that gas. Thus, it is not absolutely incumbent upon the oil and gas companies to succeed if success is not reasonably possible. However, it is incumbent upon them to be diligent, which means they cannot wait for 35-40 years to develop these assets. The oil companies have an obligation to be diligently trying to market this gas. There is an indication that reasonable diligence and marketing requires, under the law, a very diligent effort to seek out pipelines and a market. He related his professional opinion that a court could not require the oil companies to build a pipeline, and therefore the oil companies have no duty to build a pipeline. Instead, the oil companies must seek out, in an aggressive way, available markets and they must respond affirmatively to a reasonable offer. He explained the Cole Petroleum Co. v. United States Gas & Oil Co. case in which the producer, for a period of time, refused to sell into an existing pipeline. In turn, that refusal lead the Texas Supreme Court, under the lease, to rule that the aforementioned refusal was grounds for cancellation of the lease.

MR. COTHAM continued with Misconception Number 3. He offered that the terms of the leases and the common law itself require that the oil companies develop and market the ANS gas when they have a "reasonable expectation of profit." That "reasonable expectation of profit" unquestionably exists today, he opined. He related his view, in contrast to Mr. Hosie's earlier comments, that one doesn't have to look very far in order to determine whether or not the oil companies have a "reasonable expectation of profit." He explained that very small changes have to happen at the North Slope in order to process the gas, rather than reinject it, and then send it "down the line." In a situation in which an entity, such as AGPA, has offered to build the treatment facility and assume 100 percent of the risk along with the federal government loan guarantee, while the oil company bears none of the risk of financing the pipeline, there is no reasonable expectation of profit. Under the AGPA's "modest" projections, oil companies would stand to net a billion dollars a year, even if the projections turned out to be far less than what was expected. The oil companies would make an "extraordinary ... almost infinite profit," given that they

don't have to expend anything under the aforementioned circumstances.

MR. COTHAM said he found it helpful to discuss what's going on with the producers and contrast that with the legal obligations that "we" agree exist. There are basically two differing categories in terms of how producers look as these projects. Both bear significant scrutiny. The first category is whether a project is viewed as non-discretionary versus discretionary and the second category has to do with whether the project is economic or not and whether it is competitive or not. He recalled that last fall the Legislative Budget and Audit Committee heard testimony from the ANS producers and a former ARCO executive describing the category of non-discretionary items, which include mandatory health, safety, and environmental investments. An example of a non-discretionary project would be Qatar when a firm deadline was established. Additionally, the balance of the projects that may makeup an oil company budget can fall into the category of discretionary. For any of the major producers there is an "extraordinary" list of potential projects, which include doing something with the Alaska Gas Pipeline and/or simply doing something with the reserves. He related that the ANS gas can no longer be characterized as a discretionary decision because ANS has "extraordinary" reserves. In fact, "many billions of cubic feet (bcf) of gas are actually being produced on a daily basis, instead they are simply being re-injected." Furthermore, there is virtually no production expense that the oil companies would be asked to assume if they were to accept on offer such as AGPA's offer, he added. Moreover, today's strong market and high gas prices appear favorable to make the State of Alaska a substantial royalty, if this gas can be sold. He opined that the aforementioned factors combine to make more than a reasonable expectation of profit.

MR. COTHAM turned to the matter of how oil companies rank projects. He recalled that according to testimony from fall of last year, the oil companies draw a distinction between non-commercial projects, non-competitive commercial projects, and competitive projects. He explained that non-commercial projects are projects [that aren't economically savvy] while the commercial projects would return their cost, including the capital costs plus something. He noted his agreement with Mr. Hosie in that as a project moves closer to a commercial project, there are oil and gas developments that are commercial and from which a reasonable profit can be made. He relayed that it is not the state's obligation to compete with other commercial projects, instead the state must determine if the projects are

commercial such that a "reasonably prudent operator" would go forward with them. Again, the aforementioned situation exists, he opined.

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MR. COTHAM moved on to Misconception Number 4. He related his belief that the oil companies, simply because they have some rights with respect to the ANS gas, can dictate the pipeline conditions and location. As mentioned earlier, the oil companies have a duty to prudently develop and market the ANS gas; independent of any profit-making plans they have concerning the pipeline or other projects. The aforementioned duty can't be sacrificed for other profits the producers may desire.

MR. COTHAM said that he would draw a bit of a distinction with Mr. Hosie's comments in regard to antitrust implications of simply refusing to sell gas. For instance, if oil companies refuse to sell the gas, that could be construed as monopoly leveraging, he opined. Monopoly leveraging is defined as "leveraging a monopolist use of power in one market to gain an advantage in a related market, or power held in one time period to gain an advantage in the later period. Often the leveraging occurs in the vertical context as when an upstream producer with monopoly power uses that power to gain advantage in a downstream market." If the oil companies were to use their monopoly, their 90 to 95 percent lease hold interest in the North Slope, to exclude competition along the pipelines where no other pipelines could compete because of that ownership, that could be construed as monopoly leveraging, he opined.

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MR. COTHAM turned to Misconception Number 5. He related his belief that it's a fundamental misconception that the state is in a relatively weak negotiating position with the oil companies. The reality, he opined, is that the state is in a [strong] position for three fundamental reasons. First, if the oil companies insist on not marketing the gas, their leases can be cancelled. He agreed with Mr. Hosie that the traditional remedy is conditional cancellation. However, based upon the language of the leases, Mr. Cotham opined that an unconditional cancellation would be within the state's right, although it might require a judicial proceeding. Second, if the oil companies insist on not marketing Alaska's stranded gas, the damages could be "enormous." Lastly, the anti-competitive refusal to deal would be actionable under the antitrust laws.

The antitrust laws provide mandatory treble damages and injunctive relief. He pointed out that the DL1 form details default, termination, and cancellation, and reads:

> The failure of the lessee to abide by all express and implied provisions of this lease is a default whenever the lessee fails to comply with any of the provisions of this lease and fails within 60 days after written notice of that default to begin and diligently prosecute operations to remedy that default, this lease may be terminated by an appropriate judicial proceeding.

MR. COTHAM noted that [if, at the time of termination] there is no well on the property, the commissioner is given the power without going to a judicial proceeding to cancel the lease. There is no doubt, in accordance with case law, the state could cancel the lease, he said. In fact Professor W.L. Summers, one of the leading legal scholars on oil and gas, says:

> If the lease contains an express provision for forfeiture of the lease for breach of all covenants, thereof, ... which, either by express terms, or by construction of the court, includes implied covenants, and has the effect of making them conditions, there would seem to be no doubt that the lessor is entitled to declare a forfeiture for breach of the implied covenant to market and recover in an action to quiet title or cancel the lease.

MR. COTHAM related his belief that the aforementioned is the circumstance that would exist if the oil companies refuse to reasonably market this gas. The other strength the state has in these negotiations is the damages claims. If the oil and gas companies refuse to develop this gas, he opined that the state will incur "extraordinary" damages for which it would have a remedy in court. He paraphrased Professor Kuntz, one of the leading authorities on oil and gas law, from the following written remarks:

> Damages are recoverable for breach of the implied duty to market the product. It has been held that damages may be recoverable concurrently with cancellation of the lease. The measure of damages for breach of the implied duty to market the product is the royalty which the lessor would have received if the product had been marketed.

MR. COTHAM highlighted that the damage issue emphasizes the importance of something being "done sooner rather than later." Therefore, if a proposal such as AGPA's can begin the flow of gas, sell that gas, and generate royalty, the damages wouldn't accrue, he opined. However, if the oil companies attempt to put together a proposal that is stymied for several years by antitrust considerations or run into difficulties with competing pipelines in Canada, the state will be damaged because the producers choose to it a "different, ... not equal ... and not ... a prudent way, and will have damaged the state by virtue of having delayed that production." He opined that for every day for which royalty is not paid, that royalty goes to the very end of the line. If Alaska misses a year of royalty and then a pipeline starts up, the state can't make up the first year of the royalty. Instead, that royalty is only made up at the very end. In fact, if the northern parts of Alaska are even as productive as have been projected, that royalty may never be made up, he stated. The damages that would be sustained by the state from the "non-development and non-marketing" of ANS gas would be enormous and relate directly to timing issues.

MR. COTHAM turned to the antitrust claims for concerted "refusal to deal." He mentioned the Sherman Act claims, monopoly claims, and monopoly leveraging. He related that he is not stating that an antitrust violation has occurred. However, should there be a refusal to deal with this gas, it would be a violation of the antitrust laws. He indicated that Alaska's situation with its gas over the past 20-30 years constitutes a restraint of trade. Obviously, gas is unlike oil because it cannot be marketed without a pipeline. However, a pipeline cannot be built without the assurance of gas. Therefore, the state has to figure out where to start on the aforementioned equation. He related his belief that it would be a concerted refusal to deal, actionable under the antitrust laws, if there is a failure to build a pipeline and in turn a refusal to sell the gas to "others" who are willing to build such a pipeline. The antitrust remedy includes treble damages which are three times the amount of damages, and there are special provisions for injunctive relief. The aforementioned could be somewhat responsive to earlier questions about the timeframe, he added. The fore mentioned relief makes it possible under an antitrust context to see expedited relief from a court to order the sale of gas under reasonable market terms. He said:

> The bottom line as far as the duties and misconceptions [are as follows] ... First, ... the oil

companies should make available the North Slope gas to the Port Authority and other competing pipeline projects on the same terms and conditions that are the industry norm. Second, that would allow the decision with respect to the pipeline to [be] based on which pipeline is best for Alaska and not on any perceived stranglehold that the oil companies do not, we contend, possess. Third, and this is a last resort, ... litigation .... If in fact there is a complete refusal to deal, we believe then fair competition would have to be reformed by legal means. In conclusion, we believe as a consequence of the Port Authority's offer and indeed the market forces that are at work here, we no longer have a situation where Alaska's gas is stranded. Indeed a market and a offer exist today for that gas. And we believe that this body working together with the executive can in fact, using the legal remedies that I've talked about, effectively get that gas marketed.

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CHAIR THERRIAULT asked what right the producers have, with regard to a stand-alone gas pipeline, to say sell that they can't make a decision to sell until they know with certainty how the gas is going to be taxed in the field.

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MR. HOSIE said the producers have no right to say that unless they can convince the state that, absent that concession and prospective certainty, what would otherwise be an economic project is suddenly uneconomic. He highlighted that he disagrees with Mr. Cotham on a couple of issues. Since the dollars are so "enormous," $20 billion, he couldn't imagine a court making them risk $20 billion because unforeseen things happen such as the crash of oil prices in 1986. With a sum this large, there has to be lots of room for comfort within that economic circle, he opined. Therefore, if fiscal certainty and a guaranteed tax regime become the pivotal point economically, then the producers can ask for it and it's in the state's discretion to agree or not agree. He added that monopoly leveraging is not actionable in the ninth circuit and it's not improper for the oil companies to say they don't want to sell to a pipeline because they have their own plans going forward.

MR. COTHAM related he doesn't disagree if the circumstance was simply marginal. However, that isn't where the state is at today. The current situation is one in which the oil companies are literally faced with a proposition with absolutely zero risk with respect to the pipeline. That risk is going to be willingly assumed by a third party and thus those risks can no longer serve as a reason for inaction. The only risk associated would be the commodity risk, which oil and gas companies have every day of the year, he opined. In fact, upon reviewing the situation, the oil companies' expenditures would be minimal and, according to every reasonable projection of prices, their return would be extraordinary simply by agreeing to sell to a pipeline such as AGPA. He said that the profit levels would be in the thousands of percentage.

ADJOURNMENT

5:09:12 PM

There being no further business before the committees, the joint meeting of the Legislative Budget and Audit Committee and the Senate Resources Standing Committee was adjourned at 5:09 p.m.