ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE
March 23, 2012
3:32 p.m.

MEMBERS PRESENT

Senator Joe Paskvan, Co-Chair
Senator Bill Wielechowski, Vice Chair
Senator Bert Stedman
Senator Hollis French

MEMBERS ABSENT

Senator Thomas Wagoner, Co-Chair - Excused
Senator Lesil McGuire
Senator Gary Stevens

OTHER LEGISLATORS PRESENT

Senator Cathy Giessel

COMMITTEE CALENDAR

SENATE BILL NO. 209
"An Act relating to oil and gas or gas only leasing; requiring that a minimum work commitment be included in each oil and gas and gas only lease and that a proposed plan of development be included in an application for an oil and gas or gas only lease; and providing for an effective date."

- HEARD & HELD

SENATE BILL NO. 215
"An Act requiring the Alaska Gasline Development Corporation to construct a natural gas pipeline to deliver Cook Inlet natural gas to Fairbanks and other communities between Cook Inlet and Fairbanks that do not have access to a natural gas pipeline."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: SB 209
SHORT TITLE: DEVELOPMENT PLANS FOR OIL & GAS LEASES
SPONSOR(s): SENATOR(s) WIELECHOWSKI

02/21/12	(S)	READ THE FIRST TIME - REFERRALS
02/21/12	(S)	RES, FIN
03/23/12	(S)	RES AT 3:30 PM BUTROVICH 205

BILL: SB 215
SHORT TITLE: GASLINE DEV. CORP: IN-STATE GAS PIPELINE
SPONSOR(s): SENATOR(s) THOMAS

02/21/12	(S)	READ THE FIRST TIME - REFERRALS
02/21/12	(S)	RES, FIN
03/19/12	(S)	RES AT 3:30 PM BUTROVICH 205
03/19/12	(S)	Heard & Held
03/19/12	(S)	MINUTE(RES)
03/23/12	(S)	RES AT 3:30 PM BUTROVICH 205

WITNESS REGISTER

MICHELLE SYDEMAN, Staff
Senator Bill Wielechowski
Alaska State Legislature
Juneau, AK
POSITION STATEMENT: Presented SB 209 for the sponsor.

CRAIG RICHARDS, oil and gas tax attorney
Walker and Levesque
Anchorage, AK
POSITION STATEMENT: Explained the duty to develop under American oil and gas law and discussed broad concepts in SB 209.

SENATOR JOE THOMAS
Alaska State Legislature
Juneau, AK
POSITION STATEMENT: Sponsor of SB 215.

JOE DUBLER, Vice President and CEO
Alaska Gasline Development Corporation (AGDC)
Anchorage, AK
POSITION STATEMENT: Commented on ASAP report relative to SB 215.

ACTION NARRATIVE

3:32:25 PM
CO-CHAIR JOE PASKVAN called the Senate Resources Standing Committee meeting to order at 3:32 p.m. Present at the call to order were Senators Wielechowski, Stevens, French and Co-Chair Paskvan. Co-Chair Wagoner was excused.

SB 209-DEVELOPMENT PLANS FOR OIL & GAS LEASES

3:34:15 PM
CO-CHAIR PASKVAN announced consideration of SB 209.

SENATOR BILL WIELECHOWSKI, sponsor of SB 209, said this bill is a pro-development bill that seeks to get more oil in the pipeline.

Last year the Department of Natural Resources reported roughly 25 percent of the state's 1,320 leases could be sitting idle. That means no development wells, no exploratory wells, no permits; it appears not much is being done. This is not in Alaska's best interests. In fact the state is going through litigation right now with Point Thomson, the largest undeveloped oil and gas field in North America, that has been sitting vacant for more than 30 years, and finally when the state exercised its sovereignty taking away the leases it was sued! "This is not the way we should be managing our resources," he said, "I think there is a better way."

Recently, the state had a lease sale where one company took out 34 tracts of land. When asked a week later what their exploration plans were, they said they might not even explore and wanted to see what happens with the oil tax structure first.

SENATOR WIELECHOWSKI stated that leases are legal documents: the state gives up its exclusive right to a piece of property when it puts out a lease and ,in exchange, the company that takes out that lease is legally obligated to explore and produce when it can make a profit on it.

He said the state has many leases where the profits are "extraordinary" and yet development is not being seen for some reason. Our leases are seen as options to develop or explore rather than a contract to develop. The state has a constitutional obligation to get the maximum benefit for its resources and can do better than that. He said this bill requires basic plans for exploration; it requires DNR to review leases on a periodic basis to ensure the state gets the maximum benefit for its resources and it would put more oil in the pipeline quicker than just about anything else he could think of.

MICHELLE SYDEMAN, staff to Senator Wielechowski, said the purpose of SB 209 is to encourage greater development of the state's oil and gas leases consistent with Article VIII of the

Alaska Constitution. Section 8.1 of the Alaska Constitution states: "It is the policy of the State to encourage the settlement of its land and the development of its resources by making them available for maximum use consistent with the public interest."

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

MS. SYDEMAN said committee members are all aware of the Point Thomson case in which state lands with vast quantities of oil and gas were leased more than three decades ago and have yet to be developed.

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The sponsor's intent with SB 209 is to ensure that the state doesn't have more Point Thomsons and to reform Alaska's leasing laws now to avoid spending millions of dollars 20 or 30 years from now to regain control over valuable state lands and resources. Of course, these are not just any resources. They are the state's most valuable resources. They are commonly referred to as our "lifeblood." They provide tens of thousands of jobs for Alaskans. By one estimate nearly 42,000 jobs are directly or indirectly induced by the oil and gas industry. They are roughly 90 percent of our unrestricted state revenue and they support economic development in all other sectors of our economy from seafood to timber. They are critical to our economy, wellbeing and future. This importance clearly raises the stakes. It means we must exercise the greatest diligence when it comes to the management of our oil and gas resources.

3:39:28 PM
MS. SYDEMAN addressed the magnitude of the problem. Last year DNR examined 1,320 leases; 578 of them were part of production units or were producing oil or gas, 404 had been sold in the preceding three years so might still be in the planning stages, and 338 could be "idle" as lessees had not applied for a single permit to explore or develop them. The problem could be quite significant.

3:40:10 PM
SENATOR FRENCH asked what the typical term of a non-producing lease is.

MS. SYDEMAN replied her understanding is that they have varied from 3 to 10 years, but typically might have been for up to 7 years. The most recent lease sale on the North Slope had leases with a 10 year primary term.

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What is the resource potential of these lands? Could they support production at some point? Could they ever be produced and help to fill the pipeline and provide jobs for Alaskans? Ms. Sydeman said the answer is that they simply don't know. One company gave the state a bonus bid some years back and continues to pay rent (usually $1/acre per year)), indicating the land might have potential, but that potential has never been explored or realized.

She said Alaskans have gained little from having taken these lands off the public rolls that puts them out of reach from other companies who may actually want to explore or develop them. This is no way to ensure “maximum use” of our resources, especially as production in Alaska’s largest fields declines, pipeline volumes decrease and concerns over the state’s future fiscal health intensify. Regular litigation to take back idle leases is not the answer and should be the last resort. Carefully crafted laws that result in clear expectations about each party’s responsibilities and intentions is the better way to go.

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MS. SYDEMAN said that Alaskans deserve to know precisely what they are getting when they give exclusive 10-year leases, as was done recently on the North Slope, to resource-rich lands. They deserve commitments they can count on, so 10 or 20 years down the road they don’t feel misled or betrayed and ready to do battle against some of the world’s most powerful corporations.

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How does SB 209 accomplish this? First, Ms. Sydeman said it requires bidders for an oil and gas lease to submit a plan of exploration or, if appropriate, a plan of development for areas it seeks to lease prior to submitting a formal bid. The plan could outline seismic work that will be performed or exploration wells that will be drilled. Actual production commitments would not, of course, be required if the tracts have yet to be adequately explored.

Secondly, the bill requires the commissioner to review each bidder’s plan to determine if it is “reasonably expected to

develop the lease in the best interest of the state." A company may not be qualified to bid if the commissioner finds it has submitted a plan that is not in the state's best interest or the bidder is not "reasonably capable" of implementing the plan. While this "best interest" finding sounds vague and subjective, this terminology is used frequently in Alaska law and governs many state procedures. It appears 131 times in state statute and is used to determine what actions the state should take as well as to select among bidders and competing proposals.

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Thirdly, she said SB 209 requires that these plans be included in leases and requires DNR to review leases annually to ensure that plans are being implemented. It allows the commissioner to waive a work commitment if conditions preventing drilling or exploration were beyond the lessee's reasonable ability to foresee or control. It also allows for a waiver if the lessee demonstrates through good faith efforts an intent to drill or develop the lease in the following two years.

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Under existing statutes, Ms. Sydeman explained, DNR has the option of including a minimum work commitment in a lease, along with penalties if the lessee does not fulfill the commitment. This bill simply requires that work commitments, developed by bidders and approved by the state, be part of all future leases.

3:45:09 PM
Fourth, Ms. Sydeman said, SB 209 also requires DNR to analyze the economics of each "participating area" (a unitized reservoir where sustained production is occurring) every five years to determine whether the area is capable of increased production. There are 42 "participating areas" in Alaska. They are within the Badami, Colville River, Duck Island, Kuparuk, Milne Point, Nikaitchuq, Northstar, Oooguruk, and Prudhoe Bay units.

MS. SYDEMAN said knowing whether a prospect is reasonably economic matters, and the state currently lacks this knowledge. It determines what lessees obligations are under contracts they have willingly signed. The following is language from new oil and gas leases (Form DOG 200204) which speaks to lessees' obligations to develop:

> 13 (b): Upon discovery of oil or gas on the leased area in quantities that would appear to a reasonable and prudent operator to be sufficient to recover ordinary costs of drilling, completing, and producing

> an additional well in the same geologic structure at another location with a reasonable profit to the operator, the lessee must drill those wells as a reasonable and prudent operator would drill, having due regard for the interest of the state as well as the interest of the lessees.

3:46:45 PM
SENATOR FRENCH asked if she had any idea what a reasonable profit is.

MS. SYDEMAN replied that an oil and gas attorney would be on the phone later and he would be able to better answer that. She continued that language in old leases (referred to as DL-1 leases) addresses the same obligations as follows:

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

3:47:44 PM
As this contractual language makes explicitly clear, knowing whether a particular prospect is economic is key to enforcing the binding terms of leases Alaska has signed with its partners in the oil and gas industry. The economic data the state has today is limited, but indicates that Alaska remains a highly profitable place to do business. Net income per BOE is nearly double in Alaska what it is elsewhere, at least for ConocoPhillips. She provided a slide of ConocoPhillips' SEC filings indicating that the average net income in Alaska is $15.10 per barrel and in the Lower 48 it's $8.79; internationally it's $8.57.

3:48:25 PM
CO-CHAIR PASKVAN commented that the Department of Law (DOL) is analyzing SB 209 and offered to comment on it next week.

MS. SYDEMAN said they also know that two of Alaska’s three largest producers have made extraordinary profits in Alaska since ACES passed. BP Alaska's net income was $8.7 billion under ACES (from annual reports filed in UK) and ConocoPhillips has reported $7.8 billion in profits under four years of ACES according to state data.

SENATOR WIELECHOWSKI added that in 2011 ConocoPhillips profits were about $2 billion and BP's were about $2 billion, to add on to those figures.

SENATOR STEVENS asked how those profits compare to anywhere else in the world like Saudi Arabia and the Lower 48.

SENATOR WIELECHOWSKI responded that roughly 13 percent of ConocoPhillips' oil and gas comes from Alaska and from that they have routinely generated anywhere from 28 to 30 percent of their worldwide profits (excluding refining).

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MS. SYDEMAN said they also know that Gaffney Kline, consultants retained by both the administration and legislature, estimated a return of 123 percent when oil was selling at $80 a barrel in Prudhoe Bay.

3:52:30 PM
She said a final provision in SB 209 requires DNR to annually submit a report to the legislature that lists each lease found to be out of compliance and the action taken by the commissioner to bring the lessee back into compliance.

She said the DNR had expressed its view on timely lease development in a variety of public statements. The following statements were made in the context of Point Thomson, but could apply to any lease on which no exploration or development has taken place over an extended period of time:

> The State and the public are primarily interested in timely oil and gas production from State leases. Every year that production is delayed costs the State millions of dollars in unrealized interest on production revenue....(Denial of the proposed plans for the development of the Point Thomson Unit, page 18)

3:53:48 PM
Another statement:

> It is not in the public interest to grant a state lessee an indefinite extension on development merely because development in their view is not currently profitable enough or is too risky. (Denial of the proposed plans for the development of the Point Thomson Unit, page 20)

Another statement:

> It is not in the public interest to change leasehold intent by allowing a lessee's parochial interests to supersede the State interest for orderly and reasonably prompt development. (Denial of the proposed plans for the development of the Point Thomson Unit, page 20)

Another statement:

> … delaying timely production also constitutes waste." (Denial of proposed plans for the development of the Point Thomson Unit, page 21)

Another statement:

> One of the state's most significant interests in oil and gas leasing is production. The interest is realized by compliance with the terms of the oil and gas leases....(DNR Commissioner decision on appeal from DNR oil and gas Director's October 27, 2005 decision on the 22nd PTU POD, page 15)

3:54:31 PM
Another statement:

> The unitization scheme is intended to cause state leases to be developed efficiently. It is not intended to allow lessees to simply hold oil and gas leases indefinitely until such time as the probable profit from a project meets their subjective and internal expectations or the state agrees to modify its royalty or other contract rights or the state's right to collect taxes. (DNR Commissioner decision on appeal from DNR oil and gas Director's October 27, 2005 decision on the 22nd PTU POD, page 17)

3:55:07 PM
MS. SYDEMAN said the last slide was of particular interest in light of statements made by ConocoPhillips' Exploration Manager Michael Faust following Conoco's successful acquisition of 35 North Slope tracts this past December. Mr. Faust said that exploration funding would depend in part on whether changes are made to the state's ACES production tax. He said, "One of the things that certainly weighs into that decision is the fiscal

regime in Alaska." (Michael Faust, Petroleum News, December 8, 2011)

She said the sponsor believes this is an inappropriate approach to the development of leased state lands and violates the terms of leases ConocoPhillips has signed.

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A DNR statement:

> The state oil and gas leasing system is not intended to require DNR to engage in a murky subjective contest about a Lessees' internal economics, development risk, or view of the difficult of developing the unit. One of the state's primary interests is production. If production is not the plan, the state's remedy is to terminate the unit and find another means to develop the unit." (DNR Commissioner decision on appeal from DNR oil and gas Director's October 27, 2005 decision on the 22nd PTU POD, pg 17)

3:56:43 PM
And:

> Continuing this 30-year record of non-development and delay of an oil and gas lessee's obligations to develop and produce its oil and gas leases makes a mockery of the statutory, regulatory and contractual protections for the State as owner of the oil and gas estate. (Denial of proposed plans for the development of the Point Thomson Unit, page 21)

MS. SYDEMAN said as the legislature considers strategies to increase oil and gas production, the sponsor believes it's important to review and strengthen the state's leasing laws and commitment to lease enforcement. Changing fiscal terms is not the only way to increase production. As John Minge, the president of BP Exploration Alaska, recently said, "It's not always only about taxes."

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

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

3:58:06 PM
SENATOR STEVENS said it seems often in the end what is understood best are penalties and financial loss. It is a shock to hear that the state receives only $1 a year rent per acre. He asked if the bill addresses that.

SENATOR WIELECHOWSKI replied the bill doesn't have penalties and that he is trying to set up a structure to avoid litigation and penalties, but he was open if the committee decided to change that. He wanted a structure where everything is clear.

He said that Norway has a system that doesn't bid out lands. They do seismic studies and then invite companies to come in and whichever company comes forward with the best development plan that is in the best interests of the country is the one that gets picked. He said he is trying to get more to a system like that with concrete plans up front where they are not fighting with industry. Penalties could be an option but a better approach is to work together and be in alignment.

MS. SYDEMAN added that there are existing penalties for violation of work commitments in statute and this bill doesn't change those.

4:00:07 PM
CRAIG RICHARDS, oil and gas tax attorney with Walker and Levesque, Anchorage, said he was asked to address two points in SB 209 and to broaden the scope of the testimony to explain the duty to develop under American oil and gas law.

His first question posed by SB 209 was should the state modify the terms of its leases to prevent acreage from being held with no present intent to develop. In answering that, he thought through some of the situations where they know warehousing and speculation has occurred in the past in Alaska and the three primary examples are Point Thomson, North Star and Prudhoe Bay.

The North Star story is from the mid-1990s, a situation where Shell, Amerada Hess and Murphy did leases in the early 1980s; they bid not only 1/8 royalty, but the state made a net profit share one of the bidding variables. The average net profit share of those leases was 89 percent. That means that Amerada Hess and

Shell agreed to not only pay 1/8 royalty, but after costs of development and royalty were paid, to then pay 89 percent of the profits to the state.

Those leases went undeveloped when oil prices collapsed in the early 1980s through 1995. The leases were held in defect by the unit agreement. Amerada Hess and Shell ultimately sold them to BP in 1995 and BP took the position that it was profitable to develop the leases, but they weren't going to do so unless the state renegotiated terms. The outcome of BP's position is that the state waived the 89 percent profit in return for a slightly increased royalty, some in-state hiring preferences and the building of some of the modular units in Alaska.

MR. RICHARDS said he brought this up as a microcosm of the debate that is occurring as a whole: where development is economic and profitable, there is a reasonable expectation of profit but the lessee is unwilling to go forward with development because it feels it can gain some advantage through negotiation.

4:03:59 PM
The third classic example of warehousing in Alaska is Prudhoe Bay; it has about 30 tcf and they are currently authorized to take off about 2.7 bcf and 8 bcf/day are being re-injected. But there has been no marketing of that resource.

So they have examples of warehousing and non-development within existing units and the question is what can be done about putting those resources into development without renegotiating tax or royalty terms.

MR. RICHARDS said an important distinction to make in looking at SB 209 is between the primary term and the secondary term of a lease. He said American oil and gas leases are structured pretty much the same way; in the Lower 48 a primary lease is for 1-5 years (it's longer in Alaska). This is where you don't have an obligation to produce from the lease to maintain the estate, but it's about proving up the resource and getting it into production. You lose the leases at the end of the primary term unless oil and gas is being produced in paying quantities. If you have production in paying quantities from a lease or a unit, it stays in effect indefinitely. Then the addendum clause kicks in or the secondary term of the lease.

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SENATOR STEDMAN joined committee.

MR. RICHARDS said SB 209 focuses primarily on how to ensure development during the primary term of leases. The primary term in Lower 48 oil and gas leases might be as short as one year or up to five years or longer. In Alaska, from 1965 through the 1990s all leases had a 10-year primary term. In the 1990s he started seeing seven-year terms and in 2003 to 2009 he saw model DNR lease forms using seven years, as well. He ran across a model form for the Beaufort with a primary term left blank.

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He explained that in the primary term you generally get your lease under development. It's often recognized that speculating (holding a lease without the present intent to develop) on a lease can have some value or be destructive. The reason there isn't mandatory production in the first 5 or 10 years is because it is often good policy on the part of the landowner to give somebody the lease and let them get out there and raise capital and get business partners interested or alternatively to sell it to someone else as a pure speculator that will in turn develop it.

MR. RICHARDS said of course, the natural consequence if the speculation does not work out is that the lease will terminate at the end of the primary term. So, SB 209 removes some of the speculation element by inserting mandatory work commitments. It is very common in the Lower 48 for oil and gas leases to have mandatory work commitments. The downside of having them in a lease is that it might freeze out the role of the speculator in the market place. He went on to explain that speculators provide real liquidity in some markets and as entrepreneurs they do provide some value.

One of his concerns with SB 209 is the high cost of developing Alaska leases; it is difficult to get rigs up here and bonding requirements are high. So the cost of doing business could become compounded with mandatory work commitments if they were very expensive and the net effect of that might be to freeze out some otherwise good speculation. Mr. Richards said he didn't know if speculation was occurring in a positive way in Alaska's oil and gas basins. His intuition was that speculation was occurring in Cook Inlet, but it was harder for him to imagine how the role of the independent speculator on the North Slope could have a lot of value to someone and he suggested doing a study that looks at whether any speculators had historically taken on land with no work commitments and then turned around

and either brought in financiers to drill or alternatively been able to convince another party to take on that activity.

4:10:21 PM
Another thought he had about how to deal with warehousing is to shorten the primary term to a year or two so the problem has less of an impact. Having a dual primary term would be another option where the first one would be for five years and if something hasn't been drilled in five years, then a company has to make a showing of a work commitment to get an approved plan by DNR to get maybe the next five or three years on the primary term. But SB 209 is really aimed at preventing speculation on an ongoing basis and maybe they should focus more on the secondary term after the lease has been through the fixed period of time and is into its indefinite term, because there is either production or an operation.

CO-CHAIR PASKVAN asked what risk a speculator has if they are not able to transfer to an actual developer at the end of the primary term.

MR. RICHARDS replied that reflects the common treatment of oil and gas leases in America. He explained that the landowner can be paid in three ways: the leasing bonus, rental and royalty. As mentioned earlier rentals in state leases are often nominal amounts. The real risk comes in to the bidding entity in forms of paying the leasing bonus which can be small or large depending on the interest that is shown at the auction. A speculator's primary risk is having nothing to show for the leasing bonus.

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Two specific harms the state can suffer from warehousing are one, when unitization is used as a tool to maintain leases that are not in production (Point Thomson is an example of this). A similar thing happened in North Star where the state, rather than terminating the unit agreement at the end of its primary term when no production had occurred essentially allowed an extension and then allowed renegotiation rather than sticking to the terms of the lease directly. So, the state as a matter of policy should not allow unitization as a means to extend the terms of un-producing acreage indefinitely. A subcategory issue (although he didn't know that it had occurred enough in Alaska to be an issue) is where an existing unit is in production and lessees have received permission to attach adjoining leases to it without the actual direct intent that that lease ever be

drilled. That happened a couple of times in Cook Inlet over the last one or two decades.

The second concern the state (and all landowners) should have is when there is production in a unit or on a lease but it isn't being fully developed, a classic oil and gas leasing scenario. For example a landowner in Texas leases his land to an oil company that drills a well that is marginally profitable. As a royalty owner, you want to see a second well drilled some distance away from it so you can produce even more, but the oil company doesn't want to. Because they have this one well, under the addendum clause their lease will remain in effect indefinitely and will never be cancelled, and the owner will never see additional royalty because the oil company isn't willing to undertake a second well.

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MR. RICHARDS said this is a classic example that led the courts to develop "implied covenants" that are obligations that an oil or gas lessor has to an oil and gas lessee once production has commenced. This is the same sort of argument the state would make if it was upset about the lack of development in Prudhoe Bay, for instance. Traditionally, a state would go to court to prove that it would be profitable to undertake project X.

SENATOR STEVENS asked the possible value of speculators who just want to hold a lease and turn it over to somebody else at a profit. What is he missing when Mr. Richards says "good speculator."

MR. RICHARDS asked him to imagine a more dynamic and smaller marketplace - like Texas where one county might have 2000 different land owners that all want to get somebody to drill a well. They can't go hold a big lease sale that gets every oil company in the world going over their financials; so they might find a speculator who puts the deal together and gets the financing. The speculator performs a very fluid function in that situation; he could be called a market maker and that certainly can have value. In the context of Cook Inlet, there might be some circumstances where individuals are taking on leases and trying to get capital and bring up drill rigs when they can't commit to do it. He said he wasn't familiar enough with what was occurring in Cook Inlet to say whether not that was the case.

SENATOR STEVENS asked him how speculators might operate in Prudhoe Bay.

MR. RICHARDS replied that he couldn't think of a way speculation would be beneficial on the North Slope just because the cost of putting a project together would be so high; the skill sets needed would be high as well. But he cautioned people to do their homework before passing legislation to disallow it.

CO-CHAIR PASKVAN asked him to restate what duties developed out of the implied covenant doctrine.

MR. RICHARDS answered that the implied covenant doctrine serves several purposes in oil and gas leases, but the relevant one here is they provide a mechanism for the landowner to be able to force development when a lease is under production and can't otherwise be terminated. That is the express purpose of the covenants.

Section 804 of Wayman Meyers (the leading treatise on oil and gas) says:

> An oil company has a duty to reasonably develop a producing lease. That means that operators have a legal obligation to drill known and producing formations. They have a duty to explore further, which means they must drill past wells and non-producing but potentially productive formations. They have a duty to market, which means that they have an obligation to exercise diligence in selling oil and gas from the lease and they have a duty to conduct with reasonable care and due diligence all operations on the leasehold that affect the lessor's royalty interest.

He explained that this is a catch-all provision that stands for various propositions such that you must develop a lease reasonably and not damage the reservoir; you can't prematurely abandon a lease; you must use advanced technologies in production; and that you have a legal obligation to seek regulatory approvals.

MR. RICHARDS said that different states and treaties might state the obligations of implied covenants differently, but he didn't think there was much dispute that they exist in all leases in all states in some form. Alaska's Supreme Court, although they have not addressed them specifically, has said they exist in a footnote of one of its decisions on Alaska's leases.

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So, what do those implied covenants mean? Mr. Richards said these issues first came up about 100 years ago when the courts began to recognize that oil companies can act opportunistically towards the royalty interest owners, and they might do what is in their best interests and not the landholder's best interests. One of the first things they wrestled with was the standard of care or the implied obligation that an oil company owes a landowner. Some of the early cases said that an oil company just must exercise standard business judgment for a lessee's perspective (basically, all an oil company has to do is behave in a way that is sound business from the oil company's perspective). This standard was uniformly rejected because it didn't protect the landowner's interest enough.

Some of the early cases said that an oil company must act as a fiduciary towards the landowner and that they must act in the landowner's best interests. That was also pretty widely rejected as going too far the other way. Virtually every jurisdiction, with a few exceptions, developed the standard of care that is called "the prudent operator standard" and quoted again from William Meyers, Section 806.3 as follows:

> The prudent operator is a reasonable man engaged in oil and gas operations. He's a hypothetical oil operator who does what he ought to do, not what he ought not to do with respect to operations on a leasehold. Since the standard of conduct is objective, a defendant cannot justify his act or omission [sic] on personal grounds or by reference to his peculiar circumstances. It is no excuse the defendant failed to drill the offset well a prudent operator would have drilled because the defendant is short of cash or over committing on drilling programs, has no need for more production, or prefers to spend his money on other things. In short, the question is not what was proper for the defendant to do given his peculiar circumstances, but what a hypothetical operator acting reasonably would have done given the circumstances generally obtained in the locality.

This means that the oil company owes a standard of care to the landowner to behave as a reasonably prudent oil and gas company would, and that's the standard at which actions to further develop are measured. He said a subset of that requirement that case law is also extremely clear on is that a reasonably prudent operator undertakes all development activities for which there is a reasonable expectation of profit. A reasonable expectation

of profit in modern cases and in academic literature is pretty uniformly understood to mean that there is a positive net present value on the project (well, new development field, marketing gas et cetera) and there is an obligation to undertake it so that the royalty owner can receive his royalty interest.

4:26:29 PM
SENATOR FRENCH said he is familiar with Point Thomson where there is no development whatsoever, a foot-dragging oil company and some pressure from the landowner to get things going, but he asked him for examples of producing leases where there is an allegation of insufficient investment or something along those lines. He also was interested in any case law that further defines reasonable profit.

MR. RICHARDS responded that Amanda Cohen with the Alaska Dispatch asked him a similar question and he dug out a few law review articles on that topic and he would forward those.

SENATOR WIELECHOWSKI said he thought he heard that a reasonable expectation of profit is whether the project would have a positive net present value.

MR. RICHARDS answered that was accurate in general.

SENATOR WIELECHOWSKI said from the state's perspective in determining whether or not the state's leases are being adhered to the first thing they would want to check for is a positive net present value.

MR. RICHARDS agreed and said one of the things he liked about SB 209 was the idea of DNR having a mandatory obligation every few years to run economic analysis on non-developed pools within existing units and gas development in units that are producing oil but gas has not been brought to market.

SENATOR WIELECHOWSKI said one of the big arguments they hear over and over again is that Alaska is not competitive and asked Mr. Richards if he believed that statement and philosophy was in compliance with Alaska's leases.

4:29:12 PM
MR. RICHARDS replied no. Alaska has the right to have its resources developed if the lessee has a reasonable expectation of profit and development. The reason he read the quote from the BP president about North Star is because he finds that entire discussion to be a microcosm of what is occurring right now on

the North Slope where projects will be profitable but they are refusing to develop until tax concessions are made that makes them more profitable. If he were in charge of DNR, he wouldn't tolerate that.

4:30:12 PM
He concluded that the state shouldn't be trying to address declining oil production solely through the rubric of tax incentives. Reducing taxes is not the only rational and available policy means by which to get increased production. Yet that seems to be what the debate is focused on.

First, Mr. Richards said the state should be focused on removing competitive barriers to entry to independent producers; and it should disallow warehousing, speculation and non-development in producing leases when the operator has an expectation of profit. Some of the ways it can do that (that are in SB 209) are to mandate that DNR do economic analyses of non-producing pools and gas that haven't been developed on a periodic basis.

Second, he said while the bill has an obligation for a unit operator to submit a plan of development/exploration/operation, there is no requirement to submit a plan of marketing. The thing that would break the logjam on North Slope gas more than any other item would be if the state mandated on an annual basis detailed reports (any conversation they had, every conservation they intend to have with any potential market participant including, for instance, Japan and the Asian market) of all efforts made demonstrating that the Prudhoe Bay lessees had acted with due diligence to find a market for that resource. That concluded his remarks.

CO-CHAIR PASKVAN found no questions and said SB 209 would be held in committee.

SB 215-GASLINE DEV. CORP: IN-STATE GAS PIPELINE

4:32:35 PM
CO-CHAIR PASKVAN announced consideration of SB 215.

4:32:38 PM
SENATOR JOE THOMAS, sponsor of SB 215, said the route in SB 215 has been studied by Enstar, ANGDA, the ASAP pipeline and others. It is nothing new. It is the southern route using the Parks Highway, which is the route preferred by Enstar and the Alaska Gasline Development Corporation (AGDC) and it could be reconfigured to serve the AGIA line if it ever went to Valdez.

Last week, Buccaneer and Furie indicated that a line going to the Interior would be good for the market and that it is also the shortest route. It also has the shortest timeline and probably the most reasonable cost.

He said that the Resources Committee knows exactly what is going on in the state with gas and this southern portion would dramatically increase the opportunity for gas exploration and development in the Interior basins some of which have been explored for decades. There is a fair amount of potential, but no way to move the gas. This route would also reduce costs for natural resource development in Southcentral, and the Upper Kuskokwim and Interior regions of the state.

SENATOR THOMAS said the Donlin Creek Mine is planning on building a pipeline which would almost parallel this one and there is some potential for a partnership there even though their line would veer to the west at some point. There is also great potential in the Interior with the new International Tower Hills Mine. If the gas does prove up in the Cook Inlet, it would only make sense to build at least the southern portion of the line.

4:35:45 PM
JOE DUBLER, Vice President and CEO, Alaska Gasline Development Corporation (AGDC), said he prepared a precursor to a fiscal note, a rough thumbnail shot at what the cost would be on SB 215. He said Black and Vetch provided a very sophisticated tariff model that cost $50,000 to run. For it he estimated the capital expenditures that a tariff would support in two different scenarios. One was just the tariff and the other was tariff plus the gas. It compared Cook Inlet to Fairbanks route (southern) and the North Slope to Fairbanks route. The North Slope to Fairbanks numbers came from their July 1 report as did the southern route numbers to make it easy for the readers to determine what costs went towards which tariffs and which destinations.

For the tariff in the first column they used the estimated costs from the North Slope to the Fairbanks City Gate (including the lateral from the main line and the straddle plant) and came up with $6.45 (not including the estimated cost of gas at $2 or the estimated $2 distribution cost).

4:38:28 PM
SENATOR FRENCH asked why they used that number and if it would be the same amount going south to north.

MR. DUBLER replied that they were trying to come up with an estimated CAPEX that could be supported by that tariff.

CO-CHAIR PASKVAN said he understood that the tariff in the ASAP report to Fairbanks was $10.80 and asked he came up with $6.45.

MR. DUBLER responded that adding the $2 cost of gas on the North Slope and the $2 distribution cost in the Fairbanks area to the $6.45 gets you $10.45. Then they figured an average 60 mmcf/d and number of days per year (adding a quarter of day for leap years) and came up with an allowable cost recovery per year of $141,351,750 and when that is multiplied by 20 years you get a CAPEX of $2.827 billion.

The bottom of the spreadsheet showed the pipeline would cost $1.565 billion to build from Big Lake to Dunbar. The report had $1.999 billion but he backed out the Cook Inlet NGL extraction plant because that didn't belong there and some compression station costs.

CO-CHAIR PASKVAN said he thought the fractionation plant in the ASAP report was $954 million by itself.

MR. DUBLER replied he got those numbers from page 5-35 of the report; and the Cook Inlet NGL extraction facility was $410 million.

CO-CHAIR PASKVAN said something at the southern end of the line was $954 million.

MR. DUBLER said he would help him figure it out.

SENATOR WIELECHOWSKI asked if the gas is different coming from Cook Inlet such that it doesn’t have to be processed in the same way gas from the North Slope does.

MR. DUBLER replied yes; that is why the North Slope facility (to extract H_2S, H_2O and CO_2 at a cost of $1.840 billion) is not included in any of these costs.

SENATOR STEDMAN said he found the spreadsheet a little confusing and asked if it compares two alternatives why a conditioning plant wouldn't be included on the North Slope if one was needed.

MR. DUBLER replied that the conditioning plant is included in the $6.45 number going from the North Slope down, but the

conditioning facility isn't relevant on the Big Lake to Dunbar route.

4:43:14 PM
SENATOR WIELECHOWSKI asked what the equivalent tariff would be to build a line from Cook Inlet to Fairbanks.

MR. DUBLER replied that he didn't run that number, but he had converted tariffs to CAPEX for comparison. He offered to pay the consultant to do another run if that's what the committee wanted.

4:43:57 PM
CO-CHAIR PASKVAN said he was looking for the tariff figure to the Big Lake area.

MR. DUBLER said the total tariff at Big Lake was $5.63 and he didn't include the straddle plant in Fairbanks and the lateral line.

CO-CHAIR PASKVAN asked the tariff between Big Lake and Dunbar.

MR. DUBLER replied the capital cost for a pipeline from Dunbar to Big Lake is $1.99 billion and he didn't have the tariff for that number handy, but said he would get it.

4:48:11 PM
MR. DUBLER said page 3-10 of the report had the estimated tariff build up case with no inflation: the gas conditioning facility was $1.42, the pipeline from the North Slope to Dunbar was $2.56, and the pipeline from Dunbar to Big Lake was $1.65. These equal the $5.63.

CO-CHAIR PASKVAN said he assumed the tariff from Big Lake to Interior Alaska would be the same under either pipeline.

MR. DUBLER replied that is not a valid assumption; many things go into a tariff and capital expenditures is only one. His spreadsheet showed that it's $412 million cheaper to run from south to north, because you don't have the straddle plant, an off-take facility or the conditioning on the North Slope. Throughput on the line is another consideration. Gas going south is 500 mmcf/d and on gas going north is only 60 mmcf/d. While the numerator gets smaller, the denominator gets a lot smaller; so, the tariff gets bigger.

CO-CHAIR PASKVAN asked if the ASAP tariff of $1.60 and the tariff from Big Lake to Dunbar of $1.65 was accurate (on page 3-10).

MR. DUBLIER replied that was correct.

4:50:34 PM
SENATOR FRENCH asked how big of a pipe is needed to carry 60 mmcf/d.

MR. DUBLER replied their engineers estimated getting by with 12 inches and maybe smaller. The issue with the wording in SB 215 is that they are prebuilding for an in-state line so it would have to be bigger and more expensive.

SENATOR STEDMAN said the spreadsheet is hard to follow and he wanted more footnotes or explanations.

MR. DUBLER replied this is just a brief shot at coming up with a thumbnail sketch of where they are. He asked for a few more minutes to explain the rest of the spreadsheet.

4:52:48 PM
CO-CHAIR PASKVAN said they wanted him to do that, but the point is that at 24 inches this line going from Cook Inlet north could operate as the lateral serving Southcentral if there ever is a 48-inch line that would go to Valdez and if Cook Inlet goes dry in the future. Otherwise the line could be smaller.

MR. DUBLER said he was correct.

He continued the report's listing of costs: $1.565 billion for the pipeline less the noted deductions; $60 million for the lateral line; $80 million for a Cook Inlet compressor station (less than the $140 million compressor station for the 24-inch, 2500 psi line).

Going from south to north with a smaller volume of gas instead of going from the North Slope south (where the 500 mmcf is chilled to well below freezing so it doesn't melt the permafrost) they had to add a chilling unit at Cantwell (the limit where engineers estimated the permafrost would begin) for a cost of $20 million; annual operating costs were estimated at $690 million over the 20 year term (roughly 2 percent of CAPEX); that was a total cost of $2.4 billion (south to north). Compared to the estimated $2.8 billion for the north to south route, it's $412 million cheaper.

4:55:26 PM
CO-CHAIR PASKVAN asked if the $954 million for the fractionation plant was included in the 2 percent annual CAPEX for the ASAP project.

MR. DUBLER replied no; a fractionation plant would process the liquids in Cook Inlet; it would be built by a third party and would not be included in the cost of this project. It would be at Big Lake closer to the pipeline.

CO-CHAIR PASKVAN asked if there would be no liquids shipped out of the Cook Inlet facility under the ASAP project.

MR. DUBLER replied that was correct and it would alleviate the need for a straddle plant in Fairbanks.

4:57:17 PM
SENATOR STEDMAN asked if the $6.45 tariff includes the gas processing plant on the North Slope.

MR. DUBLER replied yes. He estimated the total capital costs to be recovered through the tariff at $2.8 billion (North Slope to Fairbanks including a pro-rata portion of the processing plant).

SENATOR STEDMAN asked if the $2.8 billion line goes just to Fairbanks and where the line goes south stops in his analysis.

MR. DUBLER replied the $2.8 billion is just for the North Slope to Fairbanks' "city gate" and all the facilities in between. That includes the processing plant on the North Slope, the pipeline from North Slope to Dunbar and the straddle plant at Dunbar to take the liquids off and re-inject them in the main line that runs into Fairbanks.

SENATOR STEDMAN said it would be nice to see a summary so they could understand it two months from now.

MR. DUBLER said he would do that in the coming days.

CO-CHAIR PASKVAN said Mr. Dubler had been very busy and they appreciated him putting this presentation together, but the committee needed more information in a clearer format.

[SB 215 was held in committee.]
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5:01:07 PM

Finding no further business to come before the committee Co-Chair Paskvan adjourned the Senate Resources Standing Committee meeting at 5:01 p.m.