

**HOUSE  
COMMITTEE REPORT**

(11)

Date referred: 4/21/86

FURTHER REFERRALS:

DATE: 5-5-86

The FINANCE Committee has considered CSSSSB 430(R1s)

"An Act relating to reduction or revocation by the commissioner of the Department of Natural Resources of oil or gas royalty obligation increases made in connection with the institution or operation of a cooperative or unit plan; and providing for an effective date."

and recommends:

- do pass
- do not pass
- do pass with attached amendment(s)
- no recommendation
- replace with HCS CSSS SB 430 (RES)  same title  
 new title

and recommends no recommendation

further referral to the \_\_\_\_\_ Committee

- and attaches:
- letter of intent
  - first fiscal note
  - new fiscal note
  - zero fiscal note

SIGNING DO PASS:

Albert H. Gehr  
John P. ...  
Steve ...  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

SIGNING OTHER RECOMMENDATIONS:

John P. ... - NO REC -  
Mike ... - NO REC -  
John ... - NO REC -  
Ronald ... - NO REC -  
Pat ... - NO REC -  
Neil ... (NO REC)  
Mark ... NO REC  
John ... NO REC  
Jim ... NO REC  
Albert H. Gehr

Chairman

# STATE OF ALASKA 1986 LEGISLATIVE SESSION FISCAL NOTE

Revision Date : 5-1-86

**REQUEST**

Bill/Resolution No. : CSSSSB 430 (RES)  
 Title : Revoke/Reduce Royalty Increase  
 \_\_\_\_\_  
 Sponsor : Senator Fahrenkamp  
 Requestor : House Finance  
 Date of Request : 4-28-86

**FISCAL DETAIL**

Agency Affected : Natural Resources  
 BRU : Petroleum Management  
 \_\_\_\_\_  
 Components : \_\_\_\_\_  
 \_\_\_\_\_

**EXPENDITURES/REVENUES : (Thousands of Dollars)**

OPERATING	FY 86	FY 87	FY 88	FY 89	FY 90	FY 91
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
<b>TOTAL OPERATING</b>						

CAPITAL						
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REVENUE	(34.0)*	(404.0)*	(370.0)*	(328.0)*	(285.0)*	(258.0)*
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**FUNDING : (Thousands of Dollars)**

GENERAL FUND						
FEDERAL FUNDS						
OTHER						
<b>TOTAL</b>						

**POSITIONS :**

FULL-TIME						
PART-TIME						
TEMPORARY						

**ANALYSIS :** Attach a separate page if necessary

Prepared by : Kay Brown *[Signature]* Phone : 762-4241  
 Division : Oil and Gas Date : 5-1-86

Approved by Commissioner : William D. Zimmler Date : 5/1/86  
 Agency : Natural Resources

Distribution (by Agency preparing fiscal note):

- Legislative Finance
- Legislative Sponsor
- Requestor
- Office of Management and Budget
- Impacted Agency(ies)

CSSSSB 430(RLS)  
Fiscal Note Analysis

\*This revision, requested by the House Finance Committee, is necessary to incorporate a wellhead oil price of \$1 per barrel (versus \$5.45 per barrel) to reflect further deterioration in crude oil prices that has occurred recently. The revision also displays the numbers by fiscal year, rather than by calendar year.

The projected \$1 per barrel wellhead value reflects a West Coast sales price of about \$12 per barrel, and is based on Conoco's estimated costs and sales prices in the month of April, 1986.

The losses shown assume a royalty reduction from 20 percent to 12½ percent for leases in the Milne Point Unit that currently have a 20 percent royalty. This would affect 82 percent of Milne Point Unit production. The remaining 18 percent of production comes from leases that already have a 12½ percent royalty.

Without a royalty reduction it is likely that production from the unit will be shut in if crude prices remain at current levels for an extended period. A royalty reduction would provide an incentive to eventually develop and produce additional oil reserves (the "Shallow Sands") in the unit area.

It is assumed that a royalty reduction would take effect June 1, 1986. The FY86 figure reflects a single month effect.

Offered: 4/21/86  
Referred: Finance

Original sponsor: Fahrenkamp

1 IN THE SENATE BY THE RESOURCES COMMITTEE  
2 HOUSE CS FOR CS FOR SPONSOR SUBSTITUTE FOR SENATE BILL NO. 430 (Resources)  
3 IN THE LEGISLATURE OF THE STATE OF ALASKA  
4 FOURTEENTH LEGISLATURE - SECOND SESSION

5 A BILL

6 For an Act entitled: "An Act relating to the reduction or revocation by  
7 the commissioner of the Department of Natural Re-  
8 sources of oil or gas royalty obligation increases  
9 made in connection with the institution or operation  
10 of a cooperative or unit plan; and providing for an  
11 effective date."

12 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

13 \* Section 1. AS 38.05.180(p) is amended to read:

14 (p) To conserve the natural resources of all or a part of an oil  
15 or gas pool, field, or like area, the lessees and their representa-  
16 tives may unite with each other, or jointly or separately with others,  
17 in collectively adopting or operating under a cooperative or a unit  
18 plan of development or operation of the pool, field, or like area, or  
19 a part of it, when determined and certified by the commissioner to be  
20 necessary or advisable in the public interest. The commissioner may,  
21 with the consent of the holders of leases involved, establish, change,  
22 or revoke drilling, producing, and royalty requirements of the leases  
23 and adopt regulations with reference to the leases, with like consent  
24 on the part of the lessees, in connection with the institution and  
25 operation of a cooperative or unit plan as the commissioner determines  
26 necessary or proper to secure the proper protection of the public  
27 interest. The commissioner may require oil and gas leases issued  
28 under this section to contain a provision requiring the lessee to  
29 operate under a reasonable cooperative or unit plan, and may prescribe

1 a plan under which the lessee must operate. The plan must adequately  
2 protect all parties in interest, including the state. Notwithstanding  
3 (j) of this section, the commissioner may reduce or revoke a royalty  
4 obligation increase that was made by the commissioner in connection  
5 with the institution or operation of a cooperative or unit plan, if  
6 the commissioner determines that the public interest warrants the  
7 reduction or revocation. If the commissioner reduces or revokes a  
8 royalty obligation increase, the commissioner shall include a mecha-  
9 nism to raise the royalty to a level not exceeding its former level in  
10 the event that the lessee's market conditions improve or if the  
11 profitability of a lessee's operation increases to a specified level.  
12 As a condition of the reduction or revocation of a royalty obligation,  
13 the commissioner shall require the lessee to comply with all valid and  
14 applicable laws and regulations of the state

15 (1) that concern the hiring of state residents; and  
16 (2) that are in effect or take effect during the term of  
17 the lease.

18 \* Sec. 2. This Act takes effect immediately in accordance with AS 01.-  
19 10.070(c).

NORTH SLOPE PRODUCTION AND THE ELF

<u>FIELD</u>	<u>PRUDHOE BAY</u>	<u>KUPARUK</u>	<u>MILNE POINT</u>	<u>LISBURNE</u>
Wellhead price at which field becomes sensitive to ELF	\$1.30 or less/bbl	\$3.67 or less/bbl (PEL = 300 at 3.61 WH)	\$4.86 or less/bbl (PEL = 300 at \$4.85 WH)	\$4.91 or less/bbl (PEL = 300 at \$4.90 WH)
Sales price/value at which ELF reaches .7				
West Coast Gulf	7.05 WC 9.55 Gulf	Approx 10.62 WC 13.12 Gulf	Approx 13.72 WC 16.22 Gulf	Approx 10.66 WC 13.16 Gulf
Sales price/value at which ELF reaches 0	Below \$1.00 at WH	Below \$1.20 at WH	Below \$1.50 at WH	Below \$1.50 at WH
West coast Gulf	6.75 WC 9.25 Gulf	8.15 WC 10.65 Gulf	10.36 WC 12.86 Gulf	7.25 WC 9.75 Gulf
Basis for calculation of current direct operating costs (PEL)	300 bbls/day	300 bbls/day	300 bbls/day	300 bbls/day
Time period for filing PEL adjustment hearing request	Before Feb. 15, 1987	Before Feb. 15, 1987	(1) Within first 6 months of production (by May 2, 1986)  (or) (2) by Feb. 15, 1987	(1) Within first 6 months of production (Scheduled to begin Dec. 1986 or Jan. 1987)  (or) (2) Feb. 15, 1987, whichever is later
Time period when new ELF would apply	1987	1987	(1) Retroactive to beginning of production  (or) (2) 1987, depending on time of request	(1) Retroactive to beginning of production  (or) (2) 1987
Percentage of North Slope production:				
w/o Lisburne	85.3%	13.6%	1.1%	N/A
with Lisburne	83.6%	13.3%	1.1%	2.0%
Percentage of expected severance tax for FY 87 (based on March forecast) and dollar value	92% \$708.9 million	6% \$46.2 million	1% \$7.7 million	1% \$7.7 million
Percentage of expected severance tax for FY 88 (based on March forecast) and dollar value	89.4% \$476.5 million	7.1% \$37.8 million	1.3% \$6.9 million	2.2% \$11.7 million

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# STATE OF ALASKA 1986 LEGISLATIVE SESSION FISCAL NOTE

Revision Date : 03-21-86

**REQUEST**

Bill/Resolution No. H CSSSSB 430 (RPs)  
 Title : Revoke/Reduce Royalty Increase  
 \_\_\_\_\_  
 \_\_\_\_\_  
 Sponsor : Fahrenkamp  
 Requestor : Senate Finance  
 Date of Request : 03-21-86

**FISCAL DETAIL**

Agency Affected : Natural Resources  
 BRU : Petroleum Management  
 \_\_\_\_\_  
 \_\_\_\_\_  
 Components : \_\_\_\_\_  
 \_\_\_\_\_

**EXPENDITURES/REVENUES : (Thousands of Dollars)**

OPERATING	FY 86	FY 87	FY 88	FY 89	FY 90	FY 91
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
<b>TOTAL OPERATING</b>	-0-	-0-	-0-	-0-	-0-	-0-
<b>CAPITAL</b>						
<b>REVENUE</b>	(2260.0)	(2150.0)	(1900.0)	(1660.0)	(1460.0)	

**FUNDING : (Thousands of Dollars)**

GENERAL FUND						
FEDERAL FUNDS						
OTHER						
<b>TOTAL</b>						

**POSITIONS :**

FULL-TIME						
PART-TIME						
TEMPORARY						

**ANALYSIS :** Attach a separate page if necessary

See Attached Explanation

Revenue reduction figures are based on a calendar year, not a fiscal year.

Prepared by : Kay Brown Phone : 762-4241  
 Division : Oil and Gas Date : 03-21-86

Approved by Commissioner : *Wm D. Ammel, Deputy* Date : 03-21-86  
 Agency : Natural Resources

Distribution (by Agency preparing fiscal note):

- Legislative Finance
- Legislative Sponsor
- Requestor
- Office of Management and Budget
- Impacted Agency(ies)

Attachment Fiscal Note for SSSB 430

This amended fiscal note is necessary because CONOCO last week revised downward their projected rate of production. This fiscal impact (Revenue) is estimated on the basis of several assumptions:

... The bill would affect only Milne Point unit production;

... Milne Point Unit production at:

1986	18,500 bpd
1987	17,600 bpd
1988	15,500 bpd
1989	13,600 bpd
1990	11,900 bpd

... Royalty reduction from 20% to 12.5% under SSSB 430;

... Wellhead price is assumed to be \$5.45/barrel

HOUSE FINANCE COMMITTEE  
May 1, 1986

Chairman  
Adams:

The last bill we have before us today is Senate Bill 430. We have had that one up in the past. We are supposed to have a new fiscal note on that. Okay, I think you all have the new fiscal note in here. There should be a new fiscal note in here somewhere.

Unknown:

Yeah, it's in here.

Cotten:

The one dated 4/30/86. Yes, you do have one that's before you and we have to explain the fiscal note. We just received this. I understand there are some errors in this one. Was anybody here. You, sir?

Van Dyke:

My name is Bill Van Dyke. I work for the Department of Natural Resources. The fiscal note passed out this morning dated 4/30/86 in the bottom right-hand corner. The decimal point on the revenue line needs to be moved one point to the left, so the fiscal impact is smaller than what is shown on the bill.

Cotten:

So what we're doing here, instead of 340,000, let's start with FY 86, it should be 34,000 and do that for each year. So just move it over.

Van Dyke:

This fiscal note was prepared at the request of the Committee. It reflects fiscal impact of the well-head value at Milne Point was \$1 per barrel. The previous fiscal note had been prepared at a \$5.45 well-head value. We will prepare a revised fiscal note with [indiscernible].

Chairman:

When will you prepare that revised fiscal note?

Van Dyke:

We'll prepare that this afternoon.

Chairman:

Representative Cotten?

Cotten:

I didn't really have anything else. That's, I think, that the director testified that the well-head value was approximately \$1 today and that was why we wanted to see a fiscal note that reflected current levels.

Van Dyke:

At Conoco we haven't seen the April well-head values because the reports haven't been filed yet; but we believe the estimate is about \$1 for the month of April.

Cotten: The only other question I have, another question for Conoco and for the Department of Revenue.

Chairman: Does anybody have any questions regarding the fiscal note that the Department of Revenue has submitted to the Committee. Thank you, sir.

Van Dyke: Thank you, Mr. Chairman.

Chairman: Representative Cotten, your request.

Cotten: The Department of Revenue folks.

Chairman: Vince, whoever, come on up. Both of you.

Monkman: Thank you Mr. Chairman.

Chairman: Would you both state your name for the record please.

Monkman: My name is Dick Monkman. I am the deputy commissioner for taxation for the Department of Revenue. Vince.

Wright: I'm Vincent Wright, chief of research for the Department of Revenue.

Chairman: Go ahead with your testimony please.

Monkman: Our testimony is fairly brief. We have been requested to come before the Committee by Representative Cotten to address the issue of severance taxes on the Milne Point lease properties. It's, I think, generally assumed that the severance taxes, that is the one-time tax for the removal of a non-renewable resource, oil, has a fixed floor of \$.80 per barrel. In fact, the severance tax floor is more like a trap door because it's multiplied against the economic limit factor, the elf factor. The elf factor is commonly assumed to be a factor which is multiplied against a tax liability to encourage production from the depleting oil fields, that is, to encourage oil companies to continue to pump oil even as the costs rise because the volume of oil is running low. The way the statute works though, the elf factor also comes into play when the price declines on oil and with the present price decline, we are seeing that the economic limit factor has a potential of cutting severance taxes from Milne Point as well as, potentially, some of the other fields on the North Slope. As it happens, as you know, I'm sure the Committee members know, we are limited in what we can tell the Committee as to the particulars of

any taxpayers income tax returns or any particulars of their business which are disclosed in their income taxes; however, the Attorney General's office has assured me that we are permitted to tell you that the producers of oil at Milne Point have come in and requested hearings under the statute to apply the economic limit factor to their production of oil at Milne Point. The office of Management and Budget has estimated, and Mr. Erickson is here today, that should the producers come in and make their case that the economic limit factor should be applied at present prices, the fiscal impact on the severance taxes will be about \$11 million over the next twelve months. Basically if the well-head price is \$1, as we just heard and that's the first time I have heard that, the economic limit factor is going to be zero. There will be no severance taxes from Milne Point on the oil that is produced there. They can produce full tilt. They will not be paying any severance taxes if that is the case as we just heard. I did give Representative Cotten a chart yesterday. I don't know if that has been passed out to the members of the Committee; however, I brought some extra copies just in case. This is a chart which was actually prepared originally, and then checked by our people, but prepared by Mary Halloran who works for Representative Grussendorf, using figures which come from the trade press, estimates of production costs, estimates of severance tax liability of when the elf would impact on the various fields. The elf is a fairly complicated formula but to simplify matters we have gone over this chart and I think it will give the Committee a rough idea of what happens as oil prices decline. The first line is the well-head price at where the field becomes sensitive to the economic limit factor. That is until the well-head price reaches these levels, the economic limit factor is not applied. As you can see under Milne Point, the economic limit factor starts applying at about \$4.86 a well-head price. We've heard today that the price is \$1, so it's obvious that it would be applying there. For Kuparuk it's \$3.67 or less a barrel; for Prudhoe Bay it's \$1.30 a barrel. The difference in these prices is because of the difference in the cost of production in oil from the various fields and the difference in the cost of transportation of oil from the fields to the Trans-Alaska Pipeline system. When the elf reaches .7 is when it actually begins operating. That's when the oil companies can come in and say we want you to apply the elf against our severance taxes. For Prudhoe Bay that point comes when the

price of oil is \$7.05 on the West Coast. For Milne Point, you'll notice this is the second line, that figure we hit the .7 when oil is at \$13.72 on the West Coast. I'm sure you are all familiar that the Sohio posted price right now is \$11.50 on the West Coast. The third line is, I think, the most crucial line as far as the severance tax is concerned. When the elf reaches zero we essentially lose all severance taxes from the oil field. There would be no severance taxes from the oil field when the elf reaches zero. The calculations we had for Milne Point are below \$1.50 at the wellhead which we estimated to be \$10.36 on the West Coast. Now if the well-head price right now at Milne Point is \$1, our figure on the West Coast may be somewhat off. Like I said, these are figures which we have estimated from the public information the Department of Revenue has gathered from all the different sources that we look at constantly. Basically at \$.80 a barrel, the State of Alaska is guaranteed a revenue stream of about \$450 million a year if the severance tax is \$.80 a barrel. When the prices hit these prices you see on the third line across, then that revenue stream is cut into drastically. When the Prudhoe Bay field, for example, if West Coast prices were to drop to 6.75, we would be getting no severance taxes from Prudhoe Bay. You'll see down at the very bottom our estimated severance taxes from each of the fields for fiscal year '87 and fiscal year '88 based on our March forecast. So at this point with the application of the elf factor and assuming that the companies do go ahead and prove their case at hearing, there will be essentially a tax break, a tax cut, a revenue loss to the State of about \$10-11 million over the next calendar year from Milne Point. This is, of course, very different from the royalty matters which are addressed in Senate Bill 430, but Representative Cotten asked that we be here to explain this to you as well so you can get the full picture. That concludes my prepared remarks.

Chairman: Representative Cotten.

Cotten: I'm looking at this next to the last line there, percentages of expected severance tax for '87, it says \$7.7 million and I'm trying to figure out what the difference between that and the \$11 million is. Is it leased at calendar year, is that what the ...?

Monkman: Yeah, I'm sorry I said calendar year. I think Mr. Erickson is here today. His original estimates

were we would lose \$6 million in fiscal '86 and then \$5 million in the first half of '87. The elf is figured on a calendar year basis.

Cotten: Okay. The reason I wanted to have this information here was because I thought it was important to understand what, and I think that Representative Frank raised the question a couple of days ago when he suggested that the fiscal note might want to reflect what we would lose if the field got shut in as far as severance taxes were concerned. I think the fiscal note probably doesn't need to reflect that since it appears that under current conditions, at least, there won't be any severance tax. The other question I'd like to ask is how does this work when a person applies to have the elf be reconsidered as apparently the Milne Point operators have? Is there a certain time span or time period in which they can make that request?

Monkman: There is and that, you'll notice there is a line that says time period when the new elf would apply, basically a producer can come in within six months of the date that the producer commences production or can come in between January 1st and February 15th of any calendar year to request that the elf be calculated and then applied against severance taxes. So we've gone past February 15th for all the other fields, for Kugaruk and Prudhoe Bay. For Milne Point, we are within the six months from commencement of production and they have come in essentially in that initial time period, the severance tax adjustment would be retroactive to the commencement of production we feel.

Cotten: Oh, I see, so they could actually have the severance taxes that they have already paid be reimbursed, is that right?

Monkman: That's possible. Yes. That's very possible.

Cotten: Now, see their deadline was, what's today's date? Is it May 1st?

Monkman: I think their deadline was tomorrow, May 2nd.

Cotten: When did they apply?

Monkman: The request came in, most of them came in last week.

Cotten: Most of them? Oh, so they each ...

Monkman: Yes, there are, I believe five different producers and I think we received one the week before last

and the remaining four last week. I'm not exactly sure, but it's been within the last ten days.

Cotten: They're cutting it pretty close in other words.

Monkman: They are.

Cotten: So it appears that under any circumstances that the more significant relief is going to be in the severance tax. I mean it's pretty obvious that this fiscal note shows a \$400,000 relief as far as Senate Bill 430.

Monkman: That's correct. It also, of course, it's true that as the well-head value approaches 0, the value of the royalty oil is worth less and less. So when you have a situation where the elf is being applied and we're getting no severance taxes, the value of our royalty oil is also going to be quite a bit less. So there won't be much value there. But the big chunk is the severance tax.

Cotten: Although the Department of Natural Resources says without a royalty reduction, it is likely that production from the unit will be shut in if prices remain the same. How much contact do they have with you? Do they know what is going on over in Revenue?

Monkman: We try and keep in contact, yes.

Cotten: Because I know that the director really wasn't able to answer a lot of questions. It didn't appear that the director was completely aware of what was happening over in Revenue.

Monkman: Well, as I did say, the request for hearings came in within the last ten days. So it's pretty new to all of us. We recognize that this problem might be there and we are fairly sure that the oil companies know about it as well early on. But they did wait until the very last possible moment to come in here.

Cotten: I hesitate to ask, but can you imagine any reason? Would you be willing to speculate as to what might have motivated timing on that?

Monkman: You would have to ask the oil company, their representatives, for that.

Cotten: I think I will. Thank you.

Chairman: Representative Rieger.

Rieger: Just one question. When we discussed the elf earlier on in recent bills in [indiscernible], I was really under the impression that the elf was based on a formula which compared the performance of the well on a well by well basis and it was tied to output and I was surprised to hear that this is tied to price somehow. I was wondering if you could explain how price even figures into this?

Monkman: Well that's the common misconception about the elf is that the formula only works for volume. In fact, the formula includes price and cost of production as well as volume and so it turns out to be price sensitive to the point where you can have, here we have \$6.75 West Coast price for Prudhoe Bay, you could have full production out of Prudhoe Bay. At \$6.75 West Coast price, we would not be getting any severance tax from that oil. That's the way the formula worked. I think the explanations I have heard is that it was more or less unintentional that the price would be such a determining factor and that it wasn't expected that you could, we would every be in this situation where you could have full production at a low price and no severance taxes at all, especially because the severance tax is to compensate the State for the one-time removal of a resource that is non-renewable and it could be taken out now, it could be taken out in the 1990's when the price is much higher; so the assumption was you have a sort of fixed severance tax until the field starts declining. In fact, the way the formula works it's price sensitive as well.

Rieger: Okay. That's all I have, Mr. Chairman.

Chairman: Representative Cotten.

Cotten: Do we pay field costs at Milne Point?

Monkman: No.

Cotten: No. We do, we pay \$.70 a barrel at Prudhoe, but nothing at Milne, is that correct?

Monkman: I believe that's correct.

Chairman: Representative Ringstad.

Ringstad: Thank you, Mr. Chairman. Maybe this is a little bit off center here but looking at your prices, your chart here, where you get to we're talking about \$1.50 the well-head price when your elf kicks in and we just got testimony that we're at \$1 for Milne, I'm assuming the rest of them are

probably in the ball park, what happens when the price of oil drops another \$2 a barrel?

Monkman: When it drops under \$2 a barrel?

Ringstad: No, another \$2 a barrel. We're at \$11.50 now, what happens when it goes to \$10 or \$9.50?

Monkman: You would actually have a negative well-head value. Our rough calculations, Chuck Logsdon who appeared before the Joint Committee yesterday calculates that the shutdown point for Prudhoe Bay is actually a negative well-head value. That is to say that the oil is worth less than nothing at the well-head but because of the TAPS tariff, because of down-stream opportunities to take profits in refining distribution in the retail level and anyone who has bought gasoline in Juneau lately will know that there are opportunities for down-stream profits in the oil business. Because of the opportunities for down-stream profits, the oil companies will continue to make money and even though the well-head price is negative. Of course, at that point we are not getting any severance tax and at that point, I think, the Department of Natural Resources will have some serious problems of what to do with royalty oil. How to value it and what to do with it.

Ringstad: Therefore our income.

Monkman: Pardon?

Ringstad: And therefore the State's income.

Monkman: Yes, we would be in serious trouble at that point.

Chairman: Representative Pourchot.

Pourchot: Mr. Chairman. Maybe we should sell royalty oil in Juneau and take advantage of some of those down-stream opportunities.

Chairman: Any further questions? Thank you, gentlemen. At this time the Chair will call up Al Hastings. Again, would you state your names for the record please.

Hastings: I'm Al Hastings with Conoco.

Tillinghast: And I'm John Tillinghast, an attorney for Conoco.

Chairman: Representative Cotten had a few questions.

Cotten: I guess I was surprised when I found out, you know, you were doing two things at once and you hadn't mentioned that before. It was just a matter of curiosity to me that the other one was so much more significant, it seems like that should have been part of what we were talking about as this went along.

Tillinghast: Let me say as to not mentioning it before and then Al will talk about the timing. As far as not mentioning it before, up until about ten minutes ago, it had been the policy of the State not to divulge the pendency of tax proceedings because they were confidential and just as your filing your return with the IRS is confidential; that's why we didn't tell you.

Hastings: As to ...

Cotten: Ten minutes ago?

Tillinghast: This was a surprise when I heard that they now feel that they can divulge the pendency of tax proceedings. I represented the Department of Revenue for years and that was never their policy.

Chairman: You had a question on the timing.

Cotten: Yes, it looked like tomorrow was your deadline and you filed it last week. I was just curious about why you waited until such a close time to the deadline and I don't really mean to be suggesting anything, I'm just curious about it. It looks like you can file at the last minute and apparently enjoyed a rebate on the severance taxes you might already have paid if the elf qualifies.

Hastings: According to AS 43.55.013, we have to have four months of operating data if we apply to change the PEL. The first four months of operating data that we had were December, January, February and March. Our March Data does not come out until around the 20th of April so we did not have four months of operating data to file until after the 20th of April. November was not a full month and there was no way we could file before around the 20th of April.

Tillinghast: Two other observations. One, of course, we haven't been granted any relief and I do not think the Department of Revenue thinks it's a sure thing and second, I think it's wrong to call it a tax break or a tax cut. As you know, we have a progressive severance tax and the progressive severance tax

says that the more profitable you are, the higher your rate and the less profitable, the lower your rate, just like the federal personal income tax. The pending proceeding is intended solely to find out what our rate ought to be under the statute. We are in no sense seeking a tax cut or a tax break from the statutorially tax that we have to pay.

Cotten: I fully understand that. I guess a lot of people didn't understand that this was, you know, Senate Bill 430 was relatively insignificant as far as relief for your company as opposed to what else was available. Until this came out the other day that you had another method of relief, I don't think people were even considering it. I think a lot of people were under the impression that you needed this bill and this was it. This was the relief you were looking for in order to prevent a shut in of the Milne Point unit.

Tillinghast: That still lists true. The obvious information has been divulged. One, we haven't been granted any relief and two, the Department of Natural Resources and Conoco knows how the elf works and knows how the severance tax works and then the very detailed confidential calculations that we've run with DNR, severance tax liability has been factored into that. It doesn't lessen the significance of SB 430 one bit.

Cotten: Well it's just that we're being asked to make a decision on a piece of legislation and I think now we do have all the information that is available. I guess we do. Is there something else we don't know of that we should as a consideration?

Tillinghast: Is that a loaded question, Representative Cotten?

Cotten: I don't know. It isn't meant to be. Again, when we are asked to do one piece of a large puzzle, I think it's helpful for us to know how significant that is and how necessary it is.

Tillinghast: Had it been proper for us to disclose the pendency of the proceeding, we would have been happy to, but under law the pendency of tax proceedings is confidential just as your filing an IRS return is confidential.

Cotten: Apparently, the Department of Revenue disagrees with that.

Tillinghast: I'm shocked; I really am.

Cotten: It wouldn't have been illegal for you to, you just felt that you were protected by law from having to [indiscernible].

Tillinghast: Yeah as does everybody else who files a tax return with any governmental authority in the United States, that's right.

Cotten: Are there some other, this might be a pretty important question, too. Are there some legal opinions or other cases, what's going to happen now? Are you going to challenge the State on that or what?

Tillinghast: Well, the horse is out of the barn.

Cotten: I don't have any other questions, Mr. Chairman.

Chairman: Any further questions? Thank you, gentlemen. Does anybody else like to testify on House Bill #430? Yes. Do you have a new fiscal note?

Van Dyke: Not yet, sir. Would just like quick clarification. We prepared the fiscal note at a \$1 well-head value at the request of the Committee. We don't know what the April well-head value is. In March we believe it was about \$2 at the well-head. We haven't seen the April relative returns because they haven't been filed yet. So the \$1 was at the request of the Committee. There was a lot of debate of what number to use, so it was prepared at \$1. If it ends up being \$2, you can just double the numbers. We are not sure what the April number actually is. We believe the March number is about \$2 at the well-head.

Chairman: Representative Ringstad.

Ringstad: If the price of oil has come down \$1.50 on the March price of the West Coast price, whatever, the average price, would it be fair to say that you're down \$1.50 from the March well-head price.

Van Dyke: If Conoco is marketing its oil at the same price that Sohio is going to market its oil at, it will take that same drop. They don't all market, some of the oil from Milne Point, I believe, is sold right at Pump Station 1 and then other people market it further down-stream. And Conoco doesn't enjoy all the down-stream profits in pipeline or tanker operations from Milne Point either since they don't own a part of the Trans-Alaska Pipeline. And I don't believe they own part of the tankers that transport the oil, so there is some additional

incentive, I think, for relief at Milne Point. They don't enjoy some of those additional profit centers.

Cotten: I want to ask another real quick question here. The reason I think the Committee asked for the \$1 was because I think that was the impression that the Department of Natural Resources gave us as to what the likely well-head value was. It wasn't that we picked a number out of the air.

Van Dyke: When I spoke to the director, she said there was a lot of debate.

Cotten: We wanted [indiscernible] reflected what your opinion of the most likely current situation was.

Van Dyke: Okay, she hadn't seen, at that point she had not even seen the March royalty returns. I looked at those earlier this week and they came in at about the \$2 number for Prudhoe Bay or net back from Prudhoe Bay, so the \$1 may be a little low.

Chairman: When will we have a new fiscal note for the Committee?

Van Dyke: This afternoon, sir.

Chairman: The Chair is holding this particular bill. I would like that fiscal note distributed to all members of the House. I would like to try to bring this bill up tomorrow afternoon at 1:30 once you have the corrected fiscal note. House Finance is adjourned.

# STATE OF ALASKA

BILL SHEFFIELD, GOVERNOR

## DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

POUCH M  
JUNEAU, ALASKA 99811  
PHONE: (907) 485-2400

April 24, 1986

The Honorable Al Adams  
Chairman, House Finance Committee  
Alaska State Legislature  
P.O. Box V  
Juneau, AK 99811

Dear Representative Adams:

House CS for CS for Sponsor Substitute for SB No. 430 (Resources) is pending in the House Finance Committee. The bill would authorize the commissioner of the Department of Natural Resources to reduce or revoke a royalty obligation increase made in connection with the institution of a unit agreement.

The bill also provides that if the commissioner reduces or revokes a royalty obligation increase, the commissioner shall include a mechanism to raise the royalty to a level not exceeding its former level in the event that market conditions improve, or if the profitability of a lessee's operation increases to a specified level. Several questions have been raised by members of the Legislature regarding how this mechanism would work.

The mechanism we propose to implement the bill's intent is contained in the attached draft "Commissioner's Decision on Conoco's Application for Amendment of the Milne Point Unit Agreement," dated April 23, 1986. The decision as drafted would implement the bill in its present form.

Generally, the draft decision provides that the royalty rate to be paid by Conoco and the other affected Working Interest Owners would remain at 12 1/2% until the wellhead price reaches \$17.00 per barrel, at which point the royalty would be increased to 16-2/3%. The royalty rate would remain at that level until the wellhead price reached \$25.00 per barrel, at which point the royalty would be increased to 20%. In no case would the royalty rate fall below 12 1/2% or rise above 20%.

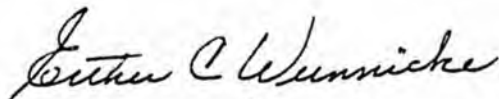
The Honorable Al Adams  
Page 2  
April 23, 1986

The threshold prices that would trigger the higher royalty rates are based on a preliminary staff analysis of the information previously submitted by Conoco. Before issuing a final decision, the staff and I will further evaluate available information to determine what specific threshold values would be appropriate to include in the final decision.

This mechanism would protect the state's interest by providing a higher royalty rate in the event that market conditions improve. This approach is administratively simpler and more straight-forward than any determination based on the profitability of the lessees' operations. After two year's of production from the field has occurred, the lessees would be eligible for consideration of a royalty adjustment under the provisions of AS 38.05.180(j).

If you or committee members have questions about the draft proposal, please feel free to contact me at 465-2400, or Kay Brown of my staff at 762-4241.

Sincerely,



Esther C. Wunnicke  
Commissioner

cc: Representative Pourchot  
Representative Cotten  
Representative Sund  
Senator Fahrenkamp

2001K

Commissioner's Decision on Conoco's Application  
for Amendment of the Milne Point Unit Agreement  
(to be issued pending passage of House CS for CS  
for Sponsor Substitute for Senate Bill No. 430 [Resources])

Introduction

By application dated October 28, 1985, Conoco, Inc., Reading and Bates Petroleum Company, Champlin Petroleum Company, and Cities Service Oil and Gas Corporation (hereafter collectively referred to as the "Companies") requested the Commissioner to amend paragraph 14 of the Milne Point Unit Agreement to reduce the 20 percent royalty on certain of their Milne Point Unit oil and gas leases.<sup>1</sup>

Commissioner's Authority and Duties

The Commissioner of the Department of Natural Resources is empowered to change the royalty requirements of unitized leases when proper to secure the public interest. AS 38.05.180(p) reads in part, "The Commissioner may reduce or revoke a royalty obligation increase that was made by the Commissioner in connection with the institution or operation of a cooperative or unit plan."

The Department has promulgated regulations to guide the Commissioner in her determination of when an amendment to a unit agreement would be proper to protect the public interest. 11 AAC 83.385 makes unit agreement modifications subject to the Commissioner's approval, and 11 AAC 83.303(c) requires the Commissioner to consider several criteria when evaluating a request for approval of a unit agreement amendment. The Commissioner must find that the amendment will (1) promote the conservation of all natural resources, (2) promote the prevention of economic and physical waste, (3) provide for the protection of all parties of interest, including the State. 11 AAC 83.303(a). In evaluating those criteria the Commissioner must consider the following factors: (1) the environmental costs and benefits, (2) the geological and engineering characteristics of the reservoir, (3) exploration

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<sup>1</sup>The oil and gas leases are identified as ADL 47432, ADL 47433, ADL 47434, ADL 47437, ADL 47438 and ADL 47439 (hereinafter referred to as the "leases"). In October, 1979 lease ADL 47432 was divided (severed) into two separate leases - ADL 47432 and ADL 319717. Lease ADL 319717 has identical terms and conditions as lease ADL 47432, including the 20 percent royalty. Likewise, lease ADL 47439 was divided into two separate leases - ADL 47439 and ADL 315846 - both having identical terms including the 20 percent royalty. As such, leases ADL 319717 and ADL 315846 also will be considered in this decision and are to be included in any references to the "leases".

activities in the unit area, (4) the applicant's plans for development, (5) the economic costs and benefits to the state, and (6) any other relevant factors the Commissioner determines necessary or advisable to protect the public interest. 11 AAC 83.303(b). Further, the department has defined "conservation of natural resources of all or part of an oil or gas pool, field or like area" to mean "maximizing the efficient recovery of oil and gas and minimizing the adverse impacts on the surface and other resources." 11 AAC 83.395(1).

#### Abbreviated Unit History

By decision dated October 29, 1979, former Commissioner Robert E. LeResche approved the Milne Point Unit Agreement. Paragraph 14 of the Agreement stated in part that, "The State's royalty share due on leases ADL 47432, ADL 47433, ADL 47434, ADL 47437, ADL 47438 and ADL 47439 shall be one-fifth (20%)." Prior to the Commissioner's 1979 Decision, the royalty rate on the leases had been 12 1/2 percent.

#### The Companies' Application

The application filed by the Companies was supported by the following materials: (1) the Companies' Brief, (2) an affidavit of Alan Hastings, (3) an affidavit of David Uldrich, and (4) an affidavit of Lou L. Pai. The Companies also filed certain economic, geological, geophysical and engineering data with the application and requested that those data be held confidential. In the application the Companies argue that they cannot expect to earn a reasonable rate of return on their investments in the field if the royalty rate on the leases remains at 20 percent. In the application the Companies provide evidence to support their position.

#### Basis for the Decision

Under AS 38.05.180(p), I may grant a change in unitized lease royalty rates only when proper to protect the public interest. In this instance, I find that the public interest is best protected by a royalty change (reduction) which would promote maximum production under existing economic conditions yet provide for an automatic and specified increase in the royalty rate should market conditions improve.

AS 38.05.180(a)(1) states in part, "the Legislature finds that the people of Alaska have an interest in the development of the State's oil and gas resources to: (A) maximize the economic and physical recovery of the resources...."

Under existing and forecasted economic conditions and with a 20 percent royalty on the leases there is a high likelihood that both the economic and physical recovery of oil and gas at Milne Point will not be maximized for either the Companies or the State. Production of oil and gas from the developed reservoir (i.e., the Kuparuk River formation) will not be maximized; development and production of oil and gas from yet to be developed reservoirs (i.e., the Shallow Sands) likely will not occur at all. At a 20 percent royalty, the Companies have made a persuasive case that they cannot be reasonably assured an adequate rate of return on any future or incremental

investment. Given the further erosion of crude oil prices since the date the application was filed with the State, it is possible that current production will be halted if the royalty rate on the leases remains at 20 percent.

A careful review by staff of the data and analyses supplied by the Companies confirms that, under current and expected market conditions, the Companies likely will not receive an adequate rate of return on their current investments and that future investments in the Milne Point Unit also would yield a less than satisfactory return. It is also very likely that if current market conditions persist (or get worse), the field will be shut-in if the royalty remains at 20 percent. In addition, future development of the Milne Point Unit Shallow Sands (heavy oil and gas reservoirs, geologically equivalent to ARCO's West Sak-Ugnu reservoirs) is almost certain not to occur at a 20 percent royalty if current market conditions prevail.

It is acknowledged that a change in the royalty rate from 20 percent to 12 1/2 percent will result in a short term revenue decrease to the state of approximately 2 million dollars per year from the Milne Point Unit. However in the long term the state should be more than compensated for that loss by continued production from existing wells and development of the Shallow Sands reservoirs at Milne Point and the application of a royalty to that production. In addition, a change in the royalty rate also should result in a prolonged production life for the Kuparuk reservoir at Milne Point.

It is also acknowledged that as a result of amending the unit agreement as outlined in this decision, continued production and increased ultimate recovery of oil and gas at Milne Point are not guaranteed. However, there is a substantially greater likelihood that the benefits resulting from maximum production will be forthcoming if the royalty rate on the leases is 12 1/2 percent vis-a-vis 20 percent during periods of depressed world oil prices.

A fixed royalty, regardless of the percentage, is not sensitive to field operating costs or the overall profitability of the operation. In effect, there is no sharing of downside risk. In contrast, a royalty rate that changes in proportion to value of the oil produced is responsive to both relative increases and decreases in lessees' profits. There is a sharing of both downside and upside risks. A royalty rate that changes in response to changes in the value of the oil produced allows continued operation and development of the field during times of decreasing crude oil prices (and profitability), yet protects the public interest by increasing the State's royalty share of lease revenue during times of increasing crude oil prices (and profitability).

On balance, an affirmative decision to amend the unit agreement to change the fixed 20 percent royalty on the leases to a royalty that is responsive to changes in the value of the produced oil is necessary and advisable in the public interest and properly protects the public interest.

The Companies and the State shall proceed, as necessary, to amend the Milne Point Unit Agreement to include the terms and conditions necessary to implement this decision.

## Decision

I find that a decision to amend paragraph 14 of the Milne Point Unit Agreement is necessary and advisable in the public interest. I further find that by including the terms and conditions cited below in the amendment, the amendment protects the public interest.

1. The royalty rate on the leases will be as follows:

When the value of the produced oil at the inlet to the Milne Point Pipeline is less than \$17.00 per barrel, the royalty rate will be 12 1/2 percent. When the value of the oil is \$17.00 per barrel or greater, but less than \$25.00 per barrel, the royalty rate will be 16.667 percent. When the value of the oil is \$25.00 per barrel or greater, the royalty rate will be 20 percent.

The state will limit its taking of royalty in kind from the leases to a maximum of 12.5 percent.

2. The Companies and the State will proceed to amend the Milne Point Unit Agreement to incorporate the provisions necessary to implement this decision.
3. This decision is effective \_\_\_\_\_ 1986. Royalty payments for the leases due the State in the month of \_\_\_\_\_, 1986 and thereafter shall be calculated using the royalty rate schedule specified above.
4. Article 30 of the Milne Point Unit Agreement will be amended as follows: The Unit Operator and lessees shall comply with all valid and applicable laws and regulations that concern the hiring of Alaska residents and that are in effect or take effect during the term of the leases.
5. It is acknowledged that this decision does not preclude the Companies from making future applications for royalty alterations or reductions under applicable Alaska statutes and regulations.
6. The Companies' simultaneous application for reconsideration/reopening of Commissioner LeResche's 1979 Decision is hereby denied. The Companies' simultaneous application for a royalty reduction pursuant to AS 38.05.180(j) also is denied.

\_\_\_\_\_  
Esther C. Wunnicke, Commissioner  
Department of Natural Resources

\_\_\_\_\_  
Date

4551Z

TESTIMONY OF AL HASTINGS  
BEFORE THE HOUSE RESOURCES COMMITTEE  
REGARDING CSSSSB 430 (APRIL 21, 1986)

CONOCO IS THE OPERATOR OF THE MILNE POINT UNIT, WHICH IS THE THIRD PRODUCING UNIT ON THE NORTH SLOPE. IT BEGAN PRODUCTION LAST FALL, AND IS CURRENTLY PRODUCING ONLY 18,000 BARRELS PER DAY--THIS IN COMPARISON TO PRUDHOE BAY'S 1.5 MILLION BARRELS PER DAY, AND 260,000 BARRELS PER DAY FROM THE KUPARUK UNIT. BY ANY DEFINITION, MILNE POINT IS A MARGINAL UNIT.

DESPITE ITS MARGINAL NATURE, MILNE POINT, AND MILNE POINT ALONE, IS REQUIRED TO PAY A SPECIAL ROYALTY SURCHARGE. AT THE STATE'S 1969 COMPETITIVE SALE, THE SUCCESSFUL BIDDERS STRUCK AN AGREEMENT UNDER WHICH THEY AGREED TO PAY A 12.5% ROYALTY. HOWEVER, IN 1979, WHEN THE MILNE POINT COMPANIES SOUGHT APPROVAL OF THEIR UNIT, THE STATE REFUSED UNLESS THE COMPANIES AGREED TO PAY A ROYALTY SURCHARGE OF 7½%, THUS INCREASING THE ROYALTY TO 20%. SINCE REJECTION OF THE UNIT WOULD CAUSE THE COMPANIES TO LOSE THEIR LEASES, WE HAD LITTLE CHOICE BUT TO ACCEPT.

IN 1979, THE STATE BELIEVED THAT THIS ROYALTY SURCHARGE WAS IN THE PUBLIC INTEREST, BECAUSE IT ALSO BELIEVED THAT WELLHEAD OIL PRICES IN 1985 WOULD BE NEARLY \$35 PER BARREL. AS EVENTS HAVE TRANSPIRED, ANS CRUDE IS SELLING ON THE WEST COAST SPOT MARKET AT \$12-\$14/BBL., AND TRANSPORTATION COSTS FROM MILNE POINT TO MARKET ARE \$11-\$12/BBL. AS A

RESULT, INSTEAD OF INCREASING STATE REVENUES, THE ROYALTY SURCHARGE THREATENS TO FORCE PREMATURE ABANDONMENT OF THE UNIT.

LAST NOVEMBER, CONOCO SUBMITTED A FORMAL REQUEST TO THE DEPARTMENT OF NATURAL RESOURCES TO RECONSIDER THE ROYALTY SURCHARGE IN THE MILNE POINT UNIT AGREEMENT. ON FEBRUARY 5th OF THIS YEAR, WE RECEIVED A LETTER FROM COMMISSIONER WUNNICKE, WHICH INDICATED THAT EXISTING LAW COULD PRECLUDE HER FROM REDUCING OR REVOKING THE ROYALTY SURCHARGE.

AT THAT POINT, AND IN LIGHT OF DNR'S CONCERNS OVER THE STATUTE, IT BECAME OBVIOUS THAT LEGISLATION WAS NECESSARY IF DNR WAS TO CONSIDER REVOKING OR REDUCING THE SURCHARGE, AS OPPOSED TO SIMPLY CHANGING ITS FORM. THIS BILL WOULD ACCOMPLISH PRECISELY THAT.

THERE ARE A FEW POINTS THAT I WOULD LIKE TO BRIEFLY MAKE WITH RESPECT TO THE BILL AND THE URGENCY BEHIND IT. FIRST, THE BILL IS VERY NARROWLY DRAFTED. IT WOULD ONLY AUTHORIZE THE COMMISSIONER TO REDUCE OR REVOKE ROYALTY SURCHARGES IMPOSED AT THE TIME OF UNIT FORMATION. THIS BILL DOES NOT GIVE THE COMMISSIONER ANY AUTHORITY WHATSOEVER TO REDUCE ROYALTIES BID UPON OR AGREED TO AT A COMPETITIVE SALE. IT ALSO REQUIRES THE COMMISSIONER TO PROVIDE A MECHANISM TO INCREASE THE ROYALTY IF THE COMPANIES' SHOULD EVER MAKE WINDFALL PROFIT. THE MILNE POINT UNIT IS CURRENTLY OPERATING AT A SUBSTANTIAL CASH LOSS. THE PROBABILITY OF MAKING ANY PROFIT IN THE NEXT 2-3 YEARS IS VERY UNLIKELY EVEN WITH MODEST CRUDE PRICE INCREASES.

NEXT, THE BILL DOES NOT GRANT CONOCO, OR ANYONE ELSE, ROYALTY RELIEF. IT MERELY AUTHORIZES THE COMMISSIONER TO RECONSIDER ROYALTY SURCHARGES IN UNIT AGREEMENTS WHEN THE PUBLIC INTEREST WARRANTS. CONOCO WILL STILL HAVE TO PROVE ITS CASE BEFORE THE DEPARTMENT. THE ISSUE BEFORE THIS COMMITTEE IS NOT WHAT CONOCO'S ROYALTY SHOULD BE; THAT ISSUE WILL HAVE TO BE RESOLVED BY DNR, BASED ON THE CONSIDERATION OF FINANCIAL DATA, SOME OF IT CONFIDENTIAL. THE ONLY RELIEF CONOCO IS ASKING HERE IS TO REMOVE A PERCEIVED, DISCRIMINATORY, AND VERY UNINTENTIONAL IMPEDIMENT TO DNR'S ABILITY TO RECONSIDER THE SURCHARGE.

THERE IS URGENCY TO THIS LEGISLATION. AS YOU KNOW, THE UNIT HAS ALREADY HAD TO SUSPEND NEW DRILLING AT MILNE POINT, AND IN LIGHT OF THE RECENT DRAMATIC DECLINE IN OIL PRICES THE SURCHARGE IS JEOPARDIZING NOT ONLY FUTURE DEVELOPMENT, BUT EXISTING PRODUCTION AS WELL. IN A LETTER TO SENATOR STURGULEWSKI, COMMISSIONER WUNNICKE STATED (AND I QUOTE) "IT IS ALSO VERY LIKELY THAT IF CURRENT CONDITIONS PERSIST (OR GET WORSE), THE FIELD WILL BE SHUT IN IF THE ROYALTY REMAINS AT 20%."

CONOCO'S INTENT IS A LONG-TERM COMMITMENT TO REMAIN AN OPERATOR IN ALASKA. WE HAVE CONTINUED TO BE ACTIVE IN BOTH STATE AND FEDERAL LEASE SALES, AND MILNE POINT IS AN IMPORTANT KEY TO THIS COMMITMENT. WITH THE CURRENT CRUDE PRICES, WE ARE NOT MEETING OUR OPERATING COSTS. PASSAGE OF THIS BILL WILL PROVIDE SUBSTANTIAL ENCOURAGEMENT FOR CONOCO AND ITS PARTNERS TO STAY IN OPERATION DURING THESE DIFFICULT ECONOMIC TIMES.

THANK YOU FOR THE OPPORTUNITY TO TALK WITH YOU TODAY REGARDING SB 430,  
AND I WOULD BE DELIGHTED TO TRY TO ANSWER ANY QUESTIONS YOU MIGHT  
HAVE.

referring hereto and shall be binding upon all those parties who have executed such a counterpart, ratification or consent hereto with the same force and effect as if all such parties had signed the same document and regardless of whether or not it is executed by all other parties owning or claiming an interest in the lands within the above described unit area.

\* { 30. ALASKA RESIDENT HIRE. All State of Alaska leases committed to said agreement are hereby altered to require that the lessee and unit operator shall comply with all valid and applicable laws and regulations with regard to hire of Alaska residents. Qualified Alaska residents shall be hired as required in AS 38.40; lessee shall not discriminate against Alaska residents, as prohibited by AS 38.40 and other applicable laws and regulations of the State of Alaska.

CONOCO INC.

\_\_\_\_\_  
Attent

By J. R. Sanders  
J. R. Sanders  
Attorney-in-Fact  
Unit Operator

# STATE OF ALASKA



POUCH V  
JUNEAU, ALASKA 99811  
(907) 465-4841

## HOUSE SPECIAL COMMITTEE ON OIL AND GAS

### CSSSSB 430 (Rules)

CSSSSB 430 (Rules) would allow the commissioner of the Department of Natural Resources to reduce or revoke a royalty increase that was made in connection with the institution or operation of a cooperative or unit plan. Such a reduction or revocation would also have to contain a mechanism to provide that if the profitability of a lessee's operation increases to a specified level after the reduction or revocation is made, the commissioner shall increase the royalty obligation to a level not exceeding the amount of the royalty increase that the commissioner reduced or revoked.

This legislation is directed specifically toward Conoco's Milne Point Unit. The renegotiation of lease terms in 1979 between Conoco and DNR occurred as a result of the unitization of the Milne Point field. One condition of unitization was a royalty increase from 12.5 to 20 percent. Milne Point is the only producing unit that has been subjected to a royalty increase. Non-producing units that have been subjected to similar royalty increases are Gwydyr Bay and Duck Island.

It is the view of DNR that present law prevents the commissioner from making the royalty reduction or revocation sought by the operator of the Milne Point Unit. DNR believes that the specific royalty reduction limitations stated in AS 38.05.180(j) control the general royalty reduction powers granted in AS 38.05.180(p).

AS 38.05.180(j) states that "To prolong the economic life of an oil and gas field, the commissioner shall adopt regulations for all bidding methods to allow reduction of royalty on leases within the field to compensate for increasing costs in the later stages of production decline. The commissioner may not grant a reduction of royalty until two years' initial production from the field has occurred and each lessee requesting the reduction has made a clear showing that the revenue from all hydrocarbons produced from the field is insufficient to produce a reasonable rate of return with respect to that lessee's total investment in the field."

SSSB 430 started to move actively through the Senate after Conoco and DNR failed to negotiate an agreement to alter the royalty obligation at Milne Point. The most hopeful attempt at resolving this issue was DNR's offer of a royalty reduction to 12.5 percent, in combination with a 12.5 percent royalty and a 35 percent net profit share from the Shallow Sands reservoirs at Milne Point. This would have provided the state with revenues equivalent to a 20 percent royalty, while allowing Conoco to defer payment of 7.5 percent of its royalty obligation. Negotiations broke down, however, when Conoco stated that the company must have a real reduction in its royalty obligation rather than simply the deferring of a share of this obligation.

Conoco's request for a royalty reduction derives from the company's unfortunate economic timing. The Milne Point Unit and the consequent royalty increase were established at a time when the price for crude oil was near its record high. Profitability projections at the time were sufficient to warrant the commencement of production activities, notwithstanding the 20 percent royalty.

Because of the lower current price for crude oil, however, Conoco claims that the life of the Milne Point field will be terminated prematurely unless the company is provided with some measure of royalty relief. Conoco further states that the reduction or revocation of its Milne Point royalty obligation will enhance the company's opportunity to develop the nearby Shallow Sands reservoir. However, the costs of field development are expected to far exceed the revenues retained by Conoco through a reduction in its royalty obligation.

# STATE OF ALASKA

## DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

BILL SHEFFIELD, GOVERNOR

POUCH M  
JUNEAU, ALASKA 99811  
PHONE: 907-465-2400

March 17, 1986

The Honorable Arliss Sturgulewski  
Chair, Senate Resources Committee  
P.O. Box V  
Juneau, AK 99811

Dear Senator Sturgulewski:

The Department of Natural Resources supports SS SB 430, which is scheduled for a hearing today in the Senate Resources Committee. The bill would authorize the commissioner of the Department of Natural Resources under certain circumstances to reduce or revoke oil or gas royalty obligation increases made in connection with the institution or operation of a cooperative or unit plan.

The bill primarily would affect the Milne Point Unit, a small North Slope oil field which began production last fall.

Conoco, Inc., the Milne Point Unit operator, has been seeking for several years to roll back a 20% royalty on certain Milne Point leases. The royalty obligation on those leases was increased from 12.5% to 20% under an agreement required by the department in 1979 as a condition of approval of the Milne Point Unit.

As a result of an application for royalty relief filed last fall by Conoco and Milne Point Unit working interest owners Reading and Bates Petroleum Company, Champlin Petroleum Company and Cities Oil and Gas Corporation, the department has examined confidential economic, geological, geophysical and engineering data supplied by the companies. Based upon that review, the department believes that rescinding the royalty increase would encourage continued production and further development of oil reservoirs within the Milne Point Unit.

Under existing and forecasted economic conditions, there is a high likelihood that both the economic and physical recovery of oil and gas at Milne Point will not be maximized for either the companies or the state at a royalty rate of 20%. Production of oil and gas from the developed reservoir (i.e., the Kuparuk River formation) will not be maximized, and development and production of oil and gas from yet to be

developed reservoirs (i.e., the Shallow Sands - heavy oil and gas reservoirs, geologically equivalent to ARCO's West Sak-Ugnu reservoirs at Kuparuk Unit) likely will not occur at all. The companies have made a persuasive case that they cannot be reasonably assured an adequate rate of return on any future or incremental investment under the existing 20% royalty. Given the further erosion of crude oil prices since the application was filed with the state last October, it is possible that current production will be halted if the royalty rate on the leases remains at 20 percent.

A careful review by staff of the data and analyses supplied by the companies confirms that, under current and expected market conditions, the companies likely will not receive an adequate rate of return on their current investments, and that future investments in the Milne Point Unit also would yield a less than satisfactory return. It is also very likely that if current conditions persist (or get worse), the field will be shut-in if the royalty remains at 20%. In addition, future development of the Milne Point Unit Shallow Sands is almost certain not to occur at a 20% royalty.

A reduction in the royalty rate from 20% to 12.5% would result in a revenue decrease to the State of approximately \$4.5 million a year from the Milne Point Unit. (See attached fiscal note.)

The department has tried to address the need for royalty relief within the current statutory framework, and earlier this year proposed that the royalty obligation be changed (not reduced) to a 12.5% royalty and a 35% Net Profit Share in lieu of the current 20% royalty. The companies have not accepted this proposal, even though it would have the effect of an immediate reduction in the royalty obligation, and would leave open the opportunity for the companies to apply for further relief after two years of field production based on the facts and circumstances at that time.

The department has been constrained from considering an outright royalty reduction by AS 38.05.180(j), which precludes the commissioner from granting a reduction of a lease royalty "until two years' initial production from the field has occurred and each lessee requesting the reduction has made a clear showing that the revenue from all hydrocarbons produced from the field is insufficient to produce a reasonable rate of return with respect to that lessee's total investment in that field."

The department's proposal to change the existing royalty rate was based on the authority of AS 38.05.180(p), which authorizes the commissioner to change royalty requirements of unitized leases "as the commissioner determines necessary

or proper to secure the proper protection of the public interest." Under the department's proposal, the state likely would have been compensated for the near-term revenue losses resulting from a reduction to a 12.5% royalty rate by the further receipt of revenues from the development of the Shallow Sands reservoirs at Milne Point and the application of the 35% Net Profit Share and the 12.5% royalty to that production. Revenues to the state over time likely would have been equivalent or greater under the department's proposal, but the income would have been delayed.

The department believes that it is not authorized to reduce the royalty obligation under AS 38.05.180(p), because of the limitation AS 38.05.180(j) appears to place on the commissioner's powers. If AS 38.05.180(j) applied only to leases that had not yet been unitized, AS 38.05.180(j) would be a nullity because, as a practical matter, unitization always precedes production. Related statutes should not be construed to make one statute a nullity.

Further, the general rule of statutory construction is that specific provisions control general provisions. Under this rule, the specific royalty reduction provisions of AS 38.05.180(j) would control the general provisions of AS 38.05.180(p).

Further, the legislative history of AS 38.05.180(j) argues against using AS 38.05.180(p) to circumvent the royalty reduction limitations stated in AS 38.05.180(j).

Testimony before the Legislature in 1978 focused on royalty reductions in conjunction with the increased flexibility given to the commissioner to select bidding methods. A prime concern was to prevent royalty bid manipulation, where a bidder obtains a tract by bidding an unreasonably high royalty counting on a subsequent royalty reduction to make the lease profitable. Although the companies obtained their leases at a fixed royalty sale, the policy against royalty bidding is arguably still applicable. The companies' leases were about to expire, causing the companies to agree to increase royalties in order to keep from losing the leases which were about to expire.

The bill that created AS 38.05.180(j) went through several committee substitutes. One committee, the House Resources Committee, voted to place an express limit on the commissioner's powers under AS 38.05.180(p) by adding the language: "however, the commissioner may not reduce the state's royalty within any unit except as provided in [j] of this section." A subsequent committee reviewing the bill, the Senate Resources Committee, deleted that language, but its sole motive was that the language was unnecessary since that committee had already decided to delete AS 38.05.180(j) altogether.

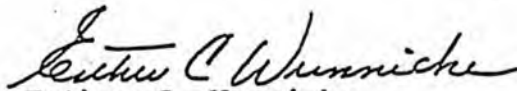
March 17, 1986

Later in the Senate Resources hearing, DNR pointed out that AS 38.05.180(j) granted the commissioner less power to reduce royalties than existed at that time under AS 38.05.140. The committee then voted to amend AS 38.05.140 to delete the commissioner's royalty reduction powers for oil and gas, and voted to reinstate AS 38.05.180(j). The committee immediately adjourned, without taking up the question of whether the previous committee's limitation of AS 38.05.180(p) should be retained.

In view of this legislative history, the department concluded that the specific royalty reduction limitations stated in AS 38.05.180(j) control the general royalty reduction powers granted in AS 38.05.180(p).

Thank you for the opportunity to comment on SS SB 430.

Sincerely,



Esther C. Wunnicke  
Commissioner

Attachment

cc: Senator Bettye Fahrenkamp



Conoco Inc.  
3201 C Street  
Suite 200  
Anchorage, AK  
(907) 564-7600

December 23, 1985

The Honorable Mike Davis  
Representative, Alaska  
315 Barnette Street  
Suite 101  
Fairbanks, Alaska 99701

Re: Enclosed Request for Unit  
Agreement Amendment

Dear Representative Davis:

Enclosed is a copy of a request by Conoco Inc. and other Milne Point Unit working interest owners to amend the Milne Point Unit Agreement. The companies submitted the request to DNR on November 4, 1985. The amendment would remove a 7½% royalty surcharge that was imposed upon these companies by DNR Commissioner Robert LeResche in September, 1979.

Granting the companies' request for removal of the surcharge will have a negligible effect on current state revenues. Indeed, the surcharge will net the state only some \$8 million in additional royalties in 1986. However, if the surcharge results in premature field abandonment, the state will suffer a foreseeable \$1.1 billion net loss in taxes and royalties. Moreover, the subsequent production at Milne Point which is jeopardized by the surcharge is critical to the state. For example, if the surcharge is removed, and the unit is fully developed, the state's projected FY 1996 oil production decline will be reduced by 31%.

Either inaction by DNR, or DNR's refusal to acknowledge its authority to grant the companies' request, may necessitate a legislative response in order to prevent premature abandonment of the only currently-active marginal field on the North Slope, and the resultant loss in state revenue. As a result, we hope that you, and your staff, will have the opportunity to review the companies' papers.

This matter arose in 1979, when the Milne Point companies applied to Commissioner LeResche for approval of the Milne Point Unit. The commissioner refused to approve the unit unless the companies consented to pay a 20% royalty, rather than the 12½% that had been agreed to at the 1969 competitive sale. The companies, of course, had little choice but to accept the commissioner's demands, since a rejection of the unit

application would mean that the companies would lose their leases, and no production would occur at Milne Point at all.

Commissioner LeResche was motivated, at the time, by his assumption that wellhead prices in the mid-1980's would be about \$34 per barrel, and that the market could therefore bear this royalty surcharge. In fact, wellhead prices are now about \$14 per barrel. As a result, the effect of the surcharge will, in all probability, not be to increase state revenues, but rather to substantially reduce overall state taxes and royalties because of a premature field abandonment. Indeed, as the enclosed papers indicate, with the surcharge the Milne Point Unit may have as little as an 8-year field life.

Conoco recognizes that, in 1978, the legislature limited the commissioner's ability to reduce royalties on individual leases in order to prevent irresponsible royalty bidding at competitive sales. The limitation was intended to guard against abuses when the royalty was a bid variable -- a situation not present here. As our brief demonstrates, that limitation does not prevent the commissioner from amending her own unit agreements. And, an amendment to the unit agreement is all that is needed, and all that is asked for here. The 12½% royalty in the companies' leases will remain intact.

The companies are hoping that DNR will recognize its authority, and act upon the companies' request quickly. If the agency decides that it does not have authority to amend its own unit agreements, the companies will have two options. The first, of course, is to litigate. And, while the companies are confident that they would ultimately prevail in that litigation, that option will be costly and time consuming. As our brief indicates, it is very important that a final decision on the royalty surcharge be made shortly. Therefore, delaying resolution of this issue for 2-3 years of litigation may bring about the early abandonment of Milne Point irrespective of the ultimate outcome.

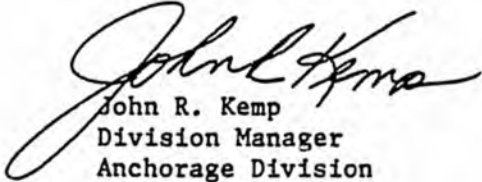
The other option is legislation that would even more clearly direct the commissioner to act in the very limited and compelling circumstances present here. We had hoped that DNR would process our request in a way that would allow the legislature to consider this matter, if it needs to consider it at all, responsibly and in due course. We therefore asked DNR to decide the companies' request well prior to the convening of the upcoming legislative session; and, to that end, we submitted our request more than two months before the session was to commence. If the agency delays our request, the legislature may find itself facing a new oil and gas issue in mid-session. We are therefore deeply concerned that DNR has yet to act on our request even at the staff level -- particularly in light of the fact that DNR has known of this issue, and the need to resolve it, since October, 1983.

At this point, then, we would appreciate whatever efforts you feel appropriate toward encouraging Commissioner Wunnicke to make her final

decision before your next session commences. And, we will certainly keep you advised of the progress of our request.

Thank you in advance for the attention which I know that you, and your staff, will give to this matter.

Sincerely,



John R. Kemp  
Division Manager  
Anchorage Division

vv

Offered: 4/21/86  
Referred: Finance

Original sponsor: Fahrenkamp

1 IN THE SENATE BY THE RESOURCES COMMITTEE  
2 HOUSE CS FOR CS FOR SPONSOR SUBSTITUTE FOR SENATE BILL NO. 430 (Resources)  
3 IN THE LEGISLATURE OF THE STATE OF ALASKA  
4 FOURTEENTH LEGISLATURE - SECOND SESSION

5 A BILL  
6 For an Act entitled: "An Act relating to the reduction or revocation by  
7 the commissioner of the Department of Natural Re-  
8 sources of oil or gas royalty obligation increases  
9 made in connection with the institution or operation  
10 of a cooperative or unit plan; and providing for an  
11 effective date."

12 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

13 \* Section 1. AS 38.05.180(p) is amended to read:

14 (p) To conserve the natural resources of all or a part of an oil  
15 or gas pool, field, or like area, the lessees and their representa-  
16 tives may unite with each other, or jointly or separately with others,  
17 in collectively adopting or operating under a cooperative or a unit  
18 plan of development or operation of the pool, field, or like area, or  
19 a part of it, when determined and certified by the commissioner to be  
20 necessary or advisable in the public interest. The commissioner may,  
21 with the consent of the holders of leases involved, establish, change,  
22 or revoke drilling, producing, and royalty requirements of the leases  
23 and adopt regulations with reference to the leases, with like consent  
24 on the part of the lessees, in connection with the institution and  
25 operation of a cooperative or unit plan as the commissioner determines  
26 necessary or proper to secure the proper protection of the public  
27 interest. The commissioner may require oil and gas leases issued  
28 under this section to contain a provision requiring the lessee to  
29 operate under a reasonable cooperative or unit plan, and may prescribe

1 a plan under which the lessee must operate. The plan must adequately  
2 protect all parties in interest, including the state. Notwithstanding  
3 (j) of this section, the commissioner may reduce or revoke a royalty  
4 obligation increase that was made by the commissioner in connection  
5 with the institution or operation of a cooperative or unit plan, if  
6 the commissioner determines that the public interest warrants the  
7 reduction or revocation. If the commissioner reduces or revokes a  
8 royalty obligation increase, the commissioner shall include a mecha-  
9 nism to raise the royalty to a level not exceeding its former level in  
10 the event that the lessee's market conditions improve or if the  
11 profitability of a lessee's operation increases to a specified level.  
12 As a condition of the reduction or revocation of a royalty obligation,  
13 the commissioner shall require the lessee to comply with all valid and  
14 applicable laws and regulations of the state

- 15 (1) that concern the hiring of state residents; and
- 16 (2) that are in effect or take effect during the term of
- 17 the lease.

18 \* Sec. 2. This Act takes effect immediately in accordance with AS 01.-  
19 10.070(c).

Offered: 4/18/86  
Referred: Resources and  
Finance

Original sponsor: Fahrenkamp

1 IN THE SENATE  
2 HOUSE CS FOR CS FOR SPONSOR SUBSTITUTE FOR SENATE BILL NO. 430 (Oil & Gas)  
3 IN THE LEGISLATURE OF THE STATE OF ALASKA  
4 FOURTEENTH LEGISLATURE - SECOND SESSION

BY THE HOUSE SPECIAL  
COMMITTEE ON OIL AND GAS

5 A BILL  
6 For an Act entitled: "An Act relating to the reduction or revocation by  
7 the commissioner of the Department of Natural Re-  
8 sources of oil or gas royalty obligation increases  
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17 in collectively adopting or operating under a cooperative or a unit  
18 plan of development or operation of the pool, field, or like area, or  
19 a part of it, when determined and certified by the commissioner to be  
20 necessary or advisable in the public interest. The commissioner may,  
21 with the consent of the holders of leases involved, establish, change,  
22 or revoke drilling, producing, and royalty requirements of the leases  
23 and adopt regulations with reference to the leases, with like consent  
24 on the part of the lessees, in connection with the institution and  
25 operation of a cooperative or unit plan as the commissioner determines  
26 necessary or proper to secure the proper protection of the public  
27 interest. The commissioner may require oil and gas leases issued  
28 under this section to contain a provision requiring the lessee to  
29 operate under a reasonable cooperative or unit plan, and may prescribe

1 a plan under which the lessee must operate. The plan must adequately  
2 protect all parties in interest, including the state. Notwithstanding  
3 (j) of this section, if the commissioner determines that the public  
4 interest warrants the reduction or revocation, the commissioner may  
5 reduce or revoke a royalty obligation increase that was made by the  
6 commissioner in connection with the institution or operation of a co-  
7 operative or unit plan; however, the reduction or revocation must  
8 contain a mechanism to provide that if a lessee's market conditions  
9 improve or if the profitability of a lessee's operation increases to a  
10 specified level after the commissioner makes the reduction or revoca-  
11 tion, the commissioner shall increase the royalty obligation of the  
12 lessee to a level not exceeding the amount of the royalty obligation  
13 increase that the commissioner reduced or revoked. The commissioner  
14 may reduce or revoke a royalty obligation only after the commissioner  
15 of labor finds that the level of resident hire on a subject lease is  
16 consistent with the lessee's stated objectives and applicable laws and  
17 regulations in effect at the time the reduction or revocation is  
18 requested. The lessee shall agree that the percentage of state resi-  
19 dents employed on the lease is not less than the average percentage  
20 employed by other North Slope operators as reported to the Department  
21 of Labor.

22 \* Sec. 2. This Act takes effect immediately in accordance with AS 01.-  
23 10.070(c).

Offered: 4/8/86

Original sponsor: Fahrenkamp

1 IN THE SENATE BY THE RULES COMMITTEE  
2 CS FOR SPONSOR SUBSTITUTE FOR SENATE BILL NO. 430 (Rules)  
3 IN THE LEGISLATURE OF THE STATE OF ALASKA  
4 FOURTEENTH LEGISLATURE - SECOND SESSION  
5 A BILL

6 For an Act entitled: "An Act relating to the reduction or revocation by  
7 the commissioner of the Department of Natural Re-  
8 sources of oil or gas royalty obligation increases  
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9 operation increases to a specified level after the commissioner makes  
10 the reduction or revocation, the commissioner shall increase the  
11 royalty obligation of the lessee to a level not exceeding the amount  
12 of the royalty obligation increase that the commissioner reduced or  
13 revoked.

14 \* Sec. 2. This Act takes effect immediately in accordance with AS 01.-  
15 10.070(c).

Offered: 4/1/86  
Referred: Rules

Original sponsor: Fahrenkamp

1 IN THE SENATE BY THE FINANCE COMMITTEE  
2 CS FOR SPONSOR SUBSTITUTE FOR SENATE BILL NO. 430 (Finance)  
3 IN THE LEGISLATURE OF THE STATE OF ALASKA  
4 FOURTEENTH LEGISLATURE - SECOND SESSION  
5 A BILL  
6 For an Act entitled: "An Act relating to the reduction or revocation by  
7 the commissioner of the Department of Natural Re-  
8 sources of oil or gas royalty obligation increases  
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6 commissioner in connection with the institution or operation of a co-  
7 operative or unit plan; if a lessee's market conditions improve or the  
8 profitability of a lessee's operations increases after the commission-  
9 er makes the reduction or revocation, the commissioner shall increase  
10 the royalty obligation of the lessee, but the increase may not exceed  
11 the amount of the royalty obligation increase that the commissioner  
12 reduced or revoked.

13 \* Sec. 2. This Act takes effect immediately in accordance with AS 01.-  
14 10.070(c).

Introduced: 2/26/86  
Referred: Resources and  
Finance

1 IN THE SENATE

BY FAHRENKAMP

2 SPONSOR SUBSTITUTE FOR SENATE BILL NO. 430

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 FOURTEENTH LEGISLATURE - SECOND SESSION

5 A BILL

6 For an Act entitled: "An Act authorizing the commissioner of the Depart-  
7 ment of Natural Resources under certain circumstances  
8 to reduce or revoke royalty oil or gas obligation  
9 increases made in connection with the institution or  
10 operation of a cooperative or unit plan; and provid-  
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9 10.070(c).