SB
309

May 1, 1986

TESTIMONY OF KAY BROWN, DIRECTOR, DIVISION OF OIL AND GAS
TO HOUSE RESOURCES COMMITTEE
ON PROPOSED HOUSE RESOURCES CS FOR CS SB309

Thank you, Mr. Chairman. For the record, I'm Kay Brown, Director of the Division of Oil and Gas for the Department of Natural Resources. I appreciate this opportunity to testify.

The bill before the committee was intended to benefit Alaska gas and electric consumers. We don't believe it is prudent to try to address other issues -- such as how to value the royalty share of gas production sold for industrial and export uses -- in this consumer bill.

The Department of Natural Resources supports the House Oil and Gas Committee Substitute for SB 309. We object to the proposed Resources Committee Substitute, which addresses industrial and export sales. If the legislature insists on addressing industrial and export sales, we have previously

provided language that would accomplish this in a way that protects the state's interest.

The approach suggested in the proposed Resources Committee Substitute is not acceptable. Let me explain why.

Fundamentally, we believe that the burden must be on the lessee to show that the royalty value is a fair value, and not on the Commissioner to show that it isn't.

The department believes it is appropriate to accept a contract price as the royalty value for arms-length sales to regulated utilities -- as provided in the House Oil and Gas Committee Substitute for SB 309 -- because Alaska consumers would be the direct beneficiaries of any royalties lost to the state as a result of using solely the contract price to establish royalty value. We do not believe that industrial and export gas uses should receive the same exception, since the likely effect would be to increase the profits of industrial and export concerns without a corresponding public benefit.

The proposed Resources Committee Substitute significantly erodes the state's rights under existing oil and gas leases. It would bind the state as landowner to prices established in contracts to which it was not a party, and, contrary to

the provisions of the leases, would forego royalties the state is entitled to receive.

Further, the proposed CS does not include language authorizing "below market" sales of royalty gas for consumer uses, which was included in previous versions of the bill and which is an important element of the department's preliminary settlement agreement with Chugach Electric. We recommend that this language be restored.

The proposed Committee Substitute expands the presumption that a contract price is the correct royalty value to cover virtually all arms-length contracts, whether for consumer or industrial purposes. There is no assurance that a contract would be structured to reflect the true value of the gas.

The department believes that adoption of the proposed Committee Substitute would adversely affect the state's ability to collect royalties in several important instances. For example, Marathon Oil Company has advised the department that it intends to take gas from new fields (not covered by past royalty settlements) to its LNG plant in Cook Inlet. Presumably Marathon will sell the gas as LNG to a Japanese purchaser not related to Marathon in management, ownership or other aspect. Thus, Marathon would be entitled to the presumption of use of the contract price under the proposed

Committee Substitute. However, the state would not be able to effectively challenge a low royalty value claimed by Marathon due to charges associated with liquifying and moving the gas. The contract price alone does not determine royalty value; other aspects of the transaction such as transportation and LNG facilities must be considered if the state's interests are to be protected.

Obviously the potential fiscal impacts of this bill are magnified with regard to the huge gas reserves of the North Slope. With North Slope gas, it is well known that pipeline, liquefaction and shipping charges will be very large. As with Cook Inlet LNG, the state will need to be vigilant to assure that the value of the gas is not attributed to these other segments of the export project. It is illuminating that millions of dollars and almost 10 years have failed to yield a concensus on the proper costs of the TAPS construction project. Yet this bill could require a Commissioner to make even more complex determinations, with no guaranteed access to necessary information, within 90 days.

At a minimum, the state must have the ability to scrutinize all elements affecting a sale for industrial and export purposes, such as pipelines, LNG facilities and LNG tankers. Further, the lessee must have the burden of providing all

information necessary for the commissioner to make an informed decision, as well as the burden of providing clear and convincing evidence that the value of the gas is reflected by the gas sales contract price rather than being attributed to transportation, marketing, manufacturing or other profit or cost centers.

Further, the commissioner should have the ability to approve use of a contract price for a lesser period of time than that covered by the lessee's gas sales contract, and to provide for a periodic review of the royalty value term by the commissioner.

Without these minimum protections for the state, the proposed Committee Substitute is unacceptable.

As drafted, the proposed Committee Substitute would require use of an arms-length contract price as the royalty value unless the commissioner makes a written finding based on ~~clear and convincing~~ evidence that

(A) the contract price is unreasonably low;

(B) the prospective reduction in royalty receipts would not be balanced by increased benefits to in-state consumers; <u>and</u>

(C) the contract price is not in the best interest of the state.

All three conditions would have to be satisfied before the commissioner could reject a contract price, a more difficult standard than finding that any one of the conditions exists. Thus, even if the Commissioner had clear and convincing evidence that using the contract price to establish royalty value would be adverse to the state's best interest, the Commissioner would nonetheless be obligated to bind the state to the disadvantageous royalty value if the other two standards could not be proven by the same high evidentiary standard.

As a practical matter, it would be virtually impossible for the commissioner to obtain clear and convincing evidence to show that a contract price was unreasonably low and not in the state's best interest within the 90-day timeframe provided. The lessee would control access to the necessary information. Lessees have an understandable desire to minimize royalty payments, and no incentive to cooperate by providing proprietary information that the commissioner might request in order to make a decision. The lessees conceivably could spend years devising a complicated pricing formula that the Commissioner would be asked to approve in only 90 days.

In summary, Mr. Chairman, we are disappointed that this bill which we have supported in order to benefit gas and electric consumers may be broadened to cover industrial and export uses without adequate protection for the state's interests. We urge the committee to adopt the House Oil and Gas Committee Substitute, with the addition of the words "based on clear and convincing evidence" after the word "finding" on page 1, line 28 of that bill. If the committee deems it necessary to address industrial and export uses, we recommend use of the language included in Commissioner Wunnicke's April 22 letter to Co-chairman Shultz.

Thank you for your time and consideration.

HOUSE

COMMITTEE REPORT

(9)
Date referred: 4/21/86

FURTHER REFERRALS: FINANCE

DATE: May 1, 1986

The RESOURCES Committee has considered CSSB 309(Rls)

"An Act relating to royalty gas contracts; and providing for an effective date."

and recommends:

[ ] do pass

[ ] do not pass

[ ] do pass with attached amendment(s)

[ ] no recommendation

[✓] replace with HCS CSSB 309 (Resources) [X] same title
[ ] new title

and recommends DO PASS

[ ] further referral to the ______ Committee

and attaches: [ ] letter of intent
[ ] first fiscal note
[ ] new fiscal note
[ ] zero fiscal note

SIGNING DO PASS:

Shultz Dick Shultz

Miller M.W. Miller

Jenkins [signature]

Pearce [signature]

Cato [signature]

Thompson [signature]

SIGNING OTHER RECOMMENDATIONS:

Ray Wallis do not pass
Wallis

Adelheid Herrmann
Herrmann
Do Not Pass
Not enough time spent in Resources on bill

Dick Shultz
Co-Chairman Shultz

STATE OF ALASKA 1986 LEGISLATIVE SESSION
FISCAL NOTE

Revision Date : 2-11-86

REQUEST

Bill/Resolution No. : HB 425
Title : ...Royalty Value of a Natural Gas Lease

Sponsor : Rep. Pearce
Requestor : Oil & Gas, Res Comm
Date of Request : 02-11-85

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						
TOTAL OPERATING						
CAPITAL						
REVENUE	(2,300)	(1,900)	(1,900)	(1,900)	(1,900)	(1,900)

FUNDING : (Thousands of Dollars)

GENERAL FUND						
FEDERAL FUNDS						
OTHER						
TOTAL						

POSITIONS :

FULL-TIME						
PART-TIME						
TEMPORARY						

ANALYSIS : Attach a separate page if necessary

FY 86 revenue losses include obligations incurred by producers since March 1985 royalty enforcement notice. See attached explanation.

Prepared by : Ned Farquhar NF
Division : Commissioner's Office
Phone : 465-2400
Date : 02-11-86

Approved by Commissioner : Norman D Arnold, Deputy
Date : 2/11/86
Agency : Natural Resources

Distribution (by Agency preparing fiscal note) :
- Legislative Finance
- Legislative Sponsor
- Requestor
- Office of Management and Budget
- Impacted Agency(ies)

10/25/85

1st DNR Fiscal Note.

Fiscal Note Background
for HB 425

Passage of HB 425 would prevent enforcement of existing royalty collection provisions in Beluga Field oil and gas leases, and enforcement of royalty gas provisions in other fields. This fiscal note represents the impact of the legislation only on the Beluga Field royalty collections, although there are likely to be impacts in other fields.

The State issued an enforcement order for the Beluga Field in March, 1985, effective April 15, 1985. While the notice is contested by producers, there have been no payments made; if the notice were implemented as written, the State would currently receive $2.8 million/year in increased royalty payments. Because the State has offered to settle the lawsuit at a lower value than embodied in the enforcement notice, however, the fiscal impact has been estimated at the proposed settlement value ($1.50/mcf) that would be lost if SB 309 passes rather than at the value that would be recovered under the original notice.

Some of the revenue loss will be felt by the Alaska Permanent Fund, which receives 25% of the revenues from state oil and gas leasing. The remainder of the impact will be on the General Fund.

There will be other significant but currently incalculable fiscal impacts from passage of the bill. If the bill passes, the State will not collect full royalty value (as stipulated in existing oil and gas lease forms) prospectively on other state leases producing gas. Additionally, producers may seek retroactive compensation for what they may regard as past royalty overpayments, including several recent settlements on royalty gas pricing in Cook Inlet.

If the Legislature's action affects the State's position regarding valuation of other State royalty oil and gas (most notably North Slope oil) there could be revenue losses amounting to tens or hundreds of millions of dollars.

Bannister
4/28/86

Original sponsors: Faiks, Kelly,
and V.Fischer

1 IN THE SENATE BY THE RESOURCES COMMITTEE

2 HOUSE CS FOR CS FOR SENATE BILL NO. 309 (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 royalty gas contracts; and pro-
7 viding for an effective date."

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

9 * Section 1. FINDINGS. The legislature finds that to provide for the
10 utilization, development and conservation of gas resources for the maximum
11 benefit of the people of the state, the value of production of gas for
12 purposes of computing the royalty reserved to the state must be based
13 primarily on the contract price of the gas. This will encourage stable
14 markets, promote investment, assure reasonable energy prices and provide
15 the maximum benefit to the people of the state. The legislature does not
16 intend this Act to apply to the policies of the state regarding the sale of
17 royalty oil.

18 * Sec. 2. AS 38.05.180 is amended by adding new subsections to read:

19 (aa) Within 90 days after the written request of a lessee of a
20 lease issued under this section, the commissioner shall enter into an
21 agreement with the lessee to use the price for the gas established in
22 the contract between the lessee and a purchaser as the value of the
23 state's royalty share of gas production sold by the lessee under the
24 contract unless

25 (1) the lessee and purchaser are related in management,
26 ownership, or other aspect; or

27 (2) the commissioner makes a written finding based on clear
28 and convincing evidence that

29 (A) the contract price is unreasonably low;

1 (B) the prospective reduction in royalty receipts
2 would not be balanced by increased benefits to in-state
3 consumers; and
4 (C) the contract price is not in the best interest of
5 the state.
6 (bb) In (aa) of this section
7 (1) "price for the gas established in the contract" in-
8 cludes tax reimbursement amounts, deliverability and other charges,
9 and other forms of consideration paid by the purchaser under the
10 contract;
11 (2) "state's royalty share of gas production" does not
12 include the state's royalty share of gas production from land patented
13 to the state under
14 (A) P.L. 84-830, 70 Stat. 709 (Alaska Mental Health
15 Enabling Act);
16 (B) 38 Stat. 1214 (Act of March 4, 1915); or
17 (C) 43 U.S.C. 1635 in settlement of the claims of the
18 state under 38 Stat. 1214.
19 * Sec. 3. AS 38.05.180(aa), enacted by sec. 2 of this Act, applies to
20 agreements to establish for a lease issued under AS 38.05.180 the in-value
21 royalties on gas production that is sold by the state's lessee under a
22 contract entered into on or after the effective date of this Act.
23 * Sec. 4. This Act takes effect immediately in accordance with AS 01.-
24 10.070(c).
25
26
27
28
29

STATE OF ALASKA

BILL SHEFFIELD, GOVERNOR

DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

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

April 28, 1986

The Honorable Drue Pearce
Alaska State Legislature
P.O. Box V
Juneau, AK 99811

Dear Representative Pearce:

You have asked the Department of Natural Resources to articulate in writing the problems with the original version of Senate Bill 309, relating to royalty gas contracts.

The bill provides that if royalty gas is taken in value, "the value of production sold under a long-term sales contract may not be greater than the price received for the production under the long-term sales contract unless it is shown by clear and convincing evidence that the long-term price was unreasonably low at the time of the contract."

The Department believes the bill would not protect the state's interests for these reasons:

- The bill significantly erodes the state's rights under existing oil and gas leases, which are contracts entered into many years ago between the state and the lessees. The leases provide that the state is entitled to royalty payments determined by the higher of the price received by the lessee under its sales contract, or the value of the gas at the time of production. The price received under a long-term gas sales contract does not control royalty valuation in those instances where inflation and market forces have caused the current value of the gas to be higher than the contract price. Thus, adoption of SB 309 would result in lower royalties for the state.

- The bill does not distinguish between consumer and industrial uses, nor between arms-length and non-arms-length sales. The effect of the bill would be to require use of a contract price in virtually all cases.

The department believes it is appropriate to accept a contract price as the royalty value for arms-length sales to regulated utilities (as provided in the House Oil and Gas Committee Substitute for SB 309) because Alaska consumers would be the direct beneficiaries of any royalties lost to

the state as a result of using solely the contract price to establish royalty value. The department is not persuaded that industrial gas uses should receive the same exception, since the likely effect would be to increase the profits of industrial concerns without a corresponding public benefit.

The department is particularly concerned about being required to use a long-term contract price as the royalty value for non-arms-length sales. For example, an integrated oil company which produces gas may sell that gas to its subsidiary at any price it chooses. This provision invites manipulations to avoid royalty obligations. Even "prices" set in bad faith with the sole intent of avoiding royalties would have to be accepted by DNR unless DNR proved not only that the "price" was low, but that it was "unreasonably low". Thus, the department does not believe the public interest in maximizing the value of state-owned oil and gas resources is protected by the language in SB 309, particularly in the case of non-arms-length sales.

- The bill provides a limited ability to reject a contract price as the royalty value if it can be shown by clear and convincing evidence that the long-term contract price was unreasonably low at the time of contract.

This exception to the presumption of use of the contract price is far too limited. A contract price that may have been reasonable years earlier but that is not adjusted to keep pace with the market through escalators or reopeners would not be a fair value for the state's royalty. Moreover, the history of the state's oil and gas royalty enforcement has demonstrated that the lessees' natural desire to minimize their royalty payments, when combined with their superior access to and control over information, has necessitated litigation to ensure the proper return to the state for its resources. Although federal law entitles the royalty enforcement agency's determination of royalty value to deference by the courts, in Alaska no such deference is due. The original SB 309 would take the unprecedented step of further handicapping DNR's lease enforcement capability by requiring that deference be given to contract price, even where it is set in bad faith in a non-arm's-length contract.

- The bill would apply retroactively. This provision is not in the state's interest. The lessees who acquired leases through competitive bidding formulated their bids on the basis of the specific lease provisions. To retroactively change material terms of a competitively bid lease contract is legally questionable, and would undermine the state's

ability to enforce other lease terms by encouraging lessees to lobby the legislature whenever DNR takes lease enforcement action.

• Some have asserted during legislative debate on SB 309 and the various committee substitutes that the state's interests are protected due to its ability to take royalty gas in kind. If the state thinks a contract value is too low, the state can take its gas in kind and sell it for a higher value, some have argued.

In kind taking is a safeguard of questionable value. The gas market is limited -- especially on a day-to-day basis. More importantly, the state is in a very disadvantageous marketing position. Royalty contracts must go through administrative and legislative procedures that discourage potential buyers. The state, unlike the producers, cannot control the volume of gas under any in kind sale, since the state simply takes a percentage of the amount produced and sold by the lessees. The state's ability to meet a potential customer's volume needs is obviously seriously handicapped by the fact that the state's royalty volume is a fixed 1/8th of whatever the lessees happen to produce in a given period. Lastly, while the state's royalty share is substantial, it comes from many wells in many fields. This provides a unique extra impediment to the state by augmenting the practical problems of collecting and delivering the gas.

• The original SB 309 may contravene important legal principles, and the policies upon which those principles are founded. Under separation of powers principles, the legislature is charged with passing laws, the executive is charged with implementing those laws, and the judiciary is charged with interpreting those laws. To date that constitutional scheme has been followed in oil and gas leasing. The legislature bestowed broad discretion upon DNR to specify the terms of competitive oil and gas leases. Pursuant to that authority, DNR has issued many oil and gas leases over the last quarter century. Lawsuits have been filed under which the judiciary would interpret those leases. In contrast, the original SB 309 would purport to legislatively establish the royalty due on existing leases, irrespective and in derogation of the terms of the leases and any judicial interpretation of those leases. For the legislature to rewrite the terms of valid lease contracts to which it is not a party violates the principle of separation of powers by invading both the executive and judicial functions. See State v. A.L.I.V.E. Voluntary, 606 P.2d 769 (Alaska 1980), Bradner v. Hammond, 553 P.2d 1 (Alaska 1976), Public Defender Agency v. Superior Court, Third Judicial District, 534 P.2d 947 (Alaska 1975), 1981 Inf. Op. Att'y Gen. (Nov. 3; J66-159-82) and 1976 Inf. Op. Att'y Gen. (Feb. 11).

The original SB 309 may also contravene the public purpose requirement of Alaska Constitution art. IX, § 6. To the extent the bill may be construed to override recent settlement agreements and to require a refund to specific oil companies of payments made under those settlements, the bill could be held to be invalid because of the lack of a public purpose. See 1980 Op. Att'y Gen. No. 19 (Sept. 22).

In summary, the original SB 309 does not protect the state's interests because it binds the state as land owner to contracts to which it was not a party, without adequate provision to assure a fair value for the state's royalty. The legislature previously has directed the department to maximize the value of the state's oil and gas resources for the benefit of Alaska citizens. Adoption of the original SB 309 would be a major departure from this goal.

Sincerely,

Esther C. Wunnicke
Commissioner

cc: Members of the House Resources Committee

YUKON PACIFIC CORPORATION

April 24, 1986

Hon. Richard Shultz, Co-Chairman
House Resources Committee
Alaska State Legislature
Juneau., Alaska 99811

Dear Representative Shultz:

Thank you for taking time recently to discuss Senate Bill 309, the bill relating to valuation of royalties collected by the state from oil and gas production.

This bill, as it comes to your committee, is more than a "tax" on Railbelt consumers, raising the price of Beluga royalty gas supplied to Chugach Electric Association from 26 cents to 75 cents per thousand cubic feet. In effect, this bill denies Alaska's oil and gas producers the ability to make promises they can keep when they negotiate terms on long-term contracts.

We believe that is very dangerous. At a time when we are involved with a large group of Japanese and Korean companies in efforts to develop the potential of North Slope gas, it is wrong to send the signal that the State of Alaska wants to establish the right to change prices unilaterally, without regard for any contract which may come about.

Some have argued that the state has had that right to revalue its royalty share all along, that the right to interfere was agreed to up front with producers in the original lease form. And while courts in Texas have backed up that interpretation, later decisions in Oklahoma have agreed that a contract is a contract and that if the price is negotiated in good faith that is the price the royalty owner deserves.

Here, in Alaska, we can afford no other approach. To succeed as an economy, Alaska must sell more and more of our resources in the highly competitive international market. Several gas contracts from production on state

P.O. Box 101700 • Anchorage, Alaska 99510 • 907-279-1598 • Telex 25-340 Capt. Cook AHG
515 South Post Oak Road • Suite 225 • Houston, Texas 77027 • 713-960-1889 • Telex 775202 SUPRA

Hon. Richard Shultz
April 24, 1986
Page Two

leases are under discussion or negotiation right now, both in the North Slope and the Cook Inlet. As an owner, the state would be foolish to install a "trap door" in the contracting process.

As you consider this legislation, I hope you will keep the following points in mind:

First, private producers making long-term contracts need the flexibility to act quickly in a competitive situation, and they are hampered in their negotiation if their results must later be approved by the royalty owner.

Second, these people are in business to make a profit. Their interest is the same as the state: to collect as much as they can from production. But first production must start, and financing production and transportation facilities requires the stability of long-term contracts.

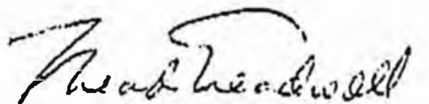
Third, in the gas market, not all gas from the same field has the same value. Just as you might pay different prices for a seat on the same airplane, depending on when you committed and where you're ultimately going, gas fetches different prices for different uses. There is no prevailing price.

Fourth, in all cases, the state maintains the ability to take its oil and gas in kind and to sell it at a higher value if it believes it is not getting the best value under the contract.

If legislation is to pass this committee, it is our hope that you will not deny those you've invited to help develop Alaska's potential the right they have to have--to keep their promises to their customers.

With best regards,

Sincerely,



Mead Treadwell
Vice President and Treasurer

Background Paper
U.S. - Japan Prefeasibility Study
Alaska Asian Gas System (AAGS)

Purpose:

To develop a capital cost estimate for and to test the market receptivity to a project to move natural gas off the North Slope of Alaska.

A gas transportation system out of Prudhoe Bay is likely to be one of the largest private projects in world history. Making it happen will require the efforts of several companies and several countries.

The American side, with Atlantic Richfield Company as study operator, will develop a capital costs estimate for an approximately 800 mile pipeline from Prudhoe Bay to the south coast of Alaska, with conditioning facilities at Prudhoe Bay and liquefaction and port facilities at Point Gravina. The choice of Gravina in this study does not preclude other potential pipeline terminuses, such as Nikiski, Valdez, and Drift River, in later determinations.

The Japanese side, with the Institute of Energy Economics as study operator, will develop cost estimates for shipping, regasification, and domestic distribution, as well as devising several scenarios for the post-1990 LNG market in Japan.

Participants:

U.S. Side

Representative/Operator

Atlantic Richfield Co.

Other sponsor

Yukon Pacific Corporation

Observer

State of Alaska

Japanese Side

Representative: The Committee for Energy Policy Promotion

Operator: The Institute of Energy Economics

Other sponsors:

C. Itoh & Co.
Marubeni Corporation
Mitsubishi Corporation
Mitsui & Co.
Nissho Iwai Corporation
The Bank of Tokyo
The Industrial Bank of Japan
Long-Term Credit Bank of Japan
Sumitomo Trust and Banking Co.
Sumitomo Corporation

Timetable:

The study officially began June 1, 1985 and is expected to last approximately 18 months.

Cost of the studies:

Total costs of the studies to be performed by both sides will amount to approximately $3.8 million, with about equal division in responsibility between the buying and selling sides.

Contractors:

The American study operator has contracted with Bechtel Petroleum to undertake the engineering studies required for a capital cost estimate.

Historical Background:

Since discovery of the Prudhoe Bay oil field in 1968, several attempts have been made to design and construct natural gas transportation facilities from Alaska to the Lower 48 states. Since commencement of oil production and shipment through the Trans Alaska pipeline system, in June 1977, gas produced with the oil has been reinjected into the field. The field reserve of about 26 trillion cubic feet could be produced at a rate of two billion cubic feet or more per day over a period of 25 years. As LNG, that production equates to 10-15 million tons per year.

In 1977, President Carter selected the Alaska Natural Gas Transportation System (ANGTS) as the preferred project to bring gas into the Lower 48 states on an overland route through Canada. The project has obtained most of the permits necessary for construction; however, lack of a gas market for the project caused sponsors in 1982 to postpone indefinitely the commencement of construction.

That same year, Governor Jay Hammond asked two of the his predecessors, Walter J. Hickel and the late William A. Egan, to undertake a screening study of alternative methods to market North Slope gas. The report of the Governor's Economic Committee on North Slope Gas proposed an 820 mile Trans Alaska Gas System estimated to cost approximately $14.6 billion. Estimated costs of financing, inflation, and taxes during construction escalated the figure to $26.2 billion. Governor William Sheffield accepted the report. That spring, Alaska's legislature endorsed further pursuit of gas exports.

In January of 1983, President Reagan and Prime Minister Nakasone set up a subcabinet level Joint Energy Working Group to discuss energy cooperation between the U.S. and Japan. Examining the opportunities of joint development of North Slope gas was part of the charge of that group, chaired on the U.S. side by Undersecretary of State for Economic Affairs, Allen Wallis. The working group, and a subsidiary group of experts, met several times and made one visit to Prudhoe Bay. In November 1983, at a summit meeting in Tokyo, President Reagan and Prime Minister Nakasone issued a joint statement endorsing the idea of a private prefeasibility study on joint development of an Alaska gas transportation system.

During late 1983 and 1984, leaders of Atlantic Richfield Company and Yukon Pacific Corporation met with representatives of Japanese companies to make arrangements for the next step -- an international study which would give both sides the information they need to make a decision concerning construction of the project.

The study agreement was signed April 26, 1985. Successful formation of the study group was reported to President Reagan by Prime Minister Nakasone at the Bonn summit in May 1985.

THIS IS FOR INFORMATION PURPOSES ONLY
The information contained herein
may not be complete, and is not to be
construed as a legal opinion.

STATE OF ALASKA

THE LEGISLATURE

[illegible]

Source

[illegible] 23(Fin)

Legislative
Resolve No.

[illegible]

Relating to marketing and transporting Alaska's natural gas.

BE IT RESOLVED BY THE LEGISLATURE OF THE STATE OF ALASKA:

WHEREAS the largest gas field in the North American continent was discovered 15 years ago at Prudhoe Bay, on Alaska's North Slope; and

WHEREAS since that time it has been the policy of Alaska's state government to promote an environmentally sound, privately financed transportation system that would allow North Slope natural gas to come to market, while providing a new source of energy for Alaska's interior and raw material for future industry throughout the state; and

WHEREAS efforts by the United States and Canadian governments and private industry to move natural gas from the North Slope to supply the midwestern and pacific states have been supported by the State of Alaska and shall continue to have the state's support; and

WHEREAS in order to explore all possibilities of marketing North Slope gas, it is also in the state's best interest to explore all markets; and

WHEREAS successful marketing of Alaska's North Slope energy reserves can result in increased energy exploration, in a secure source of energy supply, contributing to both the economic and energy security of the United States; and

WHEREAS an Alaskan natural gas transportation system is committed to deliver natural gas to Alaska's interior for energy and raw material for industry in order to support economic diversification; and

WHEREAS the State of Alaska wishes to be on record in supporting any natural gas transportation system that would deliver gas to any market; and

WHEREAS it is in the best interests of the people of Alaska that the state government immediately enter into negotiations for the sale of the state's royalty interest in North Slope natural gas for in-state use as a catalyst for construction of a transportation system for Alaska's natural gas;

BE IT RESOLVED by the Alaska State Legislature that the State of Alaska fully supports the efforts of all owners of the gas and other parties to market the North Slope gas; and be it

FURTHER RESOLVED that the State of Alaska requests the federal government to remove any impediments to freely marketing North Slope gas or oil that would not affect the ongoing efforts of private industry to construct a gas transportation system overland from Alaska; and be it

FURTHER RESOLVED that all trading partners of Alaska are strongly urged to consider and take advantage of the benefits that a secure, long-term trading relationship with Alaska would offer; and be it

FURTHER RESOLVED that the legislature calls upon the owners of the gas, Alaska's delegation in Congress, and all other parties with an interest in the gas to explore every means to privately finance and construct a transportation system for Alaska's natural gas; and be it

FURTHER RESOLVED that the State of Alaska immediately enter into negotiations for the sale of its royalty interest in North Slope gas to in-state users in order that they and the state serve as a catalyst for the construction of a transportation system for Alaska's natural gas.

COPIES of this resolution shall be sent to the Honorable Ronald Reagan, President of the United States; the Honorable George Schultz, Secretary of State; the Honorable James Watt, Secretary of the Interior; the Honorable Malcolm Baldridge, Secretary of Commerce; the Honorable George Bush, Vice-President of the United States and President of the U.S. Senate; the Honorable Thomas P. O'Neill, Jr., Speaker of the U.S. House of Representatives; and to the Honorable Ted Stevens and the Honorable Frank Murkowski, U.S. Senators, and the Honorable Don Young, U.S. Representative, members of the Alaska delegation in Congress.

Source

HOUSE 15(Res)

Establishing a Join

BE IT RESOLVED BY

WHEREAS the
established speci
issues since 1972;

WHEREAS the
oil revenues dem
deal with oil and

WHEREAS it
Legislature be
state's oil and g

BE IT RESOL
House and Senate
issues relating t

FURTHER RES
members of the
members of the
Senate Committee

FURTHER RES
on Oil and Gas
of the legislat
First Session of

HJR 38 RELATING TO MARKETING AND TRANSPORTING ALASKA'S NATURAL GAS

AMENDED TITLE: SCS CSHJR(FIN)

PRIME SPONSORS: COWDERY

CO-SPONSORS: ABOOD, BARNES, BETTISWORTH, BUSSELL, CATO, FLOOD, FRITZ, FULLER, FURNACE, GRUSSENDORF, HURLBERT, KOPONEN, LACHER, LARSON, LINDAUER, LISKA, MARTIN, MILLER.M.W., PESTINGER, PHILLIPS, RINGSTAD, SHULTZ, TISCHER, UEHLING, WARD, WENDTE, HAYES

DATE	SEQ. NO.	JOURNAL PAGE	HOUSE ACTION
03/18/83	01	0538	FIRST READING -- COMMITTEE REPORTS
04/06/83	02	0745	RES -- CS07
04/11/83	03	0811	SECOND READING
04/11/83	04	0812	RES CS ADOPTED BY UNAN CONSENT
04/11/83	05	0812	ADVANCED TO 3RD READING BY UNAN CONSENT
04/11/83	06	0812	THIRD READING
04/11/83	07	0812	PASSED BY DIV 36-00-04
04/11/83	08	0812	NOTICE OF RECONSIDERATION GIVEN
04/12/83	09	0834	RECONSIDERATION NOT TAKEN UP
06/21/83	19	1874	CONCURRED IN SENATE AMS BY DIV 37-02-01
06/22/83	20	1914	TRANSMITTED TO GOVERNOR
06/29/83	21	2127	SIGNED BY GOVERNOR
** 06/29/83	22	2127	LEGISLATIVE RESOLVE NO. 19

DATE	SEQ. NO.	JOURNAL PAGE	SENATE ACTION
04/13/83	10	0690	FIRST READING -- COMMITTEE REPORTS
04/26/83	11	0810	RES -- CS06
06/01/83	12	1160	FIN -- CS06
06/20/83	13	1387	RLS -- OTHER03
			TAKEN UP IMMEDIATELY
06/20/83	14	1395	SECOND READING
06/20/83	15	1395	FIN CS ADOPTED BY UNAN CONSENT
06/20/83	16	1395	ADVANCED TO 3RD READING BY UNAN CONSENT
06/20/83	17	1395	THIRD READING
06/20/83	18	1396	PASSED BY DIV 18-00-02

SB 309: (Original)

For the purpose of determining the value of the state's share of royalty gas, taken in-value and sold pursuant to a long-term contract, the Department of Natural Resources would be required to use the long-term contract price unless it could show, by clear and convincing evidence, that the contract price was unreasonably low at the time the contract was entered into. The bill would apply to all leases issued before and after the effective date of the act and would also apply to all types of gas sale contracts.

SB 309: (Senate Resources Committee)

Within 90 days of the written request of a lessee, the Commissioner of the Department of Natural Resources would enter into an agreement with the lessee to value the state's share of in-value royalty gas at the contract price, unless the Commissioner made a finding, based on clear and convincing evidence, that the price was unreasonably low and the reduction in royalties would not be offset by benefits to consumers. This version of the bill would only apply to arm's length contracts between lessees and non-profit electric cooperatives or municipal electric utilities. The bill would also allow in-kind gas sales at less than market value and would apply only to contracts entered into after the effective date of the act.

SB 309: (Senate Rules Committee)

Expanded the operative effect of SB 309 (Resources) to local regulated electric and gas utilities and added a procedure for establishing the royalty value of gas in arm's length contracts for the sale of gas from Prudhoe Bay reservoirs, via pipeline, for export from the state. For Prudhoe Bay gas, the Department of Natural Resources Commissioner could enter into an agreement to use the contract price to value in-value royalty gas provided the Commissioner makes a written finding that the contract price would assure maximum benefit to the people of Alaska.

SB 309: (House Special Committee on Oil & Gas)

Deleted the section dealing with Prudhoe Bay gas. The Committee also deleted the requirement that any decision by the DNR Commissioner not to use the contract price (for arm's length contracts between lessees and gas or electric utilities) must be based on clear and convincing evidence. The Committee added a new requirement that a gas utility, if it owned a gas pipeline, must agree to common carrier status under Alaska statutes, in order to obtain the benefits provided in the bill.

042386/457a-ltrs/le

CHRONOLOGY OF

ROYALTY GAS DISPUTE

(As of April 23, 1986)

1960 -	State leases with ARCO, Shell and Chevron (or their predecessors-in-interest) (DL-1)
1962 -	Beluga Unit Agreement
1965 -	Chugach signs contract with ARCO, Shell and Chevron for Beluga gas.
1968 -	Chugach's Beluga generating plant begins operation.
1973 -	Chugach signs new contracts with ARCO, Shell and Chevron for Beluga gas.
Dec. 1982 -	Alaska Pipeline signs gas contracts with Marathon and Shell.
March 18, 1985 -	DNR notice to lessees asserting "market value" for royalty gas.
Late April 1985 -	ARCO, Shell & Chevron file litigation against state over the royalty gas revaluation. (ARCO and Chevron named Chugach as a co-defendant)
May 1985 -	SB 309 and other bills introduced to tie royalty gas valuation to long-term contract price.
Feb. 19, 1986 -	Agreement between Chugach and state on Senate Resource Committee Substitute for SB 309; tentative settlement of litigation based on passage of this bill.
March 1986 -	Amended SB 309 passes out of Senate Rules Committee and Senate.
April 17, 1986 -	Amended SB 309 (Oil & Gas) passes out of House Special Committee on Oil & Gas.

042386/456-ltrs/le

STATE OF ALASKA

BILL SHEFFIELD, GOVERNOR

DEPARTMENT OF NATURAL RESOURCES

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

OFFICE OF THE COMMISSIONER

April 24, 1986

The Honorable Richard Shultz
Co-Chair, House Resources Committee
Alaska State Legislature
P.O. Box V
Juneau, AK 99811

Dear Representative Shultz:

Following up on my letter to you earlier this week on HCS CSSB 309 (O & G), I am writing to provide more information about an amendment that the Department supports and recommends to the Committee (see attachment).

The purpose of the bill, which we strongly endorse, is to provide a greater measure of certainty in royalty gas pricing for Alaska consumers. The benefits of the new policy embodied in the bill will be shared by a large number of Alaskans. We recognize that uncertainty in long-term pricing of royalty gas can cause difficulty in planning for Alaska utilities and their customers, both in financing for projects and in rate stability.

The attached amendment will help provide the certainty that we believe Alaska consumers deserve. In the specific situations enumerated (i.e., arms length sales to regulated utilities) we believe the presumption should be that the Commissioner will accept the contract price unless there is a clear and convincing reason not to do so.

Please contact me if you have questions about this language. I hope to be present at your hearing tomorrow morning, and I appreciate your attention to the bill.

Sincerely,

Esther C. Wunnicke
Commissioner

cc: Committee members

Attachments

10-J9LH

STATE OF ALASKA

BILL SHEFFIELD, GOVERNOR

DEPARTMENT OF NATURAL RESOURCES

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

OFFICE OF THE COMMISSIONER

April 22, 1986

The Honorable Richard Shultz
Co-Chair, House Resources Committee
Alaska State Legislature
P.O. Box V
Juneau, AK 99811

Dear Representative Shultz:

I am writing with regard to HCS CSSB 309 (Oil and Gas), relating to royalty gas contracts.

The Department strongly supports the bill as it has come to the Committee. After many months of negotiations and discussions about the consumer impact of our statutorily-derived royalty gas policy, we agreed to support a bill providing a preference for gas consumers in Alaska. This benefit will affect up to 270,000 gas and electric customers in Alaska and in future years if gas production occurs elsewhere in the state, we can expect even broader benefits from use of the state's royalty gas.

We remain opposed to the original version of SB 309 for a number of reasons. The original bill would have had broad constitutionally questionable impacts, and would not have protected the interests of the state or consumers.

However, we are aware that some members of the House, including some Committee members, are interested in amending HCS CSSB 309 (Oil and Gas) to affect a broader range of gas producers in Alaska. Even though I continue to believe that this issue should be considered and discussed in another piece of legislation than this "consumer bill," I am attaching possible language that protects the state's interests and could be adopted if the Committee wishes to address the broader issues of royalty gas valuation.

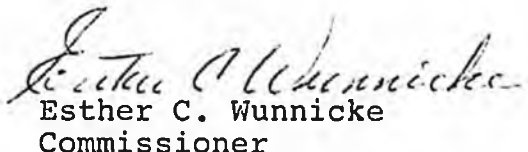
Attachment 1 is language (similar to the Senate-passed bill) to provide a mechanism for establishing the value of royalty gas that could be transported through a proposed gas pipeline from the North Slope. Proponents of the North Slope gasline have indicated that it would be difficult, if not impossible, to achieve financing for the project without the ability to obtain certainty about the price of the state's royalty gas. We recognize the desirability of a major North Slope gas marketing project, and drafted language for the Senate Rules Committee that would assist in financing a gasline project. While I would prefer to see this issue addressed in another bill, I believe that the attached language drafted by our attorneys would protect the interests of the state and could be added to HCS CSSB 309 (Oil and Gas).

Attachment 2 is broader language to establish a general framework for setting the value of royalty gas for any use other than those specific consumer uses covered by the proposed Sec. (aa) under Sec. 2 of this bill. This provision would apply to a North Slope gasline or any other user. Again, although I would prefer to see this issue addressed in another bill, I believe that the language would protect the interests of the state and could be added to HCS CSSB 309 (Oil and Gas).

Both proposals, in Attachments 1 and 2, also would require an amendment to Sec. 5 of the bill to provide that (bb) of the bill is not retroactive but applies only to gas production sold under a contract entered into on or after the effective date of the act.

An amendment that we recommend is to reinstate language that appeared in the Senate Resources and Senate Rules versions of the bill regarding the standard for the commissioner's decision to reject use of an arms'-length contract price between a lessee and a gas or electric utility. We recommend that you adopt the amendment on Attachment 3.
Please contact me if you have any comments or questions. My staff will be present at your Friday hearing on the bill.

Sincerely,



Esther C. Wunnicke
Commissioner

cc: Committee members
Dr. Joyce Murphy, Chugach Electric

Attachments

Attachment 1

Possible amendment of CS for SB 309 (Oil and Gas) which would add a new version of (bb):

AS 38.05.180 is amended by adding a new subsection to read:

(bb) In the event of a contract for the sale of gas from Alaska North Slope gas leases by means of delivery of the gas through a pipeline for export out of the state, the commissioner may enter into an agreement with the lessee to use the price for the gas established in the gas sales contract as the value of the state's royalty share of gas production sold by the lessee under the gas sales contract if the commissioner makes a written finding that the contract price assures the receipt of maximum benefits to the people of the state in return for the state's gas resources. In order to invoke this subsection, a lessee must make its written request no later than 90 days after the first delivery of gas under the gas sales contract. The commissioner shall then act on the request in writing within 120 days. The agreement between the lessee and the commissioner may be for a lesser period of time than that covered by the lessee's gas sales contract, and may provide for a periodic review of the royalty value term by the commissioner. The lessee shall have the burden of providing all information necessary for the commissioner to make an informed decision, and shall provide clear and convincing evidence that the value of the gas is reflected by the gas sales contract price rather than being attributed to transportation, marketing, manufacturing, or other profit or cost centers. In this subsection

(1) "Alaska North Slope gas leases" includes any gas lease issued by the state under this section that lies in whole or in part north of 68 degrees north latitude;

(2) "gas sales contract" includes, in addition to its ordinary meaning, a written agreement for the intracompany tranfer of gas; and

(3) "price for the gas established in the gas sales contract" includes tax reimbursement amounts, deliverability and other charges, and other forms of consideration received by the lessee under the gas sales contract.

Possible amendment of CS for SB 309 (Oil and Gas) which would add a new version of (bb):

AS 38.05.180 is amended by adding a new subsection to read:

(bb) In the event of a contract for the sale of gas from a gas lease issued under this section that does not qualify under subsection (aa), the commissioner may enter into an agreement with the lessee to use the price for the gas established in the gas sales contract as the value of the state's royalty share of gas production sold by the lessee under the gas sales contract if the commissioner makes a written finding that the contract price assures the receipt of maximum benefits to the people of the state in return for the state's gas resources. In order to invoke this subsection, a lessee must make its written request no later than 90 days after the first delivery of gas under the gas sales contract. The commissioner shall then act on the request in writing within 120 days. The agreement between the lessee and the commissioner may be for a lesser period of time than that covered by the lessee's gas sales contract, and may provide for a periodic review of the royalty value term by the commissioner. The lessee shall have the burden of providing all information necessary for the commissioner to make an informed decision, and shall provide clear and convincing evidence that the value of the gas is reflected by the gas sales contract price rather than being attributed to transportation, marketing, manufacturing, or other profit or cost centers. In this subsection

(1) "gas sales contract" includes, in addition to its ordinary meaning, a written agreement for the intracompany tranfer of gas; and

(2) "price for the gas established in the gas sales contract" includes tax reimbursement amounts, deliverability and other charges, and other forms of consideration received by the lessee under the gas sales contract.

Attachment 3

At p. 1, line 28, after "finding", insert:

<u>based on clear and convincing evidence</u>

COOK INLET ROYALTY GAS VALUATION: An Overview

A Presentation to the
Senate Resources Committee
by:

Esther C. Wunnicke, Commissioner
Alaska Department of Natural Resources

Kay Brown, Director
Division of Oil and Gas
Alaska Department of Natural Resources

Bill Van Dyke, Petroleum Manager
Division of Oil and Gas
Alaska Department of Natural Resources

Mark Worcester, Assistant Attorney General
Alaska Department of Law

February 10, 1986

2/5/86

COOK INLET GAS SUMMARY

Lease interpretation: Under the terms of its oil and gas lease contracts with the oil companies, the state is entitled to royalty payments determined by the higher of the price received by an oil company under its sales contract, or the value of the gas at the time of production. This means that the price received under a long-term gas sales contract does not control royalty valuation in those instances where inflation and market forces have caused the current value of the gas to be higher than the contract price.

DNR policy:

(1) As land manager for the citizens of the entire state, it is DNR's responsibility to obtain fair value for the state's oil and gas resources by collecting the full royalties to which the state is entitled under its oil and gas leases.

(2) DNR should not selectively abdicate its responsibility to enforce the royalty terms of the Cook Inlet gas leases just because utility companies have agreed as part of their gas purchase contracts to reimburse the oil companies for royalty collections made by the state. Any consumer subsidy should be the result of an affirmative, direct subsidy by the legislature as part of a comprehensive energy policy.

(3) DNR should not divert from uniform enforcement of the oil and gas leases, since such action could, in addition to directly reducing revenues from any leases from which royalties are not fully collected, also indirectly cause a much larger reduction in state revenues by impairing the state's ability to enforce the royalty provisions of the North Slope leases.

The potential consumer impact result from actions by Chugach, not the state. The risk that gas values might escalate to values in excess of the long-term gas sales price was a circumstance foreseen by the parties to those sales contracts. This is demonstrated by the fact that the contracts between the oil company lessees and Chugach Electric Association, Inc. (Chugach) specifically assign to Chugach the risk of any rise in royalty obligations. The state was not a party to those sales contracts. The contract price, the absence of an adequate price escalator or price reopener, and the assignment to Chugach of the risk of increased royalty obligations were all conditions established by contract between Chugach and the lessees without state participation.

Existing law provides an adequate mechanism for long-term royalty certainty: DNR is sympathetic to the desirability of long-term certainty in royalty matters. However, new statutory authorities are not necessary in order to provide such certainty. Royalty certainty can be attained by negotiation of long-term in kind gas sales contracts which parallel the contracts between the state's

lessees and their gas purchasers. This would allow an opportunity for DNR, the royalty board, and the legislature to evaluate the adequacy of the royalty over the life of the contract. This is preferable to being locked into a long-term royalty value set by prices established by lessees without any notice to or participation from the state.

Litigation: Last March DNR notified the Cook Inlet lessees of its determination to enforce the leases. The notices asserted that the most recent (December 1982) major contracts from the Kenai and Beluga River fields (the "APL II contracts") established the current value. These contracts had a base contract price of $2.05 per mcf in 1985. The state subsequently indicated its readiness to accept a lower royalty value if presented with evidence that the current value of gas in Cook Inlet is less than the price established under the APL II contracts. Union, Marathon, ARCO, Chevron and Shell responded to the notices by suing the state.

Recent Cook Inlet Gas Sales Contracts:

Date of Contract	Purchaser	Field	Starting Base Price
1982	APL (Enstar)	Beluga	$2.32
1982	APL (Enstar)	Kenai, Beaver Creek or McArthur River	$2.32
1983	Chugach	Cannery Loop	$1.80
1984	APL (Enstar)	Lewis River	$1.80
1985	Tesoro	Kenai, Beaver Creek or McArthur River	$2.01

Settlements achieved: In the last two months of 1985 DNR's royalty enforcement actions achieved significant success. Settlements relating to gas royalties due on production from the Kenai Field, and involving Marathon, Union, Alaska Pipeline Company (Enstar), CIRI, the U.S. Department of the Interior and the state, yielded the state about $4 million in retroactive royalties, and will bring in excess of $6.5 million per year more than the amounts which would have been paid under the lessees' prior reporting practices (including those increases attributable to the state's 90% interest in federal onshore royalties). Under the lessees' theory, the royalties would have been variously between $0.21 and $0.61 per mcf; under the settlement, the lessees will pay $1.95 per mcf during 1986. The $1.95 is squarely within the gas values established by recent Cook Inlet gas sales contracts, as well as the values established by Enstar's pending rates ($2.1854 for Schedule C purchasers - "Large Commercial Service", and from $1.6480 to $2.0158 for sales to power plants). The settlements confirm the soundness of the royalty enforcement action taken last spring.

Remaining disputes: The major remaining dispute relates to the Beluga River field, the primary source of gas for Chugach.

Settlement negotiations during the last six months have failed to produce any resolution. Options explored have included underlifting the state's royalty share, thus delaying the royalty into the future; an in kind sale to Enstar or Chugach; and an in value settlement. The lessees (ARCO, Chevron and Shell) assert that they should not be required to contribute any monies to any settlement, since their sales contract with Chugach requires Chugach to reimburse the lessees for any additional royalty amount the state collects. Chugach, in turn, has been unwilling to agree to an acceptable value, and has indicated that it will seek legislative relief. Recently, the state made a formal offer to its lessees to settle the dispute for $1.50 per mcf. This offer was rejected, but settlement efforts and discussions continue.

Consumer impact. Chugach estimates that a royalty rate of $2.05 per mcf on state leases would increase retail consumer rates only about 2.38%, assuming the lessees were successful in asserting that their contracts with Chugach permitted them to pass the royalty burden on to Chugach, and further assuming that the APUC permitted Chugach to pass the burden on to its consumers. DNR estimates that a $2.05 royalty would increase state revenues by about $2.8 million per year. Under the $1.50 per mcf settlement offer, the increased royalty income would fall to about $2 million per year, and the magnitude of retail consumer impact would be correspondingly reduced to less than 2%. (A two per cent increase on a monthly bill of $30 would be only $0.60).

2/5/86

COOK INLET GAS ROYALTY SETTLEMENTS
(State leases and State share of federal royalties)

Lessee	Scope of Settlement	Retro-active Payment (millions)	Current Monthly Value Under Settlement (per Mcf)	Estimated Additional Royalties per year (millions)
Phillips	North Cook Inlet Field gas sold as LNG in Japan	$36.3	$2.32	$12.00
Marathon	Kenai field gas sold as LNG in Japan	$ 4.3	$2.32	$ 0.75
Union and Marathon	All of Union's Kenai field gas disposition (including the following: urea/ammonia plant, rental gas, Enstar), plus Marathon's dispostions to Enstar under Enstar's 1975 contract	$ 4.1	$1.95	6.90
	Total	$44.7		$19.65

ATTACHMENT 3

2/5/86

COOK INLET GAS ROYALTY CHRONOLOGY

Month	Year	Description of Event
March	1964	Foster v. Atlantic Refining Company, 329 F.2d 485 (5th Cir. 1964) holds that long-term contract price does not control royalty valuation when market value rises, even if this is burdensome on the lessee.
May	1965	Chugach Electric Association, Inc. enters into 20 year contracts with ARCO, Chevron and Shell for Beluga River gas, with an initial price of 15.2 cents per mcf, subject to a volume limit.
January	1973	Chugach renegotiates its 1965 contracts, extending the term to 1998 (unless the new, higher volume limit is reached earlier). The 1986 base price under those contracts is about 21 cents per mcf.
November	1982	Chugach obtains supplemental gas deliveries under the 1973 contract at a base price of $1.48 per Mmbtu (approximately equivalent to $1.48 per mcf).
December	1982	Alaska Pipeline Company (Enstar) signs contracts for gas deliveries from Beluga River (with Shell) and Kenai (with Marathon) at a price of $2.32 per mcf, with annual adjustments based upon fuel price fluctuations (the "APL-II" contracts). This is the first totally new contract for Beluga River gas subsequent to the 1973 Chugach contract under which there were any deliveries.
March	1984	Piney Woods County Life School v. Shell Oil Company, 726 F.2d 225 (5th Cir. 1984), reh. den. 750 F.2d 69, cert. den. 105 S.Ct. 1868 (1985) reaffirms the soundness and continued validity of the rule in Foster, above.
May	1984	The state and Phillips settle their dispute concerning the valuation of Cook Inlet gas from state leases which is sold as LNG in Japan, using a formula which initially yields a royalty of $2.40 per mcf.
May	1984	The federal government informs Union that virtually all gas royalties from the Kenai field, including gas sold under below-current-market, long-term contracts with Enstar, must be valued in accordance with the price under the APL-II contracts.
November	1984	DNR determines, in consultation with the Department of Law, to enforce the Cook Inlet lease terms requiring payment of gas royalty on the basis of current value.

February	1985	U.S. District Judge Fitzgerald rules that Marathon must pay royalties on Kenai Field gas sold as LNG in Japan based upon the Japan sales price, less costs of transportation. Marathon calculates the netback value under the order to be about $3.00 per mcf, while the federal government calculates the value to be about $3.60 per mcf. The accounting remains in dispute in District Court, while the District Court's February 1985 decision is under appeal to the Ninth Circuit.
March	1985	By written notice, DNR informs its Cook Inlet lessees of its determination to enforce the royalty requirements of the leases.
May/June	1985	All Cook Inlet gas producers file separate lawsuits seeking judicial declaration of their royalty obligations under the leases.
July	1985	The state and Marathon settle their dispute concerning the royalty value of Kenai Field gas sold as LNG in Japan in accordance with the terms of the May 1984 Phillips settlement.
November	1985	The state, federal government and CIRI (all royalty owners in the Kenai field) settle most royalty issues for production from the Kenai field. Most significantly, royalty on gas used in Union's urea and ammonia plant and used to promote greater oil production from the Swanson River oil field, is set at $1.85 per mcf for 1985 and $1.95 per mcf for 1986, with annual adjustments thereafter based upon fluctuations in fuel oil prices.
November	1985	The Secretary of the Interior issues a definitive order holding that Cook Inlet gas sold by Union and Marathon to Enstar must be valued for royalty purposes according to current market values.
December	1985	The state, federal government and CIRI enter into a settlement agreement on the value of the royalty on Kenai gas sold to Enstar under long-term contracts. Under this settlement, the royalty owners receive $1.85 per mcf for the part of 1985 at issue, and will receive $1.95 per mcf for 1986 production, with annual adjustment thereafter based upon fluctuations in the oil prices.
January	1986	The state offers to the producers to settle the dispute concerning the royalty value of gas sold to Chugach. This $1.50 per mcf offer is rejected by the producers, but settlement discussions continue.

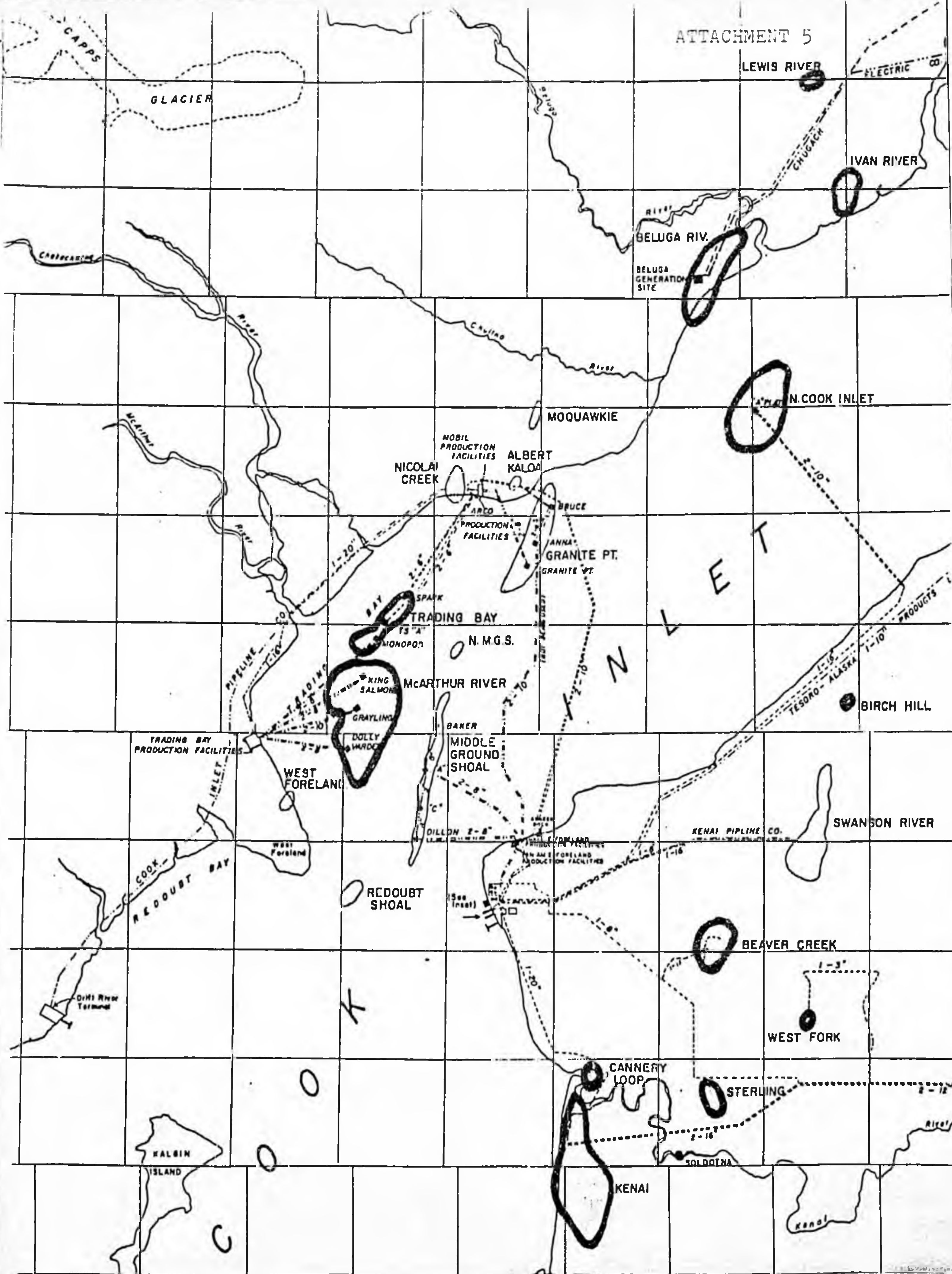
ALASKA DEPARTMENT OF NATURAL RESOURCES - DIVISION OF OIL AND GAS
SUMMARY STATISTICS
COOK INLET GAS PRICE DISPUTE
AVERAGE MONTHLY SALES VOLUMES - JULY 1984 THROUGH JUNE 1985

Date:1/14/86

FIELD Producers (% of field owned)	PURCHASER	% of FIELD on sale by sale basis	SALES VOLUMES (MCF) 1/	EFFECTIVE ROYALTY INTEREST	ROYALTY VOLUME (MCF)	VALUE REPORTED FOR ROYALTIES 2/	PRODUCER/ PURCHASER BASE CONTRACT VALUE 2/ 7/	EFFECTIVE DATE	EXPIRATION DATE	
BELUGA RIVER FIELD										
CHEVRON (33.33%)	ENSTAR	2.11%	37,790	0.07555	2,855	$1.8000	$2.0300 9/	12/20/82	10/1999	
ARCO (33.33%)	ENSTAR	2.11%	37,790	0.07555	2,855	$1.8000	$2.0300 9/	12/20/82	10/1999	
SHELL (33.33%)	ENSTAR	2.11%	37,790	0.07555	2,855	$1.8000	$2.0300 9/	12/20/82	10/1999	
AGEA (100.00%)W-214-35	ENSTAR	0.45%	8,122	0.07555	614	$1.8000	$2.0300 9/	12/20/82	10/1999	
SUB TOTAL		6.77%	121,492		9,179					
CHEVRON (33.33%)	CHUGACH	28.70%	515,065	0.07555	38,913	$0.2103	$0.2103	5/14/65	1/1998	3/
ARCO (33.33%)	CHUGACH	28.70%	515,065	0.07555	38,913	$0.2103	$0.2103			
SHELL (33.33%)	CHUGACH	28.70%	515,065	0.07555	38,913	$0.2103	$0.2103			
AGEA (100.00%)W-214-35	CHUGACH	7.13%	127,863	0.07555	9,660	$0.2103	$0.2103			
SUB TOTAL		93.23%	1,673,058		126,400					
TOTAL BELUGA RIVER FIELD		100.00%	1,794,550		135,578					
KENAI FIELD										
UNION (50%)	APL-ANCHORAGE	10.28%	845,672	0.020688	17,494	$1.9500 8/	$0.6220 6/	5/13/60	12/92	3/
UNION (50%)	APL-CHEV NIK	0.19%	15,888	0.020688	329	$1.9500 8/	$0.6220			
UNION (50%)	UNION-CHEV	0.19%	15,518	0.020688	321	$1.9500 8/	$0.6220	2/5/81	INDEFINITE	
UNION (50%)	CITY OF KENAI	0.25%	20,590	0.020688	426	$0.3000	$0.3000	5/17/66	6/1986	
UNION (50%)	RENTAL GAS	4.50%	370,334	0.020688	7,661	$1.9500 8/	$0.0700	1/17/66	1/1995	3/
UNION (50%)	ADDITIONAL RENTAL	2.37%	194,981	0.020688	4,034	$1.9500 8/	$0.3800			
UNION (50%)	UNION CHEMICAL	40.73%	3,352,041	0.020688	69,347	$1.9500 8/	$0.6130	11/1/77	1998	
TOTAL UNION SHARE		58.51%	4,814,973		99,612					
MARATHON (50%)	APL-I	14.38%	1,183,535	0.020688	24,485	$1.9500 8/	$0.6220 6/		12/1992	3/
MARATHON (50%)	APL-II	4.48%	368,603	0.020688	7,626	$2.0550	$2.0800 9/	12/16/82	12/1997	3/
MARATHON (50%)	APL-NIKISKI	0.19%	15,888	0.020688	329	$2.0550 4/	$0.6220			
MARATHON (50%)	CITY OF KENAI	0.25%	20,599	0.020688	426	$2.0550 4/	$0.3000		6/1986	
MARATHON (50%)	RENTAL GAS	4.50%	370,242	0.020688	7,660	$0.2100	$0.2100		1/1995	3/
MARATHON (50%)	ADDITIONAL RENTAL	2.36%	194,450	0.020688	4,023	$0.3800	$0.3800			
MARATHON (50%)	TOKYO UTILITIES	15.32%	1,261,073	0.020688	26,089	$2.2795	$4.7590 5/		6/1/89	
TOTAL MARATHON SHARE		41.49%	3,414,390		70,637					
TOTAL KENAI FIELD		100.00%	8,229,363		170,249					
STERLING FIELD										
UNION (50%)	PENINSULA GREENHOUSE	50.00%	736	0.015546	11	$0.4000	$0.4000	10/27/61		
MARATHON (50%)	PENINSULA GREENHOUSE	50.00%	736	0.015546	11	$2.0550 4/	$0.4000			
TOTAL STERLING FIELD		100.00%	1,472		23					
MCARTHUR RIVER FIELD										
UNION/MARATHON (50% each)		0.47%	1,671	0.125	209	0.000	0.000			
UNION/MARATHON (50% each)	RENTAL GAS	1.40%	5,260	0.125	658	0.000	0.210			
UNION/MARATHON (50% each)	UNION CHEMICAL	87.56%	311,215	0.125	38,902	0.000	0.613			
UNION/MARATHON (50% each)		9.39%	33,375	0.125	4,172	0.000	0.000			
UNION/MARATHON (50% each)		1.10%	3,910	0.125	489	0.000	0.000			
TOTAL MCARTHUR RIVER FIELD		100.00%	355,431		44,429					
TRADING BAY FIELD										
Marathon 48.66%		48.66%	580	0.125	73	0.000	0.000			
Union 48.66%		48.66%	580	0.125	73	0.000	0.000			
Superior 1.34%		1.34%	16	0.125	2	0.000	0.000			
Texaco 1.34%		1.34%	16	0.125	2	0.000	0.000			
TOTAL TRADING BAY FIELD		100.00%	1,192		149					

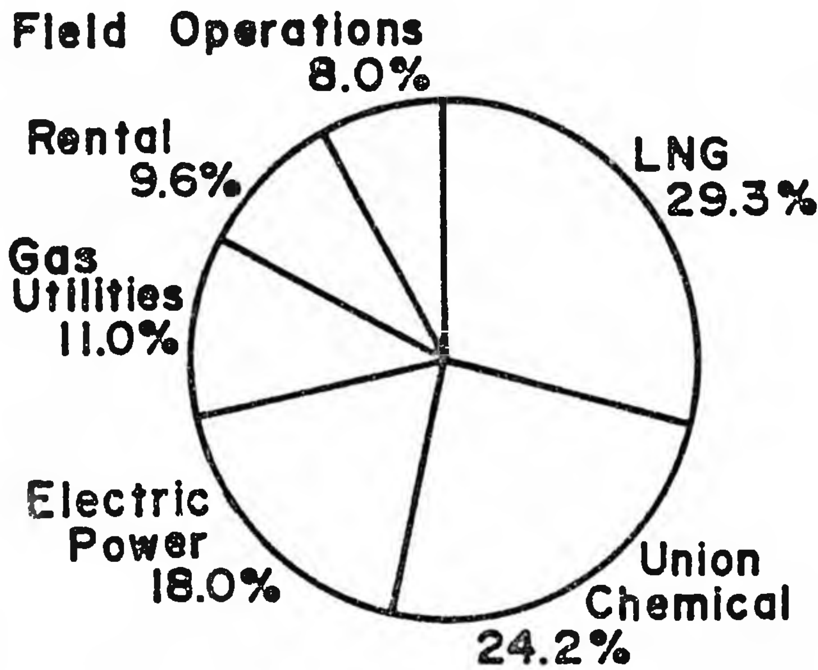
1/ ANNUAL VOLUME DIVIDED BY 12 MONTHS EQUAL AVERAGE MONTHLY VOLUME.
2/ ROYALTY AND CONTRACT VALUES ARE THE MOST CURRENT IN EFFECT AS OF JANUARY 1986. PRODUCTION AND HAVE NOT BEEN ADJUSTED FOR BTU CONTENT.
3/ QUANTITY TERM COULD OPERATE TO EXTEND OR SHORTEN THE CONTRACT PERIOD.
4/ PRICE REPORTED BY MARATHON IS BEING PAID UNDER PROTEST.
5/ CONTRACT PRICE IS A GROSS PRICE BEFORE TRANSPORTATION COSTS.
6/ CONTRACT PRICE TO GO TO $0.27 MCF DURING 1986.
7/ BASE CONTRACT PRICE DOES NOT INCLUDE LESSEE TAX OBLIGATIONS PAID BY THE PURCHASER.
8/ VALUE AGREED TO BY SETTLEMENT.
9/ SPECIAL DELIVERABILITY CHARGE OF $0.35/MCF MAY ALSO BE EFFECTIVE.

ATTACHMENT 4

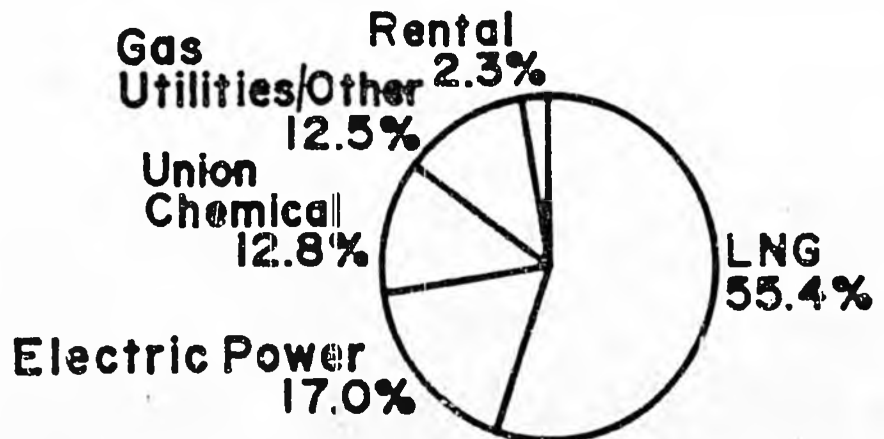

ATTACHMENT 5
CAPPS
GLACIER
LEWIS RIVER
ELECTRIC
CHUGACH
IVAN RIVER
BELUGA RIV.
BELUGA GENERATION SITE
N. COOK INLET
MOQUAWKIE
MOBIL PRODUCTION FACILITIES
NICOLAI CREEK
ALBERT KALOA
BRUCE
ARCO PRODUCTION FACILITIES
ANNA
GRANITE PT.
SPARK
TRADING BAY
MONOPOD
N. M G S.
KING SALMON
McARTHUR RIVER
GRAYLING
DOLLY VARDEN
BAKER
TRADING BAY PRODUCTION FACILITIES
WEST FORELAND
MIDDLE GROUND SHOAL
PIPELINE
TESORO-ALASKA
PRODUCTS
BIRCH HILL
DILLON
KENAI PIPELINE CO.
SWANSON RIVER
REDOUBT BAY
REDOUBT SHOAL
West Foreland
BEAVER CREEK
WEST FORK
CANNERY LOOP
STERLING
SOLDOTNA
KENAI
KALGIN ISLAND
COOK INLET

COOK INLET

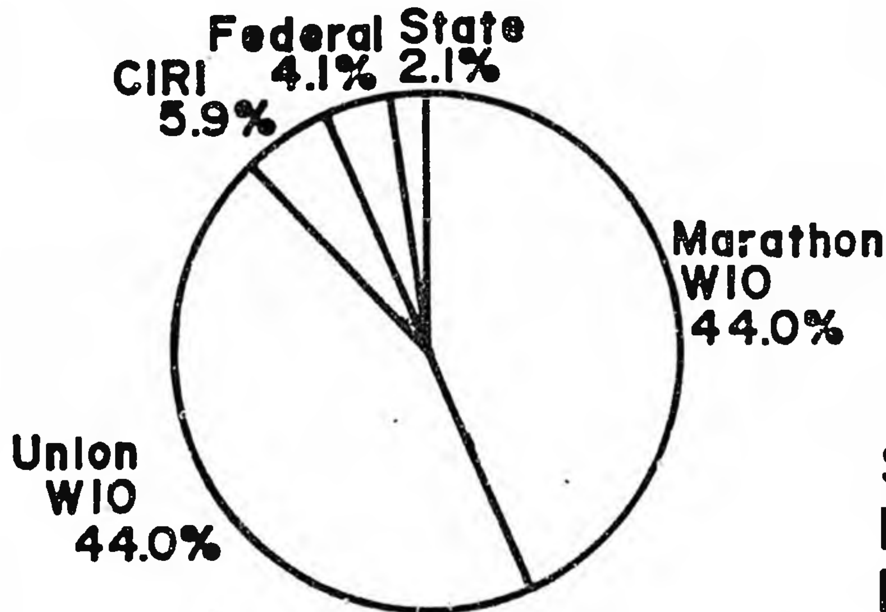
Total Sales

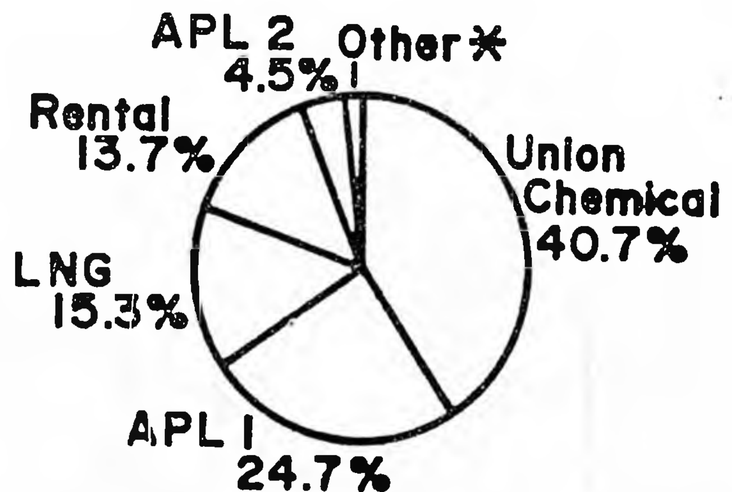


State Royalty Disposition



KENAI FIELD

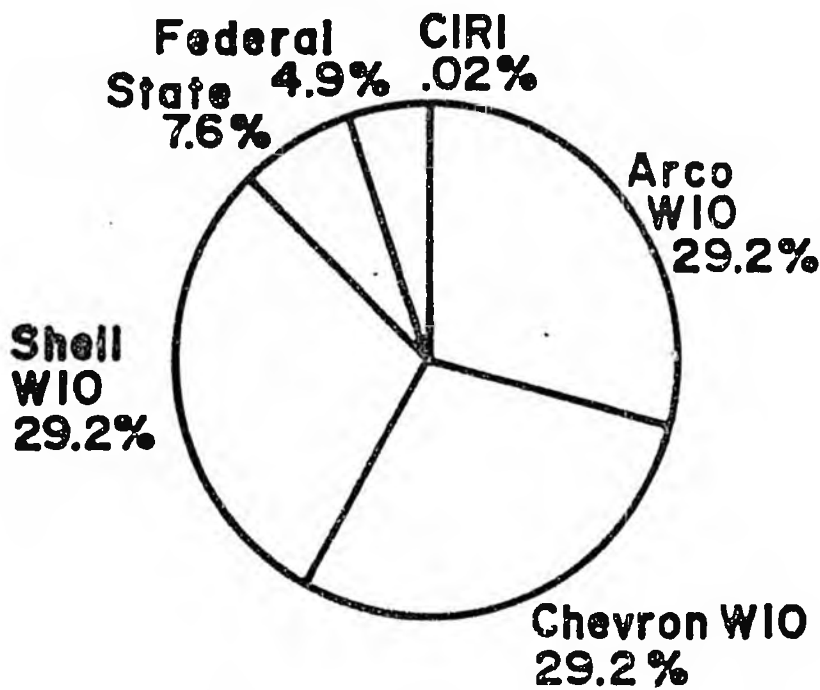




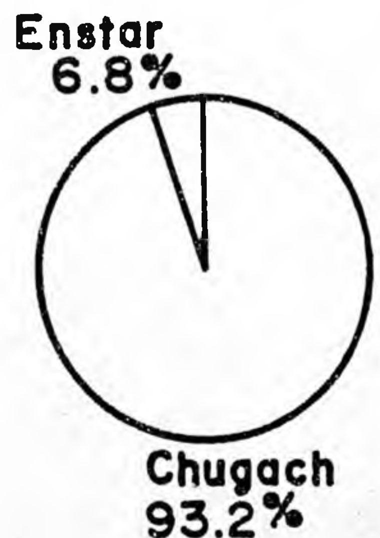
* AFL-Nikiski 0.4%
Union-Chevron Exchange 0.2%
City Of Kenai 0.5%

BELUGA FIELD

Royalty And Working Interest Ownership



State Royalty Disposition



COOK INLET GAS PRODUCTION
(For 1984)

	Total MMCF/Month	State Royalty MMCF/Month
Beluga River Field		
For: Chugach	1673	125
Enstar	121	9
Total	1794	134
Kenai Field		
For: APL 1	2029	42
APL 2	369	8
APL Nikiski	31	1
APL Kenai	41	1
Union Chevron Ex	16	1
Rental gas	741	15
Rental gas extra	389	8
Ammonia-Urea	3352	67
LNG	1261	25
Total	8229	168
McArthur River Field		
For: Rental gas and ammonia-urea	355	44
Beaver Creek Field		
For: APL 2	789	0
Lewis River Field		
For: APL 2	153	19
North Cook Inlet Field		
For: LNG	3932	491
GRAND TOTAL	15,250	856

Excerpts from Lease Form DL-1
Pertaining to the Pricing of Royalty Products

11. ROYALTY ON PRODUCTION. Except for oil and gas used on said land for development and production or unavoidably lost, Lessee shall pay Lessor as royalty the following:

(a) On oil 12-1/2 percent in amount or value of the oil produced and saved and removed or sold from said land.

(b) On gas 12-1/2 percent in amount or value of the gas produced and saved and sold or used off said land or used for the extraction of natural gasoline or other products therefrom.

(c) On associated substances 12-1/2 percent in amount or value of such substances produced and saved and removed or sold from said lands.

15. ROYALTY IN VALUE. At the option of Lessor, which may be exercised from time to time upon not less than six months' notice to Lessee, and in lieu of royalty in kind, Lessee shall pay to Lessor the field market price or value at the well of all royalty oil and/or gas. All royalty that may become payable in money to Lessor shall be paid on or before the last day of the calendar month following the month in which the oil or gas is produced. The payments shall be accompanied by copies of run tickets or other satisfactory evidence of sales, shipments, and amounts or gross production.

16. PRICE. The field market price or value of royalty oil or gas shall not be less than the highest of: (1) The price actually paid or agreed to be paid to Lessee at the well by the purchaser thereof, if any; or (2) The posted price of Lessee in the field for such oil or gas at the well, if any; or, (3) The prevailing price received by other producers in the field at the well for oil of like grade and gravity or gas of like kind and quality at the time such oil or gas is removed from said land or run into storage, or such gas is delivered to an extraction plant.

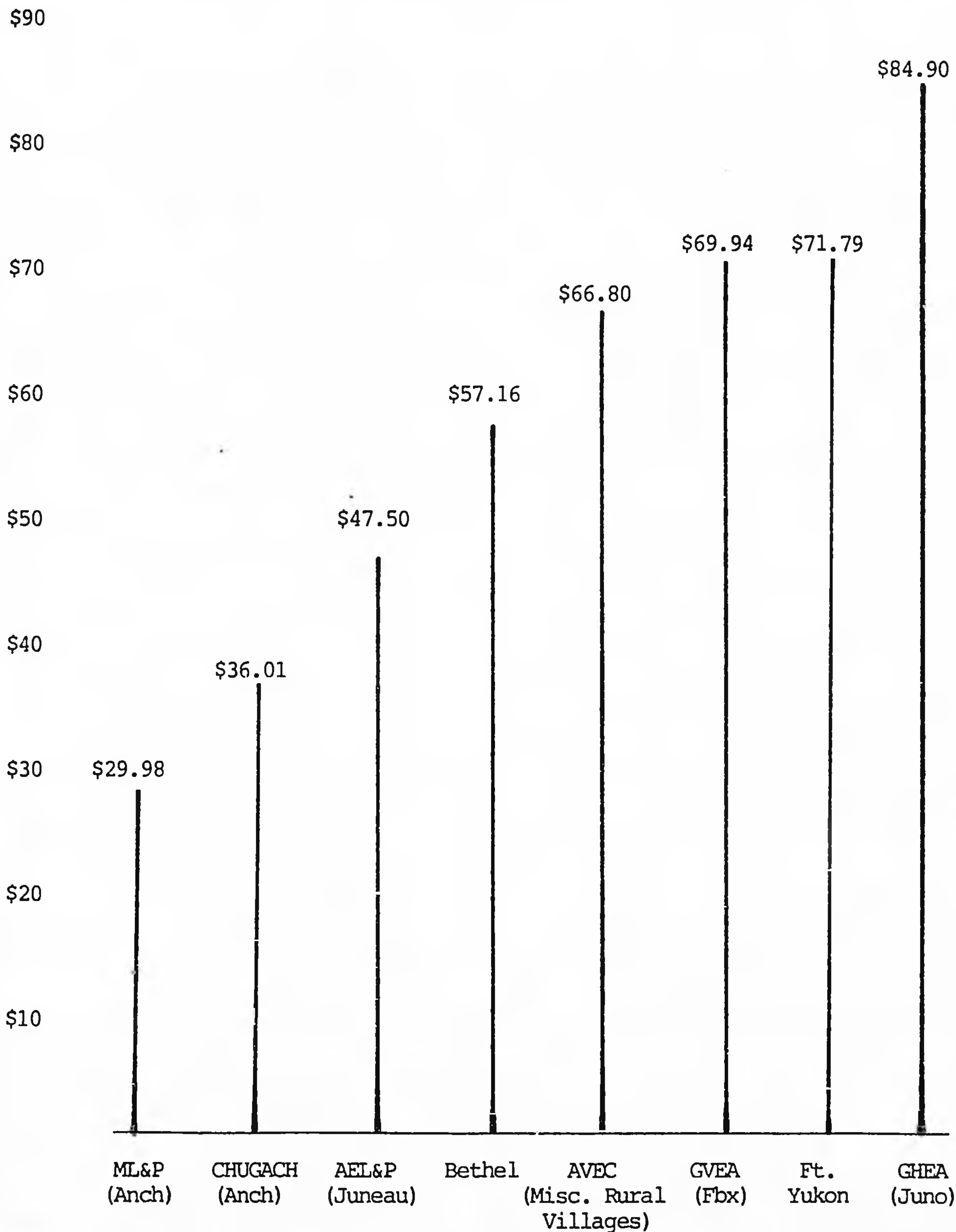
RECENT CONTRACTS AND PURCHASE AGREEMENTS

	Purchaser	Field or Seller	Starting Base Price
1977	Pac Alaska	Cook Inlet	$1.46 per mcf
1982	Enstar	Beluga River	$2.32
1982	Enstar	Beaver Creek Field	$2.32
1982-83	Chugach (Peaking Gas)	Beluga River	$1.40-1.60
1983	Chugach	Cannery Loop	$1.80
1984	Enstar	Lewis River	$1.80
1985	Tesoro	Marathon	$2.01
1985	AEG&T (Homer Electric)	Enstar	$2.04
1985	ML&P (Anchorage)	Enstar	$1.60

February 6, 1986

Representative Residential Electrical Rates for 500 KWH

Assumes: Residential rate, non-demand, hot water heater, winter season.
Power Cost Equalization payments have been subtracted.



Source: Alaska Public Utility Commission, except GHEA rates, which were obtained from GHEA.

STATE OF ALASKA 1986 LEGISLATIVE SESSION
FISCAL NOTE

Revision Date : 2/20/86

REQUEST

Bill/Resolution No. : CSSB 309 (Res)
Title : Royalty gas contracts

Sponsor : Faiks
Requestor : Senate Resources
Date of Request : 2/19/86

FISCAL DETAIL

Agency Affected : Natural Resources
BRU :

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						
TOTAL OPERATING	-0-	-0-	-0-	-0-	-0-	-0-
CAPITAL						
REVENUE						

FUNDING : (Thousands of Dollars)

	FY 86	FY 87	FY 88	FY 89	FY 90	FY 91
GENERAL FUND						
FEDERAL FUNDS						
OTHER						
TOTAL	-0-	-0-	-0-	-0-	-0-	-0-

POSITIONS :

	FY 86	FY 87	FY 88	FY 89	FY 90	FY 91
FULL-TIME						
PART-TIME						
TEMPORARY						

ANALYSIS : Attach a separate page if necessary

The valuation provisions of this bill will be applied only for future long-term gas contracts, and there is no way to estimate any fiscal impact on the state. Any revenue losses should be balanced by savings in utility costs for consumers, according to the bill.

Prepared by : Ned Farquhar — Phone : 465-2400
Division : Commissioner's Office — Date : 2/20/86

Approved by Commissioner : [signature] — Date : 2/20/86
Agency : Natural Resources

Distribution (by Agency preparing fiscal note) :
- Legislative Finance
- Legislative Sponsor
- Requestor
- Office of Management and Budget
- Impacted Agency(ies)

10/25/85

STATE OF ALASKA

POUCH V
JUNEAU, ALASKA 99811
(907) 465-4941

HOUSE SPECIAL COMMITTEE ON OIL AND GAS

Sectional Analysis
Proposed Oil and Gas Committee Substitute for CSSB 309 (Rules)

Sec. 1. Findings. It is in the best interest of the state to authorize the commissioner of DNR to establish the in-value royalty for gas sold to a gas or electric utility by using the contract price between the lessee of the state and the utility. This authorization applies only prospectively, and this Act does not apply to state policies regarding the sale of royalty oil.

Sec. 2. The commissioner shall enter into an agreement with a lessee to use the price established in a contract between the lessee and a gas or electric utility as the value of the state's royalty share of gas production, provided that:

a. the lessee and the utility are not related.
b. the agreement is requested in writing by the lessee.
c. the commissioner does not make a written finding that the contract price is unreasonably low and that a prospective reduction in royalty receipts would not be balanced by increased benefits to in-state gas and electric consumers.

This section states that a "gas or electric utility" includes electric cooperatives (such as Chugach, Matanuska, Homer, rural co-ops, and Golden Valley Electric), municipal utilities (such as Anchorage Municipal Light & Power), and gas utilities regulated under AS 42.05 (such as Enstar).

This section also states that, for purposes of this Act, the state's royalty share of gas production does not include gas production from mental health lands or school lands.

Sec. 3. Adds a new subsection to AS 38.05.183, which provides that the commissioner may sell royalty gas taken in-kind to a gas or electric utility at less than market value if the commissioner makes a written finding that the sale is in the best interest of the state. The same definitions for "gas or electric utility" and "royalty gas taken in kind by the state" found in sec. 2 of this legislation are also found in this section.

Sec. 4. Amends AS 38.05.810(a) to make this subsection consistent with the other provisions of the Act.

Sec. 5. Provides that AS 38.05.180(aa), which would be enacted by sec. 2 of this legislation, applies to agreements to establish the in-value royalties on gas production that are sold under a contract entered into, on or after the effective date of the act between the state's lessee and a gas or electric utility.

Sec. 6. Provides for an immediate effective date.

STATE OF ALASKA

DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

BILL SHEFFIELD, GOVERNOR

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

The Honorable John Sackett
Co-Chair, Finance Committee
Alaska State Senate
Juneau, AK 99811

March 3, 1986

Dear Senator Sackett:

I am responding to your request for more information on the fiscal note and potential fiscal impact of CSSB 309 (Res), now before the Senate as CSSB 309 (Rules).

<u>The fiscal note</u>

The department has submitted a zero fiscal note for the bill, which will not directly affect the state's current royalty gas revenue stream. There are two reasons that it is not possible to identify future costs of the legislation:

- the department is not able to predict how often the new valuation mechanism will be applied in the future, nor can we predict future gas contract prices and quantities; and

- market values for Alaska natural gas (particularly Cook Inlet gas now sold for instate consumer uses and most immediately affected by the proposed statute) are unpredictable, as is the possible disparity (positive or negative) between contract price and market value.

Even though there is no direct fiscal impact that can be assigned to the bill, enactment of the legislation will indirectly affect state royalty income from existing production in Cook Inlet. The state has entered into an agreement with Chugach Electric to value the state's royalty share from Beluga Field production purchased by Chugach under existing contracts at $0.75/mcf if the legislation passes. This value is one-half the state's January offer to settle the pricing dispute at $1.50/mcf, which was rejected by the Beluga producers who sell to Chugach. If the dispute had been settled at $1.50/mcf under existing state law, the

state would have received approximately $1.9 million/year in new royalty income from the Beluga field. Settlement at $0.75/mcf, as will occur if CSSB 309 (Rls) is passed, will increase state royalty revenues from Beluga production by about $810,000/year, according to our calculations, because the state's share of this production is currently valued at $0.21/mcf by the producers. This increase in state royalty revenues is less than would have been expected if 1) the state's $1.50/mcf settlement offer had been accepted, or 2) the state had successfully pursued its legal arguments regarding the value of the state's royalty share under the existing lease terms, based on existing law.

Future costs to the State

As stated above, the department has submitted a zero fiscal note because it is unable to predict future market conditions and contract terms for Alaska natural gas. It is important for the Legislature to consider that market value in the future could either exceed or remain below long-term contract prices for instate consumer gas purchases. The present situation in the Beluga field is an example of how long-term contract prices (Chugach at an adjusted $0.26/mcf and Enstar at an adjusted $2.05/mcf) can be above or below "market value" simultaneously in the same field.

Section 2. The fiscal impacts of Section 2(aa) of CSSB 309 (Rls) will largely depend on future market and contract conditions in Cook Inlet, unless there is a commitment of North Slope natural gas by the producers for instate use. The natural gas market for instate energy use will be affected by the costs of thermal and hydroelectric energy alternatives, including new or expanded coal development; production from new or shut-in gas sources; geothermal development (which has been discussed in connection with Beluga coal development); hydroelectric construction; export projects for coal, gas, or oil; and the price of fuel oil and diesel as alternative fuel sources. There have been some projections of Cook Inlet gas prices by other agencies that this department has disputed on grounds that the Cook Inlet market remains largely controlled by local factors rather than world gas or oil prices or exports. If North Slope natural gas is brought to market its pricing and availability will also become an important factor in the fiscal impact of this bill (Section 2(bb)). Because the eventual marketing arrangements for Prudhoe Bay gas would

probably have to be less diverse and more stable than are marketing arrangements for Cook Inlet gas, it is likely that there would be less disparity between Prudhoe Bay contract price and market value, although the fiscal impact of accepting the contract price as the state's royalty value (given the magnitude of the Prudhoe Bay gas resource) might be larger, either positively or negatively affecting the state's revenues.

Section 3. This section gives the commissioner authority to make below-market-value gas sales for instate energy use. Because the Legislature reviews long-term royalty oil and gas contracts before their implementation by the Department, the fiscal impact of this section will be considered by future Legislatures reviewing such below-market-value gas sales by the state. Without knowledge of how often or at what cost the state will exercise this option, there is no way to estimate the fiscal impact of enacting this statute.

Please contact me if you have any further questions or comments. I am providing copies of this letter to other members of the Senate in anticipation of the floor debate on CSSB 309 (Rls) this morning. Thank you for your interest in this issue.

Sincerely,

Esther C. Wunnicke
Commissioner

cc: All Senators
Dr. Joyce Murphy, Chugach Electric

DNR 3-3-86

SUMMARY OF CSSB 309 (RULES)

The Bill will allow the state to provide certainty in royalty gas valuation for Alaska consumer uses and North Slope gas development.

Specifically, the Bill would:

- Authorize the Commissioner of the Department of Natural Resources to accept a contract price between a state lesses (gas producer) and a gas or electric utility as the value of the state's royalty share of production.

- Authorize the Commissioner of the Department of Natural Resources to sell the state's royalty gas to a gas or electric utility at a price below market value. The Legislature reviews long-term sales under existing law.

- Establish a royalty valuation procedure which will facilitate financing for a North Slope gas pipeline.

"Gas or electric utility" includes cooperative electric utilities (such as Chugach, Matanuska, Homer, rural coops, and Golden Valley Electric), municipal utilities (such as Anchorage Municipal Light and Power), and a gas utility regulated under AS 42.05 (such as Enstar).

The Act would apply only to future contracts between a lessee and a purchaser.

A preliminary settlement agreement between the Department of Natural Resources and the Board of Directors of Chugach Electric, which would settle pending litigation over the value of the state's royalty share of Beluga gas now pruchased by Chugach at $0.26/mcf, is contingent on passage of the bill. The preliminary settlement agreement sets the price of Beluga royalty gas under the existing Chugach contract at $0.75/mcf.

<u>Revenue Impact</u>: Section 3 of the Bill, which authorizes the Commissioner to sell royalty gas taken in kind to a gas or electric utility at a price below market value, could result in lower state revenues in the future if this discretionary authority is exercised. The amounts of potential revenue loss cannot be precisely calculated, but would be identified at the time of the sale, when legislative review would occur. The state could also lose or gain revenue by any disparity between contract prices and market values, but this fiscal impact is not predictable.

DNR 3-3-86

Section-by-Section Analysis of CSSB 309 (Rules)

Section 1 of the Bill makes several findings:

- The best interest of the state will be served if the commissioner of Natural Resources is authorized to establish the in value royalty for gas sold to a gas or electric utility by using the contract price between the state lessee and the utility;

- It is in the best interest of the state to give the commissioner explicit discretionary authority to sell in kind royalty gas to a gas or electric utility at a price below market value;

- The proper exercise of discretion conferred by the Act will support and complement the other energy programs of the state;

- The state should adopt a policy for the sale of royalty gas to gas or electric utilities for in-state consumer use and in-state generation of electricity that is fundamentally different from the policies of the state for the sale of royalty oil and for the sale of royalty gas for export from the state or for uses other than in-state consumer use and in-state generation of electricity; and

- It is in the state's best interest to facilitate the financing and construction of a pipeline and increased gas production from the Prudhoe Bay reservoir by establishing a procedure by which the state could commit itself to a royalty valuation methodology for as long as the state takes its royalty share of gas production in value.

Section 2 adds new subsections to AS 38.05.180:

- Subsection (aa) provides that within 90 days after the written request of a lessee, unless the commissioner makes a written finding based on clear and convincing evidence that the contract price is unreasonably low and that a prospective reduction in royalty receipts would not be balanced by increased benefits to in-state gas and electric consumers, the commissioner shall enter into an agreement with the lessee to use the price established in a contract between the lessee and a gas or electric utility as the value of the state's royalty share of gas production, if the lessee and the utility are not related. "Gas or electric utility" includes an electric cooperative organized under AS 10.25, a municipal utility, and a gas or electric utility regulated under AS 42.05.

- Subsection (bb) provides that in the event of a contract between unrelated parties for the sale of gas from the Prudhoe Bay reservoir for delivery through a pipeline for export out of the state, the commissioner shall within 90 days after the written request of a lessee enter into an agreement with the lessee to use the price for gas established in the gas sales contract as the value of the state's royalty share of gas production, unless the

commissioner makes a written finding that the contract price does not assure the maximum benefits to the people of the state in return for the state's gas resources. The lessee shall have the burden of providing all information necessary for the commissioner to make an informed decision, and shall provide clear and convincing evidence that the value of the gas is reflected by the gas sales contract price rather than being attributed to transportation, marketing, or other profit or cost centers.

Section 3 adds a new subsection to AS 38.05.183:

- Subsection (h) provides that the commissioner may sell royalty gas taken in kind to a gas or electric utility at less than the market value of the gas, if the commissioner, after considering the consumer benefits, other benefits, and detriments of the sale, makes a written finding that the sale is in the best interest of the state. "Gas or electric utility" includes an electric cooperative organized under AS 10.25, a municipal utility, and a gas or electric utility regulated under AS 42.05.

Section 4 amends AS 38.05.810(a) to make it consistent with the other provisions of the Act.

Section 5 provides that the proposed AS 38.05.180(aa), which would be enacted by Section 2 of the Act, applies to agreements to establish the in value royalties on gas production that is sold under a contract entered into on or after the effective date of the act between the state's lessee and a gas or electric utility.

Section 6 provides an immediate effective date.

YUKON PACIFIC CORPORATION

March 18, 1986

Rep. Mike Davis
Pouch V - Mail Stop 3100
Juneau, AK 99811

Re: Position Paper/SB 309

Dear Mr. Davis:

1. Yukon Pacific Corporation is an Alaska-based company working to bring about the Trans Alaska Gas System (TAGS) a pipeline to tidewater for shipment of liquefied natural gas (LNG) to Asian markets.

2. Financing and construction of a multibillion dollar system requires the ability to make long-term contracts with certainty that the state will not later come along and change the price of the State's royalty gas. Pass-through provisions are not possible in the international market.

3. SB 309 in its original form would have addressed the problem by requiring the State to accept the price of the gas under long-term contracts when its royalty share is taken in value. SB 309 as passed by the Senate confirms the State's contention, now being challenged in court, that it does have the right to revalue gas under contract. The bill then makes certain "exceptions" to allow the state's utilities to have the certainty in long-term contract prices they believed they had before the Commissioner's decision in 1985 to raise Beluga in-value prices.

4. Yukon Pacific has sought language in SB 309 that would give it a similar "exception" to allow the Commissioner to agree to long-term contract prices if certain findings are made. The language contained in SB 309 would allow the Commissioner to see to it that producers could keep their price commitments to buyers of North Slope gas if the Commissioner was certain the transaction was both arms-length and did not unfairly diminish the value of the gas by attributing greater profits to transportation or marketing.

5. Yukon Pacific would urge the following changes to the legislation, if the issue is not first settled in court:

P.O. Box 101700 • Anchorage, Alaska 99510 • 907 279-1596 • Telex 25-340 Capt. Cook AHC
515 South Post Oak Road • Suite 225 • Houston, [illegible]

a. The so-called "exception" should be broadened to all new gas contracts so long as the state maintains the ability to prospectively take and sell its gas on an in-kind basis during the life of the contract.

The state may be protected by agreeing to a formula for transportation and for processing charges up front, before the Commissioner makes the findings to go with the contract.

b. The arms length clause in the North Slope contract could prevent a contract price decision by the State if North Slope producers take any interest in a gas pipeline. In ANGTS this was the case and it is likely the case in TAGS.

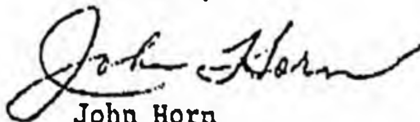
The State is protected by the parallel finding that the market value of the gas is appropriate. Had such a finding been made by the Commissioner before less-than-arms-length transactions were made to construct TAPS, the Phillips-Marathon LNG plant, and the Collier Chemical Plant, it is our belief that expensive and disruptive legal battles on appropriate values of wellhead oil or gas could have been avoided.

6. In conclusion, while Yukon Pacific believes this legislation may not have been necessary if the pending court cases were allowed to come to a conclusion, the company also believes that broadened legislation, removing the proscription on less than arms length transactions, could provide the stability in royalty policy necessary to sign long-term contracts and to finance new projects.

Please pass this information along to the Committee at the hearing on Wednesday, March 19.

With best regards.

Sincerely,



John Horn
Vice Chairman

JH:BH

MEMORANDUM State of Alaska

TO: Kay Brown, Director
Division of Oil and Gas
and Ned Farquhar, Special Assistant/
Legislative Liaison
Department of Natural Resources

DATE: March 19, 1986

FILE NO:

TELEPHONE NO:

FROM: Harold M. Brown
Attorney General

By: Mark P. Worcester
Assistant Attorney General
Oil, Gas and Mining-Anchorage

SUBJECT: Yukon Pacific's 3/18/86 letter on SB 309

I have the following comments on the Yukon Pacific position paper on SB 309, dated March 18, 1986, and addressed to Representative Mike Davis.

* The letter consistently confuses the terms "price" and "value". When the state takes royalty in value, it receives the <u>value</u> of the gas; when it takes royalty in kind, it receives a <u>price</u>. Accordingly, the state does not "change the price" of royalty on gas production taken in value. Rather, it merely enforces lease provisions which provide that value is not exclusively determined by the price established by the producer's sales contract. This is an essential distinction. For instance, Horn's confusion betweeen "price" and "value" is the predicate for his insinuation that "uncertainty" is attributable to the supposed vagaries of state administration, whereas the critical uncertainty is caused instead by the inability to predict the marketplace over time.

* The letter ignores the fact that Yukon Pacific has always had the ability to obtain "certainty" as to royalty contract "price" through a contract for in kind royalty gas paralleling any sale of working interest gas. Indeed, as indicated above, the only way the state can commit itself not to change a royalty "price" (as opposed to a royalty "value") is in the context of a sale of gas taken in kind.

* The insinuation that the state's legal case is weak is entirely false. If the producers and utilities had thought they had long-term contract prices controlled in value royalties, they would not have had "pass-through" clauses in their sales contracts. More explicitly, had Phillips, Marathon, Union, and Enstar really felt their litigation chances to be so favorable, they would not have all entered into settlements so clearly favorable to the state. Even the Chugach settlement will bring the state three times the amount of royalty that Chugach and the producers asserted was due.

* Up front agreement to a formula for apportioning price among the gas, processing costs and transportation costs for all sales contracts in unrealistic. The state still has not reached final resolution on TAPS charges, and the shipping charge issues for North Slope oil are in litigation in the Amerada Hess case. It took years to resolve these issues with Phillips and Marathon. It would be difficult for the department to make sound decisions on such apportionment "up front" - especially within a 90 day time frame.

* The present bill would not require the department to agree to a formula to apportion a North Slope gas contract price among pipeline, liquefication, shipping and the gas. For instance, the sales contract could be between the producers and Yukon Pacific at the North Slope, with Yukon Pacific marketing the gas in Japan. The bill does not require agreement as to an apportionment formula - only a finding that the value of the gas has not been diverted to transportation or other cost or profit centers.

* The apportionment issue will be a significant issue if the first sale of North Slope gas is directly to the Japanese. Mr. Horn worked with Phillips. Phillips argued in the Cook Inlet LNG litigation that under a "proper" (from Phillips' perspective) netback method, the value should be apportioned according to the amount invested in each segment. Since the pipeline, LNG facility and LNG tankers have great up front costs, this would have resulted in a very low netback value for the gas. In fact, the great profits of the Phillips/Marathon LNG plant came from an increase in the value of the gas: it was economic rent from the fortuitous worldwide escalation of energy prices that created the large profits. I am confident that any formula which Phillips would have proposed "up front" would have been designed to deprive the royalty owner from fully sharing in any fortuitous rise in the value of the gas. Any simple formula would inappropriately attribute rises in the value of the gas to liquification, pipeline and shipping, and would not account for the depreciation of the pipeline, liquefication and shippong facilities.

* It may be worth reiterating that the ability of the state to take its gas is kind is a safeguard of questionable value. The gas market is limited - especially on a day-to-day basis. More importantly, the state is in a very disadvantageous

marketing position. Not only must any contract go through administrative and legislative procedures which discourage potential buyers, but the state, unlike producers, cannot control the volume of gas under any in kind sale, since the state simply takes a percentage of what the amount produced under the lessees' sales contracts.

* The suggestion that "expensive" litigation could have been avoided had SB 309 been on the books sooner is incredible. Certainly, it has been expensive to litigate TAPS and the Phillips LNG cases. However, it has primarily been "expensive" to the oil companies, since they have been required to pay huge sums to the state. Moreover, it is disingenuous to suggest that the Phillips/Marathon LNG disputes could have been avoided if SB 309 had been in place when that project was built. Phillips and Marathon both strenuously argued that the Japan sales price could not be used to determine their royalty obligation. Instead, they argued that their royalty was controlled by the local market price (which they acknowledged could change over time). Union's dispute also could not have been resolved by a SB 309, since it does not sell its gas, but rather transfers it from its production to its chemical division. The only reason that John Horn is touting a netback for Yukon Pacific, after he adamantly opposed a netback when working for Phillips, is because the market is now different, and Yukon Pacific believes the royalty will be lower using a netback from the Japan price (especially if they can manipulate the netback "formula") than it would be if the royalty were controlled by local market values. This illustrates that the most consistent "principle" guiding the industry's stance on royalty policy is that royalties should be minimized.

* It now looks like a real push will be made to amend the (bb) subsection in SB 309 - at least to remove the restriction to arm's-length contracts. I have an additional suggestion on possible amendments. I believe that it would be important that the commissioner have the power to <u>conditionally</u> approve the use of contract price. I think that the power exists now, since a commissioner could reject a proposal, and in the decision accompanying the rejection state the changes which would make the proposal satisfactory. However, it may be difficult for a commissioner to take such actions because of political pressures not to "obstruct" significant projects. It may be easier for a commissioner to insist upon changes to protect the state's

royalty interest if the authorizing statute expressly comprehended that the commissioner's role would go beyond merely taking or leaving an oil company proposal. This kind of authority would be especially important where the proposal called upon the commissioner to agree to apportionment of a destination price among the gas, pipeline, shipping and liquefication segments.

RECEIVED APR 2 9 1985

ENSTAR Natural Gas Company
3000 Spenard Road
P.O. Box 6288
Anchorage, Alaska 99502
(907) 277-5551

April 25, 1985

Dear Senator Faiks:

The State has announced it intends to increase the price paid for royalty gas which we receive pursuant to a contract entered into in 1960 and last renegotiated in 1974, with Marathon and Union, our suppliers at the Kenai gas field. The Administration says it is compelled to take this action in order to get a fair market value for its royalty gas and stop a "subsidy". The Administration's statements are misleading. The State is receiving fair value. There is no subsidy. There is no requirement for the Administration to take such action. Without proposing regulations, holding hearings, or giving those affected an opportunity to be heard, the Administration would use the State's monopoly power to exact an excessive price from the consumers.

<u>The Fair Value of Gas Committed to a Long-Term Contract
Is The Arm's Length Negotiated Price</u>

Historically, the value of the royalty share of gas committed to a long-term contract has been considered to be the price established by the contract, if that price was set by unrelated parties in arm's length negotiations. Since gas transmission systems require massive capital investments, long-term contracts for production are a characteristic of the business. Without long-term contracts, pipelines would not have been built. In order to assure the marketability of the pipeline's out put, good business practice requires a pricing mechanism that will deliver the product at a competitive price. The free market system basically has dictated the business practices we have followed.

Royalty owners in a number of states have attacked the long followed principle that fair value is determined by arm's length negotiated prices, with mixed results. Courts in Alaska have not ruled on the issue, but ENSTAR believes that the prevailing and equitable view is that fair values are determined by arm's length negotiations, not by bureaucratic edict.

<u>Our Customers Are Not Being Subsidized by the State</u>

The Administration claims there is a subsidy because the price the State is receiving under ENSTAR's long-term contract is less than the price ENSTAR is paying for gas we more recently negotiated to purchase. That purchase covers fifteen years, cannot be terminated, and has known pricing terms. The State's royalty can be terminated on six months notice (and then taken "in kind"). The State maintains it can unilaterally "reprice" its gas at any time while taken as royalty-in-value. No willing buyer would purchase gas from the State under such conditions.

During the 1960's ENSTAR was subjected to criticism in Juneau because some politicians believed ENSTAR paid too much under the very same contract on which DNR now says ENSTAR is paying too little. We (our customers) paid the price necessary to get the commitment of half a trillion cubic feet of gas for 20

years. We (our customers) took the risk that gas prices would go down, not up. The State received what was then considered to be a high price, guaranteed for the life of the contract.

Our customers paid the market price for the risk they took. Gas prices have gone up, not down. Now the State in effect would confiscate the values the consumers paid for. Now the State maintains that without this confiscation, it is subsidizing the consumers. Baloney.

<u>The State is Using Monopoly Power
to Exact an Excessive Price from the Consumers</u>

Alaska is unique in that the Federal and State governments control substantially all royalty. The governments have a monopoly and it is not possible to negotiate royalty valuation terms of lease agreements. Terms are dictated, not negotiated. This is effectively a monopoly action at work, not a free market. DNR admitted in an internal memorandum that its present pricing proposal would "further its relations with the ANCSA corporations... and lend support to current federal royalty litigation...". If business corporations made pricing decisions in concert with or to accommodate other suppliers, they probably would be subject to prosecution.

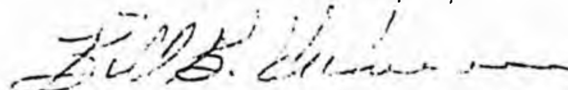
When we, as purchasers, enter into a long-term contract with a producer, we are not assured of the royalty share since the State retains the right to take its gas in kind. Yet we must take the royalty share, no matter what price may be exacted. Obviously, if a free market prevailed, we simply would not purchase State royalty on such terms. The concept of the State receiving fair value for its resources does not mean it can use its monopoly power to squeeze the last bit of revenue from the consumer. It does mean receiving the value that would be arrived at in a free market system. That is exactly what arm's length negotiations do.

For 25 years the State has accepted arm's length negotiated pricing as royalty value. We believe it is unfair and probably unlawful for the State to reverse this acceptance in the present situation, with no regulations, no public hearings, and no court decisions.

We are trying to work with the State Administration and others to develop a legislative or administrative solution to this problem, and are preparing to inform the public as to its scope and effect in the event these efforts are not successful.

Cordially,

ENSTAR Natural Gas Company



Bill B. Hickman
Executive Vice President

BBH/dms

ENSTAR Natural Gas Company
3000 Spenard [illegible]
P.O. Box 6288
Anchorage, Al[illegible]a 99502
(907) 277 55[illegible]

December 12, 1984

The Honorable Jan Faiks
Alaska State Senator
1024 West 6th Avenue, Suite 202
Anchorage, Alaska 99501

Dear Jan:

I have your September 6 letter and will try to respond in writing, somewhat as to the handout you requested. We have been quite busy through this week, but should have some time after that for the meeting with the Anchorage Caucus if that is still desired. (Jury duty December 16-21).

I will respond in this letter to the "subsidy" allegation, and relate the history of gas in Cook Inlet in a memorandum, attached. The allegation is that our price (and Chugach's) payable to the producers for gas negotiated and contracted many years ago is below the price at which gas would be negotiated at present, and that the price differential, applied to the State's royalty interest in that gas, constitutes a subsidy from State residents who are not users of that gas (or electricity made from it) to those State residents who do use the gas (or electricity made from it).

Those who allege a subsidy appear not to comprehend the character of the natural gas business, and I hope this letter will be of some help in that respect. Natural gas, unlike oil, requires a relatively large investment for delivery to market. The investment is for relatively large pipelines and compressors, (cryogenic processing, storage, and ships in the case of LNG, liquefied natural gas). The investment cannot be made without long term contracts at known pricing, generally well below the then prevailing delivered price of oil in order to assure a market against that competition. Essentially many major users of natural gas can literally switch to oil whenever oil can be obtained for less than gas. The producers run this risk in developing natural gas production, and the pipeline/utility system is exposed to relatively much greater risk because its investment per unit is normally much greater than the producer's. For both, however, long term contracts at known pricing are essential and traditional in the industry. When such contracts are abrogated, as with Canadian production since the early 70's, great distress and severe reaction develops. The experience there is an object lesson for Alaska: Canadian gas was arbitrarily repriced, and lost its market in the Pacific Northwest to OPEC oil. It was followed by depression in both Canada and the Pacific Northwest and by devaluation of Canadian money and in turn the defeat of the decades-old Canadian administration, this year.

Admittedly there has been and will be litigation on the sanctity of contracts and the "rights" of royalty interest owners, as with all controversies both private and public. The State has recently settled with Phillips on North Cook Inlet gas used in its LNG plant, and that in turn has enabled us to gain access to a portion of that gas, for standby purchases in times of high demand.

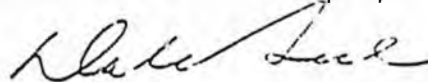
It is my opinion that a majority of Alaskan legislators and the administration and the courts will acknowledge the sanctity of contracts as to our purchase of Cook Inlet gas. In my opinion, the allegations of subsidy of gas ratepayers are advanced in order to justify admitted State subsidy to non-railbelt electric users, as enacted this year and may be increased next year.

It is worth noting that the State's royalty interest in Cook Inlet gas we buy is really rather small (about 1/6th of 1/8th, or 2% of the 26 million mcf annual production). The spread between the price we currently pay and the State's negotiated settlement with Phillips is not nearly as wide as would be inferred from statements by some political figures and other royalty interest owners. It is in the range of $1 million per year, a far cry from the admitted State subsidy to non-railbelt power users.

Jan, I hope the foregoing and the attached memorandum will be of some interest to the Anchorage Caucus. Frankly, I would prefer not to appear before your group at this time, because we are quite likely to become embroiled in the lawsuit involving CIRI, MMS (old USGS) and Union Oil Company. It would be embarrassing to me personally to respond with no comment or otherwise appear evasive, when I would really like to make announcements to the world.

Cordially,

* ENSTAR Natural Gas Company



Dale Teel
President

DT/dms

* The same Anchorage Gas Corporation, Anchorage Natural Gas, Alaska Gas and Service Company, Alaska Pipeline Company, et . etc.

ENSTAR

ENSTAR Natural Gas Company
COMPANY

Inter-Company Correspondence

To: File

Location:

From: Dale Teel

Date: December 12, 1984

Subject: History of Cook Inlet Natural Gas
Prepared in Response to Request from Senator Jan Faiks of September 6, 1984

File:

The history of Cook Inlet gas begins, I believe, with the 1959 discovery of the Kenai gas field by Union and Marathon. It was this discovery, I believe, which enabled Anchorage Gas Corporation to win the franchise referendum election in the fall of 1959. I didn't participate in the 1959 negotiations or the franchise campaign and didn't make my first visit to Alaska until January of 1960. I was told however, that the owners of Anchorage Gas Corporation had had in mind to bring me to Alaska (from Honolulu) to organize Anchorage Gas Corporation as an operating company in 1959, even prior to the Kenai discovery, when they were planning to distribute propane or manufactured gas in Anchorage in anticipation of a discovery. The Swanson River oil field had been discovered (1957 or 1958), with gas shows but not commercial quantities. My background then was in propane/butane and manufactured gas, in Hawaii, and I am a graduate chemical engineer.

We built the first marine pipeline in Alaska, across Turnagain Arm, in 1960-61, and turned on gas service in Soldotna and Anchorage in August of 1961. Our first wellhead cost was 32 cents per Mcf (thousand cubic feet), well above the nationally regulated price of 16 cents or so. For a time we believed this cost could compete against coal at Chugach's Knik Arm steam plant (now being moth-balled), and the power/heating plants at Elmendorf and Fort Richardson. Coal was then roughly 55 cents per Mcf equivalent. We were in part relying on the better efficiency and labor cost savings from gas to be competitive with coal. The conversion of these plants, all funded by the federal government, became a hot political issue, and it was not until 1968 that we won out against the politics and the government inertia.

In the meantime, Chevron and Texaco vigorously defended their fuel oil business in Anchorage. They cut their price from 24 cents per gallon to 20 cents per gallon soon after gas became available, and did heavy advertising and took other actions against the introduction of gas. One weekend they hired students to deliver a small bag of peanuts to each house in Anchorage with a flyer saying -- "If you're thinking of converting to gas, think again. Peanuts is all you'll save, so we have decided to give you the peanuts and let you save the cost of conversion." This and many other un-funny competitive actions forced me to appeal to Union and Marathon to cut the Kenai wellhead price to 24 cents (25% reduction) to enable us to remain viable without the large users (power plants) or the large commercial who were burning heavy oil from Chevron.

In 1963 or so the Beluga gas field was discovered, and Chevron and the other producers signed a 20-year contract with Chugach at 16 cents. This fact, and the City's installing its first gas turbine, led me once again to appeal to Union and Marathon for a wellhead price reduction. They agreed that any gas I could sell above 1.6 bcfy (billion cubic feet per year) to the City would be priced at 16 cents, while holding the 24 cents on the remainder. In this way we encouraged the City to add more gas turbines and compete with Chugach.

Later in 1967 or so, we amended the Kenai wellhead price again, to put the first 8 bcfy at 24 cents and all above 8 bcfy at 16 cents. By this time we had recovered from the 1964 earthquake and found good acceptance in the community. With various sales tools we were rapidly gaining customers and the coal suppliers (Evan Jones) had shut down so that coal was coming from Healy at a much higher price than gas. Until this time Union and Marathon had owned half of our common stock (non-voting), but in 1967 our owners offered a public sale of stock (Alaska Interstate Company) and bought out the Union and Marathon interest.

Our annual gas volume grew rapidly as we displaced coal at all three power plants and the City continued to install gas turbines. In turn, Union/Marathon wanted to raise the wellhead price and dedicate their gas to other markets -- ammonia (Union) and LNG (Marathon). They had made an agreement with Chevron to "rent" Kenai field gas for 8 cents per mcf, but to pay the State royalty at 16 cents, which had become the "market price" via the Beluga sale as well as our negotiations with them. I believe (but do not know) that 8 cents was the wellhead value necessary to make the ammonia and LNG feasible, so pricing the Kenai royalty at 16 cents was a subsidy to the State from Union/Marathon.

In 1967 we renegotiated Kenai gas to 21 cents and scheduled future escalations, in order to get a firm commitment of 550 bcf over a new 20 year term, to 1992, and in 1974 we again negotiated to add a 19.4 cent charge to get firm deliverability through 1985 of 160 million cubic feet per day and 700 psig delivery pressure. Firm deliverability is the right to obtain gas on any day at the contracted level despite a much lower average daily take -- in our case only 72 million cubic feet, or a "swing" of 222%. The federally regulated price at that time was about 40 cents, for 110% "swing". Thus we felt that adding the deliverability charge gave us long term protection and assurance of supply including peak demands. It was well that we did so, because from 1973 or so OPEC began to bring chaos to the price of oil, followed by the embargo and the Iranian actions which took oil (and gas, nationally) to catastrophic levels.

In 1977, again running short of deliverability, we negotiated with the State to buy the State's royalty interest from the North Cook Inlet gas field operated by Phillips. We were aware that this gas price was variable and escalating, but we considered that we could meet the escalating price on condition that we had no obligation to take that gas and would do so only to enable our customers to avoid using oil at an even much higher price. We continued using State royalty gas until we were able to negotiate the needed deliverability from Marathon (at the Beaver Creek gas field). Beaver Creek gas was initially priced at $2.32 and included assured long term deliverability, but is indexed up or down to the price of turbine fuel (oil) at the Tesoro refinery, so that its present price is $2.19. This year we began buying gas from the Lewis River gas field with negligible take or pay, at $1.80.

Clearly, the wellhead value of gas in Alaska does not have a direct correlation to the world price of oil, or even to inflation. There has been, and is, a surplus supply of gas available in the Cook Inlet area, and its real value is determined by negotiations of a willing buyer and a willing seller. We are entrusted by the Alaska Public Utilities Commission with the responsibility to behave prudently in these negotiations and to make the best deals we can for the interest of our custom-

ers and our owners. There is perhaps an art, but very little science, in deciding when to make a deal and on what terms. We have been complimented by many of our associates in the industry, by our customers, and by the APUC. We have been criticized by experts at various times that we have paid too little or too much. But a deal is a deal in the real world, and I am proud of having the lowest gas rates in the country and among the best long term supply. Where we had no customers in 1960, we now serve nearly 70,000 and the benefits extend to all of railbelt Alaska through interconnects of electric power, from Homer and Seward through the Matanuska Valley and soon to Fairbanks. There is no subsidy to our customers, or to these others, although they, in total, are saving hundreds of millions of dollars per year as compared to what they would be spending for oil if we had not developed natural gas in Alaska.

We are aware of efforts by CIRI and MMS (old USGS) to collect retroactive royalty and to set artificial wellhead values for gas used by Union/Marathon in their ammonia-LNG plants. These conditions do not attach to our purchases, all of which were made at arms-length and establish the real market, the only true value of the gas we buy for our customers.

DT/dms

JANUARY 13, 1986

STATE OF ALASKA
DEPARTMENT OF NATURAL RESOURCES
DIVISION OF OIL AND GAS

TABLE 2.20

ESTIMATED PRODUCTION AND SALES FOR NORTH SLOPE ROYALTY OIL (9)

YEAR	ESTIMATED TOTAL PRODUCTION (BARRELS PER DAY) (1) TOTAL PRUDHOE	(1) TOTAL KUPARUK	(1) TOTAL LISBURNE	(1) TOTAL ENDICOTT	(1) TOTAL MILNE PT.	TOTAL	ESTIMATED ROYALTY (BARRELS PER DAY) PRUDHOE ROYALTY	KUPARUK ROYALTY	LISBURNE ROYALTY	ENDICOTT ROYALTY	MILNE PT. ROYALTY	TOTAL ROYALTY
1985	1,550,000	180,000			3,000	1,733,000	193,750	22,500			375	216,625
1986	1,550,000	220,000			30,000	1,800,000	193,750	27,500			5,400	226,650
1987	1,550,000	220,000	50,000		30,000	1,850,000	193,750	27,500	6,750		5,400	232,100
1988	1,376,000	220,000	60,000	50,000	30,000	1,736,000	172,000	27,500	7,500	7,000	5,400	219,400
1989	1,103,000	220,000	70,000	100,000	25,000	1,598,000	137,875	27,500	8,750	14,000	4,500	202,625
1990	1,018,000	187,000	80,000	100,000	20,000	1,405,000	127,250	23,375	10,000	14,000	3,600	178,225
1991	928,000	159,000	90,000	100,000	15,000	1,292,000	11[illegible]	19,875	11,250	14,500	2,700	163,825
1992	846,000	135,000	100,000	100,000	15,000	1,196,000	105,750	16,875	12,500	14,000	2,700	151,825
1993	772,000	122,000	100,000	85,000	10,000	1,089,000	96,500	15,250	12,500	11,900	1,800	137,950
1994	706,000	109,000	100,000	75,000	10,000	1,000,000	88,250	13,625	12,500	10,500	1,800	126,675
1995	646,000	98,000	99,000	70,000	10,000	911,000	8[illegible],750	12,250	11,250	9,800	1,800	115,850
1996	591,000	89,000	80,000	65,000	0	825,000	73,875	11,125	10,000	9,100	0	104,100
1997	541,000	80,000	72,000	60,000	0	753,000	67,625	10,000	9,000	8,400	0	95,025
1998	498,000	72,000	65,000	55,000	0	690,000	62,250	9,000	8,125	7,700	0	87,075
1999	458,000	65,000	58,000	50,000	0	631,000	57,250	8,125	7,250	7,000	0	79,625
2000	421,000	58,000	52,000	45,000	0	576,000	52,625	7,250	6,500	6,300	0	72,675
2001	387,000	52,000	47,000	40,000	0	526,000	48,375	6,500	5,875	5,600	0	66,350
2002	357,000	47,000	42,000	20,000	0	466,000	44,625	5,875	5,250	2,800	0	58,550
2003	328,000	42,000	38,000	10,000	0	418,000	41,000	5,250	4,750	1,400	0	52,400
2004	302,000	38,000	34,000	0	0	374,000	37,750	4,750	4,250	0	0	46,750
2005	278,000	34,000	31,000	0	0	343,000	34,750	4,250	3,875	0	0	42,875
2006	255,000	31,000	28,000	0	0	314,000	31,875	3,875	3,500	0	0	39,250
2007	235,000	28,000	25,000	0	0	288,000	29,375	3,500	3,125	0	0	36,000
2008	216,000	25,000	20,000	0	0	261,000	27,000	3,125	2,500	0	0	32,625
2009	199,000	20,000	15,000	0	0	234,000	24,875	2,500	1,875	0	0	29,250
2010	183,000	15,000	10,000	0	0	208,000	22,875	1,875	1,250	0	0	26,000
2011	168,000	10,000	0	0	0	178,000	21,000	1,250	0	0	0	22,250
2012	155,000	0	0	0	0	155,000	19,375	0	0	0	0	19,375

YEAR	ESTIMATED SALES OF ROYALTY OIL (BARRELS PER DAY) MAPCO	(2) SVEA	(3) TESORO (OLD)	(4) TESORO (NEW)	(5) CHEVRON	(6) COMPETITIVE SALE 12-11-84	(7) PETRO/CHEVRON (PROPOSED)	(8) COMPETITIVE SALE 2-4-86 (PROPOSED)	ROYALTY IN VALUE
1985	35,000	5,167	47,533	26,867	18,600	65,000			10,658
1986	35,000	5,167	47,533	26,867	18,600	65,000	6,000	18,000	22,483
1987	35,000	5,167	47,533	26,867	18,600		6,500		73,233
1988	35,000	4,587	42,197	23,851	16,512		6,500		90,753
1989	35,000	3,943	34,278	20,506	14,196		6,500		84,202
1990	35,000	3,393	31,218	17,646	12,216		5,525		73,227
1991	35,000	3,093	28,458	16,086	11,136		4,698		65,354
1992	35,000	2,820	25,944	14,664	10,152		3,989		59,256
1993	35,000	2,573	23,674	13,382	9,264		3,605		50,452
1994	35,000	2,353	21,650	12,238	8,472		3,220		43,741
1995	35,000						2,895		77,955
1996	35,000						2,630		66,470
1997	35,000								60,025
1998	35,000								52,075
1999	35,000								44,625
2000	35,000								37,675
2001	35,000								31,350
2002	35,000								23,550
2003	35,000								17,400
2004									46,750
2005									42,875
2006									39,250
2007									36,000
2008									32,675
2009									29,250
2010									26,000
2011									22,250
2012									

(1) DNR ESTIMATE OF FIELD PERFORMANCE, DECEMBER 1985.

(2) SVEA'S TEN-YEAR CONTRACT COMMENCED JULY 1, 1985. QUANTITY IS 2.667% OF DAILY PRUDHOE ROYALTY OIL.

(3) TESORO'S CONTRACT IS CURRENTLY AT ITS MAXIMUM QUANTITY OF 24.533% OF DAILY PRUDHOE ROYALTY OIL. THE CONTRACT EXPIRES JANUARY 1995.

(4) ON OCTOBER 1, 1985 TESORO COMMENCED DELIVERIES UNDER 12/9/83 PRUDHOE CONTRACT WHICH HAS A MAXIMUM QUANTITY OF 13.86% OF DAILY PRUDHOE ROYALTY OIL AND EXPIRES JAN. 1, 1995.

(5) CHEVRON'S CONTRACT CALLS FOR A MAXIMUM QUANTITY OF 9.6% OF DAILY PRUDHOE ROYALTY OIL. THE CONTRACT EXPIRES JANUARY 1, 1995.

dnj

(6) DELIVERIES COMMENCED APRIL. 1985 FOR 50.000 BPD OF PRUDHOE BAY UNIT ROYALTY OIL AND 15,000 BPD OF KUPARUK RIVER UNIT ROYALTY OIL, AND WILL CONTINUE FOR ONE YEAR AS A RESULT OF THE DEC. 11, 1984 COMPETITIVE SALE AND THE SUBSEQUENT KUPARUK SOLICITATION. PRIOR TO THAT TIME THIS OIL REMAINED "IN VALUE."

(7) A PROPOSED PETRO STAR/CHEVRON CONTRACT WILL BE SUBMITTED TO THE LEGISLATURE FOR APPROVAL OF A SALE OF 6,500 BPD ROYALTY OIL FROM THE KUPARUK RIVER UNIT. PETRO STAR/CHEVRON INITIALLY WOULD PURCHASE 6,000 BPD. THE CONTRACT IS EXPECTED TO COMMENCE IN LATE 1986 AND EXPIRE SEPTEMBER 30, 1996.

(8) ON FEBRUARY 4, 1986 THE STATE WILL SELL BY COMPETITIVE BID APPROXIMATELY 18,000 BPD FOR A SIX-MONTH TERM COMMENCING JUNE 1, 1986.

(9) Includes only fields in, or planned for production in the near future.