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COMMITTEE REPORT

4/22

(9)

Date referred: 4/18/86

FURTHER REFERRALS: FINANCE

DATE: April 21, 1986

The RESOURCES Committee has considered CSSSSB 430(R1s)

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

and recommends:

- do pass
- do not pass
- do pass with attached amendment(s)
- no recommendation
- replace with HCS CSSSB 430 (res)  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:

SIGNING OTHER RECOMMENDATIONS:

Shultz Dick Shultz

Miller M.W. Miller

Thompson Frank Thompson

Jenkins Roger Jenkins

Cato Bette Cato

[Signature]  
Sund

Dick Shultz  
co-Chairman Shultz

Bannister  
4/13/86✓

Original sponsor: Fahrenkamp

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

5 A BILL

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

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

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

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

1 a plan under which the lessee must operate. The plan must adequately  
2 protect all parties in interest, including the state. Notwithstanding  
3 (j) of this section, (if the commissioner determines that the public  
4 interest warrants the reduction or revocation,) <sup>1</sup> the commissioner may  
5 reduce or revoke a royalty obligation increase that was made by the  
6 commissioner in connection with the institution or operation of a co-  
7 operative or unit plan; <sup>if the commissioner</sup> however, the reduction or revocation must  
8 contain a mechanism to provide that if a lessee's market conditions  
9 improve or if the profitability of a lessee's operation increases to a  
10 specified level after the commissioner makes the reduction or revoca-  
11 tion, the commissioner shall increase the royalty obligation of the  
12 lessee to a level not exceeding the amount of the royalty obligation  
13 increase that the commissioner reduced or revoked. <sup>and</sup> As a condition of  
14 the reduction or revocation of a royalty obligation, the commissioner  
15 shall require the lessee to comply with all valid and applicable laws  
16 and regulations of the state

17 (1) that concern the hiring of state residents; and

18 (2) that are in effect or take effect during the term of  
19 the lease.

20 \* Sec. 2. This Act takes effect immediately in accordance with AS 01.-  
21 10.070(c).

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

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

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

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

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

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

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

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

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

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

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

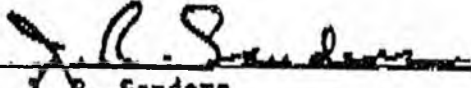
THANK YOU FOR THE OPPORTUNITY TO TALK WITH YOU TODAY REGARDING SB 430,  
AND I WOULD BE DELIGHTED TO TRY TO ANSWER ANY QUESTIONS YOU MIGHT  
HAVE.

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

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

CONOCO INC.

By

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

\_\_\_\_\_  
Attest

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

Original sponsor: Fahrenkamp

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

BY THE HOUSE SPECIAL  
COMMITTEE ON OIL AND GAS

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

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

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

TESTIMONY OF AL HASTINGS

BEFORE THE HOUSE OIL & GAS COMMITTEE

REGARDING CS SS SB 430 (APRIL 16, 1986)

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

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INTEREST WARRANTS. CONOCO WILL STILL HAVE TO PROVE ITS CASE BEFORE THE DEPARTMENT. THE ISSUE BEFORE THIS COMMITTEE IS NOT WHAT CONOCO'S ROYALTY SHOULD BE; THAT ISSUE WILL HAVE TO BE RESOLVED BY DNR, BASED ON THE CONSIDERATION OF FINANCIAL DATA, SOME OF IT CONFIDENTIAL. THE ONLY RELIEF CONOCO IS ASKING HERE IS TO REMOVE A PERCEIVED AND VERY UNINTENTIONAL IMPEDIMENT TO DNR'S ABILITY TO RECONSIDER THE SURCHARGE.

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CONOCO AND DNR HAVE ATTEMPTED TO RESOLVE THIS MATTER THROUGH NEGOTIATIONS. IN THOSE NEGOTIATIONS, COMMISSIONER WUNNICKE AND

HER STAFF HAVE USED THEIR BEST EFFORTS TO WORK WITHIN THE PERCEIVED CONSTRAINTS. SPECIFICALLY, DNR HAS DONE AS WELL AS ANYONE COULD TO CHANGE THE NATURE OF THE SURCHARGE WITHOUT REDUCING IT, AND AT THE SAME TIME AFFORD SOME MEANINGFUL RELIEF TO CONOCO. WE COMMEND DNR FOR THE EFFORTS THEY HAVE MADE IN THIS REGARD; HOWEVER, THEIR JOB MAY BE AN IMPOSSIBLE ONE UNDER THEIR VIEW OF THE STATUTE, FOR IT IS VERY HARD TO REDUCE A ROYALTY WITHOUT IN FACT REDUCING IT.

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

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

QUESTIONS YOU MIGHT HAVE.

# STATE OF ALASKA 1986 LEGISLATIVE SESSION FISCAL NOTE

Revision Date : 03-21-86

**REQUEST**

Bill/Resolution No. CSSSSB 430 (B11)  
 Title : Revoke/Reduce Royalty Increase

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Sponsor : Fahrenkamp  
 Requestor : Senate Finance  
 Date of Request : 03-21-86

**FISCAL DETAIL**

Agency Affected : Natural Resources  
 BRU : Petroleum Management

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Components : \_\_\_\_\_

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

OPERATING	FY 86	FY 87	FY 88	FY 89	FY 90	FY 91
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
<b>TOTAL OPERATING</b>	-0-	-0-	-0-	-0-	-0-	-0-

CAPITAL						
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REVENUE	(2260.0)	(2150.0)	(1900.0)	(1660.0)	(1460.0)	
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**FUNDING : (Thousands of Dollars)**

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

**POSITIONS :**

FULL-TIME						
PART-TIME						
TEMPORARY						

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

See Attached Explanation

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

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

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

Distribution (by Agency preparing fiscal note) :

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

Attachment Fiscal Note for SSSB 430

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

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

... Milne Point Unit production at:

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

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

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

# STATE OF ALASKA



POUCH V  
JUNEAU, ALASKA 99811  
(907) 485-4941

## HOUSE SPECIAL COMMITTEE ON OIL AND GAS

### CSSSSB 430 (Rules)

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

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

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

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

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

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

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

# STATE OF ALASKA

## DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

BILL SHEFFIELD, GOVERNOR

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

March 17, 1986

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

Dear Senator Sturgulewski:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

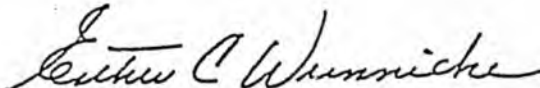
March 17, 1986

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

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

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

Sincerely,

  
Esther C. Wunnicke  
Commissioner

Attachment

cc: Senator Bettye Fahrenkamp



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

December 23, 1985

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

Re: Enclosed Request for Unit  
Agreement Amendment

Dear Representative Davis:

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

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

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

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

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

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

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

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

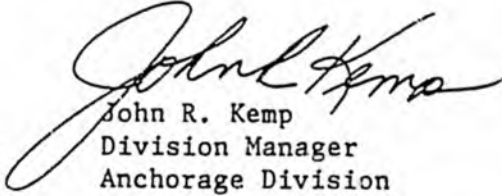
The other option is legislation that would even more clearly direct the commissioner to act in the very limited and compelling circumstances present here. We had hoped that DNR would process our request in a way that would allow the legislature to consider this matter, if it needs to consider it at all,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

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

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

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

Sincerely,



John R. Kemp  
Division Manager  
Anchorage Division

vv