

S B

3 0 9

Alaska State Legislature

Fourteenth Legislature — Second Session

Senate Calendar

MONDAY  
March 3, 1986  
11:00 a.m.

Official Business of the Senate

Fiftieth Legislative Day

Chaplain: Pastor Joseph Filancia Jr., Assembly of God Church

SENATE BILLS IN SECOND READING

SB 309

Royalty value of a natural gas lease on state land  
eff. date

Resources offered CS, zero fiscal note pg 1885

"Royalty gas contracts \_\_\_\_\_ eff. date"

Rules offered CS pg 1953

"Royalty gas contracts; \_\_\_\_\_ eff. date"

Held from 2/28

CITATIONS

In Memoriam - Fletcher Fritz Gregg, Sr.  
by Senator Ferguson

In Memoriam - Justin Maile  
by Representatives Navarre, Marrou;  
Senators Paul Fischer and DeVries

Publication Notice

In Memoriam - Maurice L. Jackson by Representatives Navarre and Marrou

All In kind sales require legislative review - this bill would not change that.

Please note starred (\*) change in floor speech.

~~Fairbanks~~  
~~to be used to establish~~

14-3  
H C  
15-2  
Paul F. Fisher  
Jay K. Fulla  
Holford  
Kertulla

(1) interest  
(2) also kind  
may be below market  
(3) in value  
at contract price

Original sponsors: Faiks, Kelly  
and V. Fischer

1 IN THE SENATE

BY THE RULES COMMITTEE

2 CS FOR SENATE BILL NO. 309 (Rules)

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 FOURTEENTH LEGISLATURE - SECOND SESSION

5 A BILL

3/28/84  
Paul  
Jay K. Fulla  
Holford  
17-4

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. (a) The legislature finds that the best inter-  
10 est of the state will be served if the commissioner of natural resources is  
11 authorized to establish the in-value royalty for gas sold to a gas or  
12 electric utility by using the contract price between the lessee of the  
13 state and the utility, whether or not the gas lease establishes a different  
14 standard for the valuation and if the lessee and the utility are not re-  
15 lated to each other. The legislature finds that this authorization should  
16 apply prospectively and does not intend the authorization to apply to the  
17 valuation for royalty purposes of gas sold by a lessee under a gas sales  
18 contract entered into before the effective date of this Act.

19 (b) The legislature finds that it is also in the best interest of the  
20 state to give the commissioner explicit discretionary authority to sell  
21 royalty gas received in kind by the state to gas or electric utilities at a  
22 price that is below market value.

23 (c) The legislature finds that the proper exercise of the discretion  
24 conferred on the commissioner by this Act would support and complement the  
25 other programs that assist the citizens of the state with their long-term  
26 gas and electrical needs, including the power cost equalization program  
27 under AS 44.83.162 - 44.83.165 and hydroelectric and other programs for the  
28 generation of electricity.

29 (d) The legislature finds that the state should adopt a policy for

1 the sale of royalty gas to gas or electric utilities for in-state consumer  
2 use and in-state generation of electricity that is fundamentally different  
3 from the policies of the state for the sale of royalty oil and for the sale  
4 of royalty gas for export from the state or for uses other than in-state  
5 consumer use and in-state generation of electricity.

6 (e) The legislature finds it is in the state's best interest to  
7 facilitate the financing and construction of a pipeline and increased gas  
8 production from the Prudhoe Bay reservoir by establishing a procedure by  
9 which the state could commit itself to a royalty valuation methodology for  
10 as long as the state takes its royalty share of gas production in value.

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

12 (aa) Within 90 days after the written request of a lessee of a  
13 lease issued under this section, unless the commissioner makes a  
14 written finding based on clear and convincing evidence that the con-  
15 tract price is unreasonably low and that a prospective reduction in  
16 royalty receipts would not be balanced by increased benefits to in-  
17 state gas and electric consumers, the commissioner shall enter into an  
18 agreement with the lessee to use the price for the gas established in  
19 the contract between the lessee and a gas or electric utility, if the  
20 lessee and the utility are not related in management, ownership, or  
21 other aspect, as the value of the state's royalty share of gas produc-  
22 tion sold by the lessee under the contract to the utility. In this  
23 subsection

24 (1) "gas or electric utility" includes an electric coopera-  
25 tive organized under AS 10.25, a municipal utility, and a gas or  
26 electric utility regulated under AS 42.05; and

27 (2) "price for the gas established in the contract" in-  
28 cludes tax reimbursement amounts, deliverability and other charges,  
29 and other forms of consideration paid by the gas or electric utility

1 under the contract.

2 (bb) In the event of a contract between parties that are unrelat-  
3 ed in management, ownership, or other aspect for the sale of gas from  
4 Prudhoe Bay reservoir gas leases by means of delivery of the gas  
5 through a pipeline for export out of the state, and within 90 days  
6 after the written request of a lessee of a lease issued under this  
7 section, unless the commissioner makes a written finding that the  
8 contract price does not assure the maximum benefits to the people of  
9 the state in return for the state's gas resources, the commissioner  
10 shall enter into an agreement with the lessee to use the price for the  
11 gas established in the gas sales contract as the value of the state's  
12 royalty share of gas production sold by the lessee under the gas sales  
13 contract. The lessee shall have the burden of providing all informa-  
14 tion necessary for the commissioner to make an informed decision, and  
15 shall provide clear and convincing evidence that the value of the gas  
16 is reflected by the gas sales contract price rather than being attri-  
17 buted to transportation, marketing, or other profit or cost centers.  
18 In this subsection, "price for the gas established in the gas sales  
19 contract" includes tax reimbursement amounts, deliverability and other  
20 charges, and other forms of consideration received by the lessee under  
21 the gas sales contract.

22 \* Sec. 3. AS 38.05.183 is amended by adding a new subsection to read:

23 (h) The commissioner may enter into a contract to sell royalty  
24 gas taken in kind by the state to a gas or electric utility at less  
25 than the market value of the royalty gas if the commissioner, after  
26 considering the consumer benefits, other benefits, and detriments of  
27 the sale, makes a written finding that the sale is in the best inter-  
28 est of the state. In this subsection, "gas or electric utility"  
29 includes an electric cooperative organized under AS 10.25, a municipal

*Not in scope*  
*in amended*  
*section*  
*with*  
*27*  
*28*  
*come to*  
*signature*

1 utility, and a gas or electric utility regulated under AS 42.05.

2 \* Sec. 4. AS 38.05.810(a) is amended to read:

3 (a) Except as otherwise provided in AS 38.05.183(h), the [THE]  
4 lease, sale, or other disposal of state land or resources may be made  
5 to a state or federal agency or political subdivision, or the lease,  
6 sale, or disposal of coal deposits suitable for mining may be made to  
7 a utility owned and operated by a government agency or nonprofit  
8 cooperative association organized to participate under the Federal  
9 Rural Electrification Act for the purpose of generating electric power  
10 and energy or the production of process steam, or both, for less than  
11 the appraised value as determined by the director and approved by the  
12 commissioner to be fair and proper and in the best interests of the  
13 public, with due consideration given to the nature of the public  
14 services or function rendered by the agency, subdivision, or utility  
15 making application, and of the terms of the grant under which the land  
16 was acquired by the state.

17 \* Sec. 5. AS 38.05.180(aa), enacted by sec. 2 of this Act, applies to  
18 agreements to establish for a lease issued under AS 38.05.180 the in-value  
19 royalties on gas production that is sold under a contract ~~entered into on~~  
20 ~~or after the effective date~~ of this Act between the state's lessee and a  
21 gas or electric utility.

22 \* Sec. 6. This Act takes effect immediately in accordance with AS 01.-  
23 10.070(c).  
24  
25  
26  
27  
28  
29

BILL SHEFFIELD, GOVERNOR

**DEPARTMENT OF LAW**

OFFICE OF THE ATTORNEY GENERAL

POUCH K - STATE CAPITOL  
JUNEAU, ALASKA 99811  
PHONE: (907) 465-3600

March 3, 1986



The Honorable Joe P. Josephson  
Alaska State Legislature  
P. O. Box V  
Juneau, AK 99811


Dear Senator Josephson:

CSSB 309, "An Act relating to royalty gas contracts; and providing for an effective date" will not affect the Legislature's ability to review and approve long term sales of royalty gas taken in-kind by the state.

If you have any question, please do not hesitate to call.

Sincerely,

HAROLD M. BROWN  
ATTORNEY GENERAL

By:   
Mark P. Worcester  
Assistant Attorney General

MPW/mw

When the administration reevaluated the method which they used to value Cook Inlet Royalty gas, they said this was the fair and legally proper method of valuing the gas and that use of any other method would set dangerous legal precedents. At the end of last session, when the <sup>consumer</sup> impact of this decision had become obvious to the public, a number of bills were introduced on the subject.

When SB 309 came before the Senate Resources Committee, we worked very hard in the limited amount of time available. We dealt with the issues before us in a responsible manner. With the active cooperation of all the involved parties, the committee achieved a compromise that protected the state's interests while providing long-term price stability for southcentral and railbelt electric consumers.

Based on the Senate Resource Committee Substitute, Chugach Electric and the State have signed a settlement based on the passage of this bill. At the time, the committee was advised by the administration that any widening of the language would establish dangerous legal precedents, be bad public policy, and would be adamantly opposed.

After this bill passed out of Resources, I continued my involvement at the request of the interested parties and the administration. With the active involvement of all interested parties, <sup>the Rules Committee</sup> ~~a new draft~~ has been worked out which protects the

★ →  
Tim says he needs your help in supporting Rules Committee action.

states interests, does not affect other oil and gas litigation, and will extend the benefits of price stability to customers of state regulated private gas utilities and also to a North Slope gas pipeline.

I think this is good legislation. It will be of benefit to customers of gas utilities and electric utilities that use gas generation, and it will help the chances of a North Slope gas pipeline. This legislation has been crafted in a limited amount of time but it has been carefully crafted and I urge your vote for it.

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 lessee (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 purchased 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.

Revenue Impact: 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.

## 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.

# STATE OF ALASKA

## DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

BILL SHEFFIELD, GOVERNOR

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

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).

### The fiscal note

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

March 3, 1986

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

# STATE OF ALASKA

## DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

BILL SHEFFIELD, GOVERNOR

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

February 28, 1986

The Honorable Tim Kelly  
Chair, Rules Committee  
Alaska State Senate  
P.O. Box V  
Juneau, AK 99811

Dear Senator Kelly:

I am writing with regard to an amendment to CSSB 309 (Res) proposed in the Rules Committee yesterday by Senator Coghill.

The Sheffield Administration is strongly committed to the development of our North Slope gas resources. We are willing to work with the Legislature and all interested groups in enhancing the development of our North Slope gas resources. The most recent estimates indicate that there are about 36 trillion cubic feet of gas known to exist under state lands on the North Slope. The state's royalty share of this gas is estimated to be about 4.5 trillion cubic feet.

It would be an enormous achievement to bring this gas to markets somewhere in the world, and the state has worked closely with lessees and transportation entities to see this accomplished.

The amendment before you, however, would not accomplish this purpose only. It has several major problems:

- the amendment is not limited to arms'-length contracts;
- only the language regarding findings restricts the amendment to North Slope gas, and, therefore, the amendment might affect other state gas royalties;
- the amendment does not allow the state to assess the adequacy of the royalty value of a tremendously valuable public resource;

February 28, 1986

- there is no assurance in the amendment that a contract would be structured to reflect the true value of the gas and of the royalty share; and
- the amendment does not assure that the citizens of the state will receive maximum benefits from the agreement to use the contract value.

With these questions and issues remaining, it is my recommendation to the Rules Committee and to other members of the Senate that such an amendment not be included in this bill, which has been crafted painstakingly to address the concerns of railbelt energy consumers.

While I would prefer to see the issues raised by Senator Coghill addressed in a separate bill, I believe that the attached language drafted by our attorneys would be in the best interests of the state and could be added to SB 309.

Please contact me if you have questions or comments. I urge the Committee to pass out the draft Rules Committee Substitute for SB 309 including amendments relating to gas utility contracts, and to consider the language that I have attached to address the North Slope gas transportation issue.

Sincerely,



Esther C. Wunnicke  
Commissioner

cc: Senator Faiks  
Senator Coghill

Attachment



*Subsistence*

STEPHEN McALPINE  
LIEUTENANT GOVERNOR

STATE OF ALASKA

POUCH AA  
JUNEAU 99811  
(907) 465-3520

February 19, 1986

Many of us believed that the question of subsistence rights in rural Alaska was settled with the election of 1982. Since that time, a Supreme Court opinion has opened the question again. Today, a bill is locked up in the Alaska Senate which would again insure subsistence priority for rural Alaskans. I am writing to urge your assistance in helping pass this important law.

The question of subsistence priority is more than one of access to our state's fish and game. It is a question of our state's responsibility to assist in maintaining cultural distinctions which predate most Alaskan's arrival here by thousands of years. It is the responsibility of all of us to protect the rights of Alaskans who depend on fish and game for their daily food and to insure that they have priority access to this food source.

You can assist me in the passage of this legislation by writing letters and sending public opinion messages (they are free of charge) to members of the Alaska State Senate. With your assistance, we can again insure that the subsistence rights of our fellow Alaskans are protected.

Warmest regards,

A handwritten signature in cursive script, appearing to read "Sed".

Stephen McAlpine  
Lieutenant Governor

Offered: 2/28/86

Original sponsors: Faiks, Kelly  
and V.Fischer

1 IN THE SENATE

BY THE RULES COMMITTEE

2 CS FOR SENATE BILL NO. 309 (Rules)

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 FOURTEENTH LEGISLATURE - SECOND SESSION

5 A BILL

6 For an Act entitled: "An Act relating to 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. (a) The legislature finds that the best inter-  
10 est of the state will be served if the commissioner of natural resources is  
11 authorized to establish the in-value royalty for gas sold to a gas or  
12 electric utility by using the contract price between the lessee of the  
13 state and the utility, whether or not the gas lease establishes a different  
14 standard for the valuation and if the lessee and the utility are not re-  
15 lated to each other. The legislature finds that this authorization should  
16 apply prospectively and does not intend the authorization to apply to the  
17 valuation for royalty purposes of gas sold by a lessee under a gas sales  
18 contract entered into before the effective date of this Act.

19 (b) The legislature finds that it is also in the best interest of the  
20 state to give the commissioner explicit discretionary authority to sell  
21 royalty gas received in kind by the state to gas or electric utilities at a  
22 price that is below market value.

23 (c) The legislature finds that the proper exercise of the discretion  
24 conferred on the commissioner by this Act would support and complement the  
25 other programs that assist the citizens of the state with their long-term  
26 gas and electrical needs, including the power cost equalization program  
27 under AS 44.83.162 - 44.83.165 and hydroelectric and other programs for the  
28 generation of electricity.

29 (d) The legislature finds that the state should adopt a policy for  
S

1 the sale of royalty gas to gas or electric utilities for in-state consumer  
2 use and in-state generation of electricity that is fundamentally different  
3 from the policies of the state for the sale of royalty oil and for the sale  
4 of royalty gas for export from the state or for uses other than in-state  
5 consumer use and in-state generation of electricity.

6 (e) The legislature finds it is in the state's best interest to  
7 facilitate the financing and construction of a pipeline and increased gas  
8 production from the Prudhoe Bay reservoir by establishing a procedure by  
9 which the state could commit itself to a royalty valuation methodology for  
10 as long as the state takes its royalty share of gas production in value.

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

12 (aa) Within 90 days after the written request of a lessee of a  
13 lease issued under this section, unless the commissioner makes a  
14 written finding based on clear and convincing evidence that the con-  
15 tract price is unreasonably low and that a prospective reduction in  
16 royalty receipts would not be balanced by increased benefits to in-  
17 state gas and electric consumers, the commissioner shall enter into an  
18 agreement with the lessee to use the price for the gas established in  
19 the contract between the lessee and a gas or electric utility, if the  
20 lessee and the utility are not related in management, ownership, or  
21 other aspect, as the value of the state's royalty share of gas produc-  
22 tion sold by the lessee under the contract to the utility. In this  
23 subsection

24 (1) "gas or electric utility" includes an electric coopera-  
25 tive organized under AS 10.25, a municipal utility, and a gas or  
26 electric utility regulated under AS 42.05; and

27 (2) "price for the gas established in the contract" in-  
28 cludes tax reimbursement amounts, deliverability and other charges,  
29 and other forms of consideration paid by the gas or electric utility

1 under the contract.

2 (bb) In the event of a contract between parties that are unrelat-  
3 ed in management, ownership, or other aspect for the sale of gas from  
4 Prudhoe Bay reservoir gas leases by means of delivery of the gas  
5 through a pipeline for export out of the state, and within 90 days  
6 after the written request of a lessee of a lease issued under this  
7 section, unless the commissioner makes a written finding that the  
8 contract price does not assure the maximum benefits to the people of  
9 the state in return for the state's gas resources, the commissioner  
10 shall enter into an agreement with the lessee to use the price for the  
11 gas established in the gas sales contract as the value of the state's  
12 royalty share of gas production sold by the lessee under the gas sales  
13 contract. The lessee shall have the burden of providing all informa-  
14 tion necessary for the commissioner to make an informed decision, and  
15 shall provide clear and convincing evidence that the value of the gas  
16 is reflected by the gas sales contract price rather than being attri-  
17 buted to transportation, marketing, or other profit or cost centers.  
18 In this subsection, "price for the gas established in the gas sales  
19 contract" includes tax reimbursement amounts, deliverability and other  
20 charges, and other forms of consideration received by the lessee under  
21 the gas sales contract.

22 \* Sec. 3. AS 38.05.183 is amended by adding a new subsection to read:

23 (h) The commissioner may enter into a contract to sell royalty  
24 gas taken in kind by the state to a gas or electric utility at less  
25 than the market value of the royalty gas if the commissioner, after  
26 considering the consumer benefits, other benefits, and detriments of  
27 the sale, makes a written finding that the sale is in the best inter-  
28 est of the state. In this subsection, "gas or electric utility"  
29 includes an electric cooperative organized under AS 10.25, a municipal

1 utility, and a gas or electric utility regulated under AS 42.05.

2 \* Sec. 4. AS 38.05.810(a) is amended to read:

3 (a) Except as otherwise provided in AS 38.05.183(h), the [THE]  
4 lease, sale, or other disposal of state land or resources may be made  
5 to a state or federal agency or political subdivision, or the lease,  
6 sale, or disposal of coal deposits suitable for mining may be made to  
7 a utility owned and operated by a government agency or nonprofit  
8 cooperative association organized to participate under the Federal  
9 Rural Electrification Act for the purpose of generating electric power  
10 and energy or the production of process steam, or both, for less than  
11 the appraised value as determined by the director and approved by the  
12 commissioner to be fair and proper and in the best interests of the  
13 public, with due consideration given to the nature of the public  
14 services or function rendered by the agency, subdivision, or utility  
15 making application, and of the terms of the grant under which the land  
16 was acquired by the state.

17 \* Sec. 5. AS 38.05.180(aa), enacted by sec. 2 of this Act, applies to  
18 agreements to establish for a lease issued under AS 38.05.180 the in-value  
19 royalties on gas production that is sold under a contract entered into on  
20 or after the effective date of this Act between the state's lessee and a  
21 gas or electric utility.

22 \* Sec. 6. This Act takes effect immediately in accordance with AS 01.-  
23 10.070(c).

SENATE BILL NO. 309 by Senators Faiks, Kelly, and Vic Fischer, entitled:

"An Act relating to the royalty value of a natural gas lease on state land; and providing for an effective date."

was read the first time and referred to the Resources Committee.

The Resources Committee considered SENATE BILL NO. 309 (royalty value of a natural gas lease on state land; efd) and recommended it be replaced with

CS FOR SENATE BILL NO. 309 (RES), entitled:

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

and a majority do pass. The report was signed by Senator Sturgulewski, Chairman and concurred in by Senators Coghill, Vic Fischer and Fahrenkamp. Senators Halford, Eliason and Zharoff signed "no recommendation".

Fiscal Note is zero. Analysis from Department of Natural Resources: "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."

SENATE BILL NO. 309 was referred to the Rules Committee.

The Rules Committee considered SENATE BILL NO. 309 (royalty value of a natural gas lease on state land; efd) and recommended it be replaced with

CS FOR SENATE BILL NO. 309 (RLS); entitled:

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

and calendar February 28. The report was signed by Senator Kelly, Chairman and concurred in by Senators Coghill, Faiks, Bennett and Josephson.

SENATE BILL NO. 309 is on the calendar.

SENATE BILL NO. 309 (royalty value of a natural gas lease on state land; efd) was read the second time.

Senator Kelly moved and asked unanimous consent that SENATE BILL NO. 309 be held in second reading to the March 3 calendar. Without objection, it was so ordered.

SENATE BILL NO. 309 (royalty value of a natural gas lease on state land; efd) which was read the second time and held on February 28 was before the Senate in second reading.

Senator Faiks moved and asked unanimous consent for the adoption of the Rules Committee Substitute offered on page 1953. Senator Kerttula objected.

The question being: "Shall the Rules Committee Substitute be adopted? The roll was taken with the following result:

## SB 309 MOTION RLS CS

Yeas:	15	Abood, Bennett, Coghill, DeVries, Fahrenkamp, Faiks, Fischer Vic, Halford, Josephson, Kelly, Rodey, Sackett, Sturgulewski, Zharoff, Ziegler
Nays:	2	Fischer Paul, Kerttula
Excused:	1	Ferguson
Absent:	2	Eliason, Ray

and so, (CS FOR SENATE BILL NO. 309 (RLS)) (royalty gas contracts; efd) was adopted.

CS FOR SENATE BILL NO. 309 (RLS) was read the second time.

Senator Halford moved and asked unanimous consent that CS FOR SENATE BILL NO. 309 (RLS) be considered engrossed, advanced to third reading and placed on final passage. Without objection, it was so ordered.

CS FOR SENATE BILL NO. 309 (RLS) was read the third time.

The question being: "Shall CS FOR SENATE BILL NO. 309 (RLS) (royalty gas contracts; efd) pass the Senate?" The roll was taken with the following result:

CS SB 309 RLS 3RD

Yeas: 14 Abood, Bennett, Coghill, DeVries,  
Fahrenkamp, Faiks, Fischer Vic,  
Josephson, Kelly, Rodey, Sackett,  
Sturgulewski, Zharoff, Ziegler

Nays: 3 Fischer Paul, Halford, Kerttula

Excused: 1 Ferguson

Absent: 2 Eliason, Ray

and so, CS FOR SENATE BILL NO. 309 (RLS) passed the Senate.

Senator Halford moved and asked unanimous consent that the vote on the passage of the bill be considered the vote on the effective date clause. Without objection, it was so ordered.

Senator Kerttula gave notice of reconsideration.

COMMITTEE REPORT  
SENATE

FURTHER:

5/4/85

Date 2/17/86

Mr. President

The Committee on RESOURCES considered SB 309

royalty value of a natural gas lease on state land; efd.

and (a majority of the committee) (the committee) reports it back with the following recommendations:

- do pass
- do pass with attached amendment(s)
- replace with/or adopt CS for SB 309 (Res)
- new title
- same title and recommends \_\_\_\_\_
- and attached a "LETTER OF INTENT"  NEW FISCAL NOTE
- reports it back without recommendation
- recommends referral to \_\_\_\_\_ Committee

MEMBERS SIGNING  
DO PASS

[Signature]

[Signature]

Betty Sakrenkamp

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

MEMBERS HAVING  
OTHER RECOMMENDATIONS

[Signature]

[Signature]

\_\_\_\_\_

\_\_\_\_\_

Celia Stungler  
Chairman

[Signature]  
Chairman recommendation

# 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						
<b>TOTAL OPERATING</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>

CAPITAL						
---------	--	--	--	--	--	--

REVENUE						
---------	--	--	--	--	--	--

**FUNDING : (Thousands of Dollars)**

GENERAL FUND						
FEDERAL FUNDS						
OTHER						
<b>TOTAL</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>

**POSITIONS :**

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 : *Arthur C. Winnick* 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)

# STATE OF ALASKA

## DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

BILL SHEFFIELD, GOVERNOR

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

May 12, 1986

The Honorable Jan Faiks  
The Honorable Tim Kelly  
Alaska State Senate  
P.O. Box V  
Juneau, AK 99811

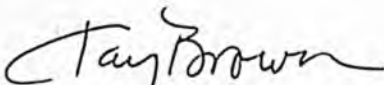
Dear Senators,

Attached for your information is a brief comparison of the differences in the House CS for CS for Senate Bill 309 (Rules), relating to royalty gas contracts, with the Senate-passed version of the bill.

We support the version passed by the House this morning, and urge your concurrence in the House amendments.

If you have any questions about the amendments made by the House, please feel free to contact me.

Sincerely,



Kay Brown  
Director

Comparison of House Rules CS and Senate Rules CS for SB 309

Alaska Department of Natural Resources

	<u>House Rules CS</u>	<u>Senate Rules CS</u>
Section 1:	shortened findings	
Section 2:	rewrote (aa) but substance is unchanged	
	put definitions into (bb)	definitions part of (aa)
	added so-called "common carrier" amendment (page 2, lines 11-16), which will require Enstar to operate as common carrier pipeline in order to obtain the benefits of the legislation. (Enstar has not objected to this provision.)	
	added exception for Mental Health and University lands at request of DNR and Dept. of Law. Royalty gas production from these lands would be valued under the lease form and not under (aa).	
	deleted provision regarding valuation of North Slope royalty gas. (Provision deleted at request of Yukon Pacific.)	Contains provision for NS gas valuation.
Section 3:	Provides that, upon legislative approval, the commissioner may sell in kind royalty gas to a gas or electric utility "at a negotiated price." (Legislative approval procedures are already provided in AS 38.06.055.)	Similar provision; price may be "less than market value."
Section 4:	Same in both versions.	
Section 5:	Same in both versions.	
Section 6:	Same in both versions.	

II

FAILED 17-22  
ON FLOOR OF HOUSE

LETTER OF INTENT

TO HCS CS SB 309 (Rules)

HCS CS SB 309 (Rules) sets out the circumstances under which the Commissioner of Natural Resources is required to use the contract price as the value of the state's royalty gas share, when the contract involves a regulated gas or electric utility. The bill, is intended to specify only those circumstances under which the Commissioner "shall" accept the contract price. It is not intended, in any way, to limit the Commissioner's discretion to use the price term of a contract entered into by entities other than gas or electric utilities.

**STATE OF ALASKA 1986 LEGISLATIVE SESSION  
FISCAL NOTE**

Revision Date : 5-9-86

**REQUEST**

Bill/Resolution No. : CSCSSB 309 (Finance)  
 Title : An Act relating to royalty gas contracts  
 Sponsor : Faiks  
 Requestor : House Finance  
 Date of Request : 5-9-86

**FISCAL DETAIL**

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

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

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

**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

The fiscal impact of this proposal is indeterminate. For explanation, see attached Supplemental Information.

Prepared by : Kay Brown Phone : 762-4241  
 Division : Oil and Gas Date : 5-9-86  
 Approved by Commissioner : *Arthur P. Hennrich* Date : 5-9-86  
 Agency : Natural Resources

Distribution (by Agency preparing fiscal note) :

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

## SUPPLEMENTAL INFORMATION

### Fiscal Note proposed House CS for CS for SB 309 (Finance)

#### Alaska Department of Natural Resources

The potential fiscal impact of the proposed House CS for CS for SB 309 (Finance) cannot be precisely specified, because it is unknown at this time how often the new valuation mechanism would be applied in the future and to what extent future contract prices would deviate from market value.

The impact of the proposed House Finance CS is limited to gas sold to regulated gas and electric utilities. The royalty share of gas sold to regulated gas and electric utilities would be valued using solely the contract price, unless the commissioner finds, based on clear and convincing evidence, that the price is unreasonably low, the prospective reduction in royalty receipts would not be balanced by increased benefits to in-state gas and electric consumers, the lessee and the utility are related to each other, and the contract price is not in the best interest of the state. (All four conditions would have to clearly and convincingly exist in order not to use the contract price.) Thus, the contract price would be used in virtually all foreseeable instances involving sales to regulated gas or electric utilities.

The fiscal impact of Section 2 of the bill would depend on the extent to which contract prices differ from value in the future. Gas that will be sold to regulated gas and electric utilities is likely to come primarily from Cook Inlet, at least in the near term. The state's royalty share of Cook Inlet gas reserves not presently committed to a contract is about 190 billion cubic feet (BCF), of which some portion would likely be sold for local consumer uses. If value is higher than contract price by 10¢, 25¢ and \$1.00 per mcf for half of the state's share of Cook Inlet royalty gas not presently committed to a contract, then state revenues would be reduced by \$9.5 million, \$23.75 million and \$95 million, respectively, as a result of basing the royalty payment on the contract price rather than on the market value of the gas. Any royalty income lost to the state as a result of using solely the contract price to determine the royalty payment would go directly to benefit local gas and electric consumers.

Sections 3 and 4 of the bill give the commissioner authority, upon legislative approval, to enter into an in kind royalty gas sale to a gas or electric utility "at a negotiated price." It is implied but not expressly stated that the sale may be at a price below market value. The fiscal impact of these sections would be considered by future legislatures reviewing an in kind sale proposed by the commissioner. If the commissioner proposed to sell royalty gas at a price below market value, and the legislature approved it, future royalty income would be reduced.

The proposed House Finance CS would allow implementation of the department's preliminary settlement agreement with Chugach Electric, which would value Beluga field production purchased by Chugach under existing contracts at 75¢/mcf, subject to the passage of the legislation. 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 law, the state would have received \$1.9 million/year in new royalty income from the Beluga field. Settlement at 75¢/mcf, as will occur if the proposed House Finance CS is adopted, will increase state royalty revenues from Beluga production by about \$810,000/year, because the state's share of this production is currently valued at 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 and existing law.

# STATE OF ALASKA

## DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

BILL SHEFFIELD, GOVERNOR

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

May 10, 1986

The Honorable John Sund  
Alaska State Legislature  
P.O. Box V  
Juneau, AK 99811

Dear Rep. Sund,

You have asked that I explain why the House Resources Committee Substitute for SB 309, relating to royalty gas contracts, does not protect the state's interests.

Fundamentally, 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 Finance Committee Substitute for SB 309 -- because Alaska consumers would be the direct beneficiaries of the certainty of price provided by such a contract and of any royalties lost to the state as a result of using solely the contract price to establish royalty value. I 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.

Recognizing the desirability of development of the state's North Slope gas resources, the administration provided language to address the royalty valuation of North Slope royalty gas, although we would have preferred that this issue be addressed in legislation other than this consumer bill. Our language -- which has been incorporated into the House Finance CS -- provides a mechanism for establishing a fair royalty value for the state's share of gas production if taken in value and exported out of Alaska through a 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.

There are significant differences in the approach we have endorsed for valuing the North Slope gas, and the approach taken in the Resources Committee Substitute. The 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.

The Resources CS 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 Resources 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 Resources 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 negative fiscal impacts of the Resources Committee Substitute 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 consensus on the proper costs of the TAPS construction project. Yet the House Resources CS 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

May 10, 1986

attributed to transportation, marketing, manufacturing or other profit or cost centers.

Because it lacks these minimum protections for the state, the Resources Committee Substitute is unacceptable.

The Resources 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; and
- (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, I believe that the Finance Committee Substitute for SB 309 will protect the state's interests in maximizing benefits for all Alaskans from development of these publicly-owned resources, and I urge your support for the House Finance CS for CS for SB 309.

Sincerely,

  
Esther C. Wunnicke  
Commissioner

Offered: 2/28/86

Original sponsors: Faiks, Kelly  
and V. Fischer

1 IN THE SENATE

BY THE RULES COMMITTEE

2 CS FOR SENATE BILL NO. 309 (Rules)

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 FOURTEENTH LEGISLATURE - SECOND SESSION

5 A BILL

6 For an Act entitled: "An Act relating to 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. (a) The legislature finds that the best inter-  
10 est of the state will be served if the commissioner of natural resources is  
11 authorized to establish the in-value royalty for gas sold to a gas or  
12 electric utility by using the contract price between the lessee of the  
13 state and the utility, whether or not the gas lease establishes a different  
14 standard for the valuation and if the lessee and the utility are not re-  
15 lated to each other. The legislature finds that this authorization should  
16 apply prospectively and does not intend the authorization to apply to the  
17 valuation for royalty purposes of gas sold by a lessee unde a gas sales  
18 contract entered into before the effective date of this Act.

19 (b) The legislature finds that it is also in the best interest of the  
20 state to give the commissioner explicit discretionary authority to sell  
21 royalty gas received in kind by the state to gas or electric utilities at a  
22 price that is below market value.

23 (c) The legislature finds that the proper exercise of the discretion  
24 conferred on the commissioner by this Act would support and complement the  
25 other programs that assist the citizens of the state with their long-term  
26 gas and electrical needs, including the power cost equalization program  
27 under AS 44.83.162 - 44.83.165 and hydroelectric and other programs for the  
28 generation of electricity.

29 (d) The legislature finds that the state should adopt a policy for  
S

Shortened

1 the sale of royalty gas to gas or electric utilities for in-state consumer  
2 use and in-state generation of electricity that is fundamentally different  
3 from the policies of the state for the sale of royalty oil and for the sale  
4 of royalty gas for export from the state or for uses other than in-state  
5 consumer use and in-state generation of electricity.

6 (e) The legislature finds it is in the state's best interest to  
7 facilitate the financing and construction of a pipeline and increased gas  
8 production from the Prudhoe Bay reservoir by establishing a procedure by  
9 which the state could commit itself to a royalty valuation methodology for  
10 as long as the state takes its royalty share of gas production in value.

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

12 (aa) Within 90 days after the written request of a lessee of a  
13 lease issued under this section, (unless the commissioner makes a  
14 written finding based on clear and convincing evidence that the con-  
15 tract price is unreasonably low and that a prospective reduction in  
16 royalty receipts would not be balanced by increased benefits to in-  
17 state gas and electric consumers,) the commissioner shall enter into an  
18 agreement with the lessee to use the price for the gas established in  
19 the contract between the lessee and a gas or electric utility, if the  
20 lessee and the utility are not related in management, ownership, or  
21 other aspect, as the value of the state's royalty share of gas produc-  
22 tion sold by the lessee under the contract to the utility. In this  
23 subsection

24 (1) "gas or electric utility" includes an electric coopera-  
25 tive organized under AS 10.25, a municipal utility, and a gas or  
26 electric utility regulated under AS 42.05; and

27 (2) "price for the gas established in the contract" in-  
28 cludes tax reimbursement amounts, deliverability and other charges,  
29 and other forms of consideration paid by the gas or electric utility

1 under the contract.

2 (bb) In the event of a contract between parties that are unrelat-  
3 ed in management, ownership, or other aspect for the sale of gas from  
4 Prudhoe Bay reservoir gas leases by means of delivery of the gas  
5 through a pipeline for export out of the state, and within 90 days  
6 after the written request of a lessee of a lease issued under this  
7 section, unless the commissioner makes a written finding that the  
8 contract price does not assure the maximum benefits to the people of  
9 the state in return for the state's gas resources, the commissioner  
10 shall enter into an agreement with the lessee to use the price for the  
11 gas established in the gas sales contract as the value of the state's  
12 royalty share of gas production sold by the lessee under the gas sales  
13 contract. The lessee shall have the burden of providing all informa-  
14 tion necessary for the commissioner to make an informed decision, and  
15 shall provide clear and convincing evidence that the value of the  
16 is reflected by the gas sales contract price rather than being attri-  
17 buted to transportation, marketing, or other profit or cost centers.  
18 In this subsection, "price for the gas established in the gas sales  
19 contract" includes tax reimbursement amounts, deliverability and other  
20 charges, and other forms of consideration received by the lessee under  
21 the gas sales contract.

22 \* Sec. 3. AS 38.05.183 is amended by adding a new subsection to read:

23 (h) The commissioner may enter into a contract to sell royalty  
24 gas taken in kind by the state to a gas or electric utility at less  
25 than the market value of the royalty gas if the commissioner, after  
26 considering the consumer benefits, other benefits, and detriments of  
27 the sale, makes a written finding that the sale is in the best inter-  
28 est of the state. In this subsection, "gas or electric utility"  
29 includes an electric cooperative organized under AS 10.25, a municipal

1 utility, and a gas or electric utility regulated under AS 42.05.

2 \* Sec. 4. AS 38.05.810(a) is amended to read:

3 (a) Except as otherwise provided in AS 38.05.183(h), the [THE]  
4 lease, sale, or other disposal of state land or resources may be made  
5 to a state or federal agency or political subdivision, or the lease,  
6 sale, or disposal of coal deposits suitable for mining may be made to  
7 a utility owned and operated by a government agency or nonprofit  
8 cooperative association organized to participate under the Federal  
9 Rural Electrification Act for the purpose of generating electric power  
10 and energy or the production of process steam, or both, for less than  
11 the appraised value as determined by the director and approved by the  
12 commissioner to be fair and proper and in the best interests of the  
13 public, with due consideration given to the nature of the public  
14 services or function rendered by the agency, subdivision, or utility  
15 making application, and of the terms of the grant under which the land  
16 was acquired by the state.

17 \* Sec. 5. AS 38.05.180(aa), enacted by sec. 2 of this Act, applies to  
18 agreements to establish for a lease issued under AS 38.05.180 the in-value  
19 royalties on gas production that is sold under a contract entered into on  
20 or after the effective date of this Act between the state's lessee and a  
21 gas or electric utility.

22 \* Sec. 6. This Act takes effect immediately in accordance with AS 01.-  
23 10.070(c).

# Alaska State Legislature

ARLISS STURGULEWSKI, Chairman  
BETTYE FAIK ENKAMP, Vice Chairman  
JACK C. HALL  
DICK JASON  
VIC FISCHER  
RICK HALFORD  
FRED ZHAROFF



POUCH V  
JUNEAU, ALASKA. 99811  
(907) 465-4807

## Senate Committee on Resources

TO: Senate Resource Committee Members February 10, 1986

FROM: Senate Resources Committee Staff *MJ*

RE: Senate Bill No. 309 "An Act relating to the royalty value of a natural gas lease on state land; and providing for an effective date."

SB 309 would provide by statute, that for purposes of determining the value of the state's royalty share of gas production, the value may not exceed the price received by the producer under a long term sales contract, unless it is shown by clear and convincing evidence that the long-term contract price was unreasonably low at the time of the contract.

In an attached memo, Senator Faiks, the bill's prime sponsor, suggests two clarifying amendments which would make certain that this provision would apply to all natural gas leases on state land.

The method of determining the fair value of the state's royalty share of natural gas has been hotly disputed during the past year. In the accompanying packet labeled "Background - Cook Inlet Royalty Gas Valuation" the issue is discussed in depth.

# Alaska State Legislature

ARLISS STURGULEWSKI, Chairman  
BETTYE FAHRENKAMP, Vice Chairman  
JACK COGHILL  
DICK ELIASON  
VIC FISCHER  
RICK HALFORD  
FRED ZHAROFF



POUCH V  
JUNEAU, ALASKA 99811  
(907) 465-4907

## Senate Committee on Resources

TO: Senate Resource Committee Members February 10, 1986

FROM: Senate Resources Committee Staff *MSU*

RE: Background - Cook Inlet Royalty Gas Valuation

The method of determining the fair value of the state's royalty share of natural gas has been hotly disputed during the past year. The issue is whether the state should accept long-term gas contract prices as determinative of royalty value, or value the royalty gas at current market value as determined by other, more recent gas contracts in Cook Inlet.

The relevant paragraphs in the lease form (form DL1, paragraphs 11, 14, 15, and 16) are interpreted differently by the attorneys for the various parties to this dispute and there are court cases that support each method of valuation. The issue is currently before the courts as the subject of a number of related law suits in which the state is involved.

Though it is the producers, Chevron, ARCO, and Shell, that the state bills for royalty value, the producers all have pass through clauses in their contracts with their customer, Chugach Electric. This results in Chugach, and ultimately its customers, paying the increased cost.

Chugach feels that the determination of royalty value should be based on long term contract price. A shift to prevailing market value will cause a rate increase for a very large number of consumers. Chugach also feels that the prevailing value method of determination injects uncertainty into power supply planning and and rate stabilization efforts. For these reasons, Chugach supports a change to state law to base royalty value on long term contract price. Proponents of the Alaska Natural Gas Pipeline also support changing the law because they feel the ability to secure financing for the pipeline would be impaired without the added price stability this change in statute would cause.

The Department of Natural Resources opposes any such change in the law. The Department feels that as land manager for the entire state, it is its responsibility to collect fair royalty value for all state leases and that failure to pursue collection of fair value on all leases would be selective enforcement. In addition to directly reducing state revenues, the Department of Law has advised that such actions could indirectly set precedents which would impair the state's ability to enforce the royalty provisions of North Slope leases. DNR feels that existing law provides a mechanism for long term royalty certainty.

In this packet are:

- 1 - the relevant paragraphs from lease form DL-1
- 2 - letters from the Resource Development Council and the Naknek Electric Association and a resolution by Alaska Rural Electric Cooperative Association in favor of valuation based on long term contract price.

3 - Department of Natural Resources Decision Memo No. 25, Royalty Gas Valuation -- Cook Inlet, November 6, 1984, (Note - Some of the issues mentioned in this memo have subsequently been decided by the courts. In addition, the figures mentioned in the memo have been revised. The memo remains, however, a valuable document in the understanding of this issue.)

4 - Cook Inlet Royalty Gas Valuation - An Overview by the Department of Natural Resources, February 6, 1986

5 - Impacts of State Royalty Gas Increase on Railbelt Consumers by Chugach Electric Asscciation

6 - Settlement offer letter by the Department of Law, January 6, 1986

7 - Chugach's response to the State of Alaska's January 6, 1986 settlement offer

Representatives of the Department of Natural Resources, Chugach Electric, and other interested parties will be present at the hearing to testify and answer questions.

STATE OF ALASKA  
DEPARTMENT OF NATURAL RESOURCES  
Division of Lands

LEASE NO. ADL \_\_\_\_\_

## Competitive Oil and Gas Lease

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.....per cent in amount or value of the oil produced and saved and removed or sold from said land.
- (b) On gas.....per cent in amount or value of the gas produced and saved and sold or used off said land or used for the extraction of natural gasline or other products therefrom.
- (c) On associated substances.....percent in amount or value of such substances produced and saved and

14. **ROYALTY IN KIND.** Whenever, at the option of Lessor, which may be exercised from time to time upon not less than six months notice to Lessee, Lessor elects to take its royalty in kind, Lessee shall deliver free of charge (on said land or at such place as Lessor and Lessee mutually agree upon) to Lessor or to such individual, firm, or corporation as Lessor may designate all royalty oil and/or gas produced and saved from said land. Such oil and/or gas shall be in good and merchantable condition. Lessee shall, if necessary, furnish storage for royalty oil free of charge for thirty days after the end of the calendar month in which the oil is produced from said land; provided, that Lessee shall not be held liable for loss or destruction of royalty oil and/or gas from causes beyond Lessee's reasonable control. Should Lessee dehydrate or clean the oil or gas produced from said land, Lessee shall be entitled to an allowance of the actual cost of dehydrating or cleaning said royalty oil or gas.

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 of 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.



# Resource Development Council

for Alaska, Inc.

SB 309  
Bill File

807 "G" Street, Suite 200, Anchorage, Alaska 99501-3440  
Box 108516, Anchorage, Alaska 99510-0516 - 907/276-0700

January 20, 1986

**EXECUTIVE DIRECTOR**  
Paula P. Easley

**EXECUTIVE COMMITTEE**  
Charles R. Webber, President  
John Forcaskie, Vice Pres.  
E. Thomas Fargeter, Vice Pres.  
Boyd J. Brownfield, Secretary  
J. Shelby Stastny, Treasurer  
Sharon E. Anderson  
Susy Collins  
Steve Ellis  
Don L. Finney  
O. K. "Easy" Gilbreth  
Robert Gilliland  
Dave Harbour  
Phil R. Holdsworth  
Jack Hull  
Charlie Johnson  
John T. Kelsey  
Larry Laughman  
Ethel H. "Pete" Nelson  
John Rense  
R. D. Stock  
Robert I. Swetnam  
Dale P. Tubbs

**DIRECTORS/FOUNDERS\***

Hameed Ahmad  
Lenny Arsenaault  
Earl H. Beistline  
Rex I. Bishopp  
Robert A. Breeze  
Kelly M. Campbell  
Alexander J. Capasso  
Sam Demientieff  
Larry Dinneen  
James V. Drew  
James G. "Bud" Dye  
Fred O. Eastaugh  
Lee E. Fisher  
Robert W. Fleming  
Dan R. Fondell  
Mano Frey  
Ray D. Gardner  
Paul Glavinovich  
Randy Goodrich  
Dick Griffin  
John L. Hall  
Jon Halliwill  
Donald L. Hansen  
Hazel Heath  
Dave Heatwole  
Joseph R. Henri  
M. A. Higgins  
David Hoffman  
William J. Hornung  
Joe E. Jackovich  
Dorothy A. Jones  
John Choon K. Kim  
Kay H. Lasley  
Phillip L. Locker  
Dennis W. Lohse  
Paul J. Martin  
Donald Marx  
Peter McDowell  
Len McLean  
William F. Meehan, Jr.  
Max D. Nalley  
Richard A. Peluso  
Erik V. Peterson  
William R. Purrington  
William E. Schneider  
Steve Seley  
Lin S. Sloane  
Dale Stotts  
Dale Teel  
Joe J. Thomas  
Richard W. Tindall  
Rudy J. Troclair  
Joseph E. Usibelli, Jr.  
Lyle Von Bargaen  
Beverly A. Ward  
Anita L. Williams  
Jed Holley, Staff Consultant

**EX-OFFICIO MEMBERS**  
Senator Ted Stevens  
Senator Frank Murkowski  
Congressman Don Young  
Governor Bill Sheffield

Senator Arliss Sturgulewski  
Alaska State Senate  
Pouch V  
Juneau, AK 99811

JAN 20 1986

re: SB 309, Royalty Gas Valuation legislation

Dear Arliss:

I want to take this opportunity to make you aware of our concerns regarding the merits of SB 309, the royalty gas valuation bill.

The Resource Development Council strongly supports SB 309. This bill will set forth a fair and stable royalty valuation policy for the state.

DNR recently changed its policy for valuing the royalty share of natural gas extracted from state leases in Cook Inlet. Previous to this change the state calculated its royalty at the price received by the producer. DNR's new position is to calculate its royalty share based on the current market value of the gas, not the price paid to the producer.

The old valuation policy, statutorily mandated by SB 309, is the better state position for the following reasons:

1) The first and most obvious is the fairness issue. Why should the state receive more value per unit than the producer? If the state is of the opinion that the producer is selling his product for an inappropriately low price, the state has the option to receive its royalty share in kind, as opposed to in value, and can sell it for whatever price it can obtain.

2) Another significant issue is stability. If DNR intends to change the value of its royalty share whenever the market price fluctuates, it will effectively doom a number of development projects with enormous potential for our state. The most obvious of these is the Trans-Alaska Gas Line.

The present state policy would make it almost impossible to finance the gas line because of the uncertain value of the state's royalty share. It is hard to imagine that a foreign buyer of North Slope gas will consider a purchase contract of sufficient length to gain adequate financing if the state can adjust the value of its royalty share at any given time. The gas line is essential to our future

Senator Arliss Sturgulewski  
January 20, 1986  
page 2

and we must not take any actions which would inhibit its development unnecessarily. Every other project in which the state holds a royalty interest could suffer the same fate.

3) The last significant concern is that the market price for natural gas could someday fall below the price set in a contract. In that case, using the rationale of the present administration, the state would make less money per unit than the producer. This scenario may seem unlikely now, but given the volatile nature of energy prices it is certainly not unforeseeable.

The old state policy, made law by SB 309, insures that the state receives one-eighth of the monetary value gained by the leaseholder from the resource.

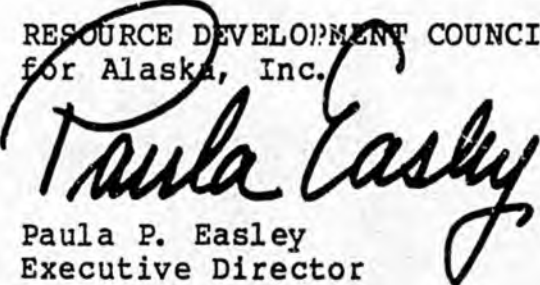
Despite the perception of some members of the administration that the issue is important only to the utilities or the leaseholders, it is in fact important to our entire economy which seems certain to rely on resource development on state lands for some time. As the owner of so much land and resources in Alaska, state government must behave in a manner which insures consistency and fairness as well as an equitable return on our resources.

We support your efforts to insure a timely review of this bill in the Senate Resources Committee. This is an issue which merits action by both the House and Senate in this session.

Please call on RDC if there is anything we can do to help you gain support for this legislation.

Sincerely,

RESOURCE DEVELOPMENT COUNCIL  
for Alaska, Inc.



Paula P. Easley  
Executive Director

cc: Members, Senate Resources Committee  
Senator Jan Faiks  
Phil Holdsworth



ALASKA RURAL ELECTRIC COOPERATIVE  
ASSOCIATION, INC.

237 E. FIREWEED LANE • SUITE 301  
ANCHORAGE, ALASKA 99503 • (907) 276-3235

ARECA

Resolution 85-19

Royalty Gas Revaluation

WHEREAS the Alaska Department of Natural Resource's recent decision to base the state's natural gas royalty on the highest value of gas rather than the contract price of gas; and

WHEREAS DNR's decision reversed a long-standing policy and was taken unilaterally without input from the public, the State Legislature, parties to existing gas contracts or other parties; and

WHEREAS DNR's royalty gas revaluation will cost consumers of Chugach Electric Association, Matanuska Electric Association and Homer Electric Association many millions of dollars; and

WHEREAS consumers of other cooperatives such as Golden Valley Electric Association and Copper Valley Electric Association would be adversely affected should those co-ops avail themselves of natural gas-fired generation,

BE IT THEREFORE RESOLVED that DNR reverse its royalty gas revaluation decision and any such future proposal be subject to timely, meaningful public and legislative input.

I hereby certify this to be a true and correct copy of Resolution 85-19 adopted at the Alaska Rural Electric Cooperative Association, Inc. Annual Meeting, August 10, 1985.

*David Hutcheon*

Executive Director

*November 5, 1985*

Date.



FEB 4 1986

# NAKNEK ELECTRIC ASSOCIATION, INC.

POST OFFICE BOX 118 • NAKNEK, ALASKA 99633 • PHONE (907) 246-4261

January 30, 1986


The Honorable Arliss Sturgulewski  
Senate Resource Standing Committee  
Alaska State Legislature  
Pouch V (MS 3100)  
Juneau, Alaska 99811

Dear Senator Sturgulewski:

We write with concern of S.B. 309 and the economic impact of rural consumers reduction of Power Cost Equalization (PCE), in the event of failure of S.B. 309.

As power costs of the "railbelt" elevate, PCE entitlement will decrease, consequently, we should like our concern made a part of the comment in the bill hearing. Thank you.

Sincerely,

  
Claude E. Franke  
General Manager

cc: Senator Fred Zharoff

MEMORANDUM  
DEPARTMENT OF NATURAL RESOURCES  
DIVISION OF OIL AND GAS

State of Alaska

TO: Esther C. Wunnicke  
Commissioner

DATE November 6, 1984

FILE NO:

TELEPHONE NO 265-4241

FROM: *duj*  
*for* Kay Brown, Director  
Division of Oil and Gas

SUBJECT Decision Memo No. 25  
Royalty Gas Valua-  
tion -- Cook Inlet

Statement of the issue: Should the state accept long-term gas contract prices as being determinative of royalty value where those prices have become significantly below current market prices because of escalating gas values?

Background: As a general matter, producers have calculated and paid their royalty as to each volume of gas based upon the contract price applicable to that volume of gas. As gas prices have escalated, the issue has arisen here, as it has in other jurisdictions, whether an older long-term contract price may control the royalty amount for gas produced and sold under that contract, even after the market value has escalated well above the contract price. Depending upon the particular jurisdiction and the governing language of particular leases, court cases have split on the issue. The issue has not been addressed by any court in the State of Alaska.

Considerations:

- o Legal analysis. Although court cases interpreting various other lease forms have gone each way in other jurisdictions, the Department of Law advises us that the proper construction of state oil and gas lease form DL-1 is that a long-term contract price should not control royalty valuation when current market price or value is higher.
- o Impact on oil and gas companies. Oil and gas companies have an obligation to diligently produce and market oil and gas. The companies believe it is unfair to have their royalty payments based upon high current market price values where (they argue) the only available means of marketing the gas in the past was by means of long-term contracts with either a fixed price or a defined escalation clause. Apparently in recognition of the possibility that the royalty value might be construed to be higher than the long-term contract price, however, the producers have mitigated, in large part, the impacts of escalating

RECEIVED

NOV 30 1984

DIVISION OF OIL & GAS  
ANCHORAGE, ALASKA

values by means of pass-through provisions in their sales contracts. These provisions make the gas purchaser liable for any additional royalty. Also, producers increasingly are insisting upon price re-openers for their long-term contracts. Such price re-openers allow the producers to benefit from escalating values on their share of the gas, while also protecting the producers against an increased royalty burden. Thus, as a general matter, the producers can protect themselves against the possibility of higher royalty obligations. However, there are possible exceptions. For instance, Union Oil Company has committed a large volume of gas for use in its own major urea processing plant. Union's royalty obligation will be higher on the gas committed to that plant if long-term contracts are considered inappropriate references in the computation of market price or value. Union may not be able to pass any increased cost through to its urea customers. However, if the application of the royalty term as written becomes too onerous, the lease provides a mechanism for seeking royalty reduction. See DL-1, ¶ 13. Thus, even those producers which cannot pass higher royalty obligations on to their customers have a limited remedy under the lease.

- o Impacts on gas purchasers. The principal long-term gas contracts in Cook Inlet which would be affected by this decision are between Chugach Electric and Chevron, ARCO and Shell (Beluga River Field), and between Enstar/Alaska Pipeline Company and Marathon and Union (Kenai Field). The long-term Chugach contract price is 21¢/Mcf, and the long-term Enstar/APC contract price is 61¢/Mcf. By contrast, prevailing current prices exceed \$2.00/Mcf. For instance, the recent long-term contracts for Cook Inlet gas have fluctuated between a high of \$2.32/Mcf and the present \$2.055/Mcf. Although seven-eighths of the gas sold under the 21¢/Mcf and 61¢/Mcf contracts would continue to be bound by those contract prices, the governing contracts permit the producers to pass on through to Enstar/APC and Chugach the burden of higher royalty rates on the one-eighth of the flow attributable to the state's royalty. It is uncertain whether Enstar and Chugach could, in turn, legally pass the charges through to their customers if the state collects additional royalties retroactively. Moreover, even if the

royalties were collected at the higher valuation rate only prospectively, the ability of the companies to pass the costs through to their consumers would be subject to Alaska Public Utilities Commission rate proceedings. Thus, the imposition of royalty valuation based upon current market prices or values could have adverse impacts upon Anchorage area utility companies.

- o Impacts on consumers of gas and gas-generated electricity. Ultimately, it is anticipated that the brunt of higher valuation on royalties attributable to long-term contract volumes will be borne by consumers of gas and electricity in the Anchorage area. It is estimated that this impact would probably be an increase over current rates of more than 10 percent, but less than 20 percent.
- o Impacts on state revenue. Obviously, the consequences of higher royalty valuation include increased royalty revenue to the state. It is estimated that eschewing long-term contract prices for current values would, under present conditions, result in additional royalty collections of approximately \$8.5 million per year from the state's Cook Inlet area leases. The impact upon North Slope gas royalty revenue is relatively insignificant at this time.
- o Uncertainty. The fluctuation of royalty value independently of the contract price under which gas is sold injects uncertainty into the long-term planning by oil companies and utilities. This uncertainty (and higher royalty rates) may reduce incentives to invest capital in oil and gas and utility enterprises, or affect the timing or structuring of such enterprises. For instance, the state's royalty treatment of long-term gas contracts might affect North Slope gas marketing.
- o Impacts on royalty collection by the United States and CIRC. The United States and CIRC are also lessors of oil and gas leases in the Cook Inlet area. The United States distributes 90 percent of the onshore royalties it collects to the state. CIRC shares its royalties with other ANCSA corporations under section 7(i) of ANCSA. Alaska has previously joined other states in encouraging the United States to ensure full royalty

collection through, among other things, using current prices or values in calculating the royalties due for gas sold under long-term sales contracts. By requiring royalty valuation according to current market values for state leases, the state would further its relations with the ANCSA corporations and other states, and would lend support to current federal royalty litigation, which, if successful, will result in greater distributions to the state under its 90 percent share.

Options:

(1) Accept long-term contract prices as determinative of market value for royalty purposes, even when those prices have been eclipsed by market transactions at higher values.

(2) Reject long-term contract prices as determinative of royalty valuation where they are below current market value. In implementing this option, the state could also:

(a) Give consideration to electing to take royalty gas attributable to long-term contracts in-kind, rather than in-value. A host of practical difficulties exist with this suboption. In particular, taking gas in-kind is difficult because of the limited and inflexible transportation and storage capacities for gas (the "deliverability" factor). Nonetheless, the state could explore the possibilities, including possible sales to Enstar, Chugach, and the proposed CIRI LNG plant; and

(b) Apply the decision only to prospective royalty valuations. This would ease a number of problems, including the difficulties attendant to retroactive pass-through charges to utility consumers.

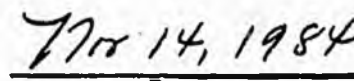
Recommendation:

Option 2, with suboptions 2(a) and 2(b).

Decision:

I concur with the recommendations:

  
\_\_\_\_\_  
Esther C. Wunnicke  
Commissioner

  
\_\_\_\_\_  
Date

Recommend Concurrence:

*William D. Arnold*  
\_\_\_\_\_  
Bob Arnold  
Deputy Commissioner

*11/15/84*  
\_\_\_\_\_  
Date

*James K. Barnett*  
\_\_\_\_\_  
James K. Barnett  
Deputy Commissioner

*11-19-84*  
\_\_\_\_\_  
Date

COOK INLET ROYALTY GAS VALUATION:  
An Overview

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

February 6, 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:

<u>Date of Contract</u>	<u>Purchaser</u>	<u>Field</u>	<u>Starting Base Price</u>
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 increase in 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).

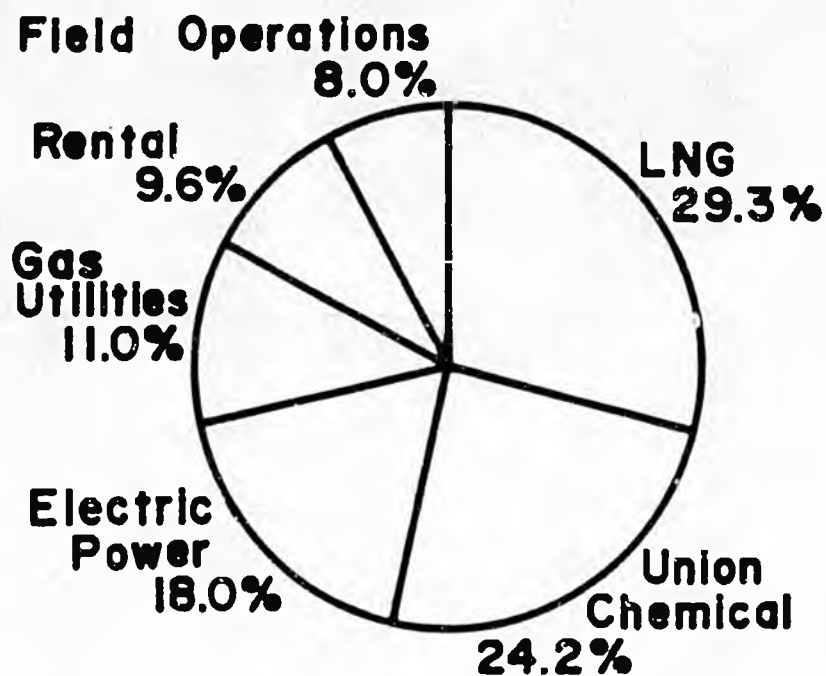
2/5/86

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

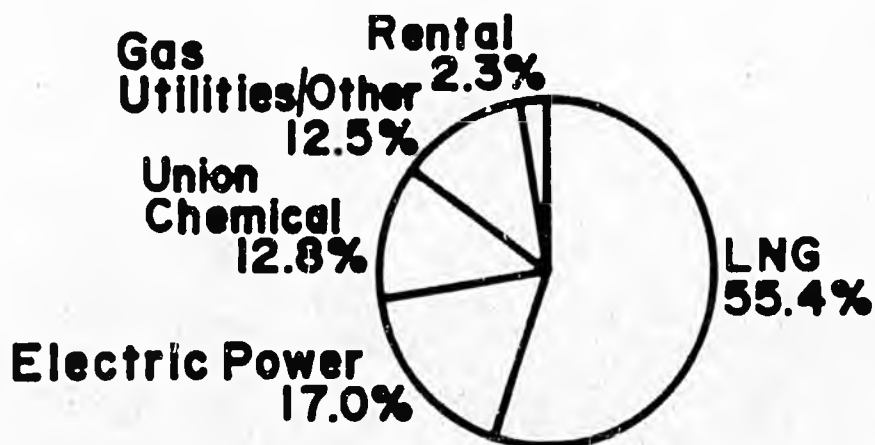
Lessee	Scope of Settlement	Retro- active Payment (millions)	Current Monthly Value Under Settlement (per Mcf)	Estimated Additional Royalties per year (millions)
Phillips	North Cook Inlet Field gas sold as LNG in Japan	\$36.3	\$2.32	\$12.00
Marathon	Kenai field gas sold as LNG in Japan	\$ 4.3	\$2.32	\$ 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 dispositions to Enstar under Enstar's 1975 contract	\$ 4.1	\$1.95	6.90
Total		<u>\$44.7</u>		<u>\$19.65</u>

# COOK INLET

## Total Sales

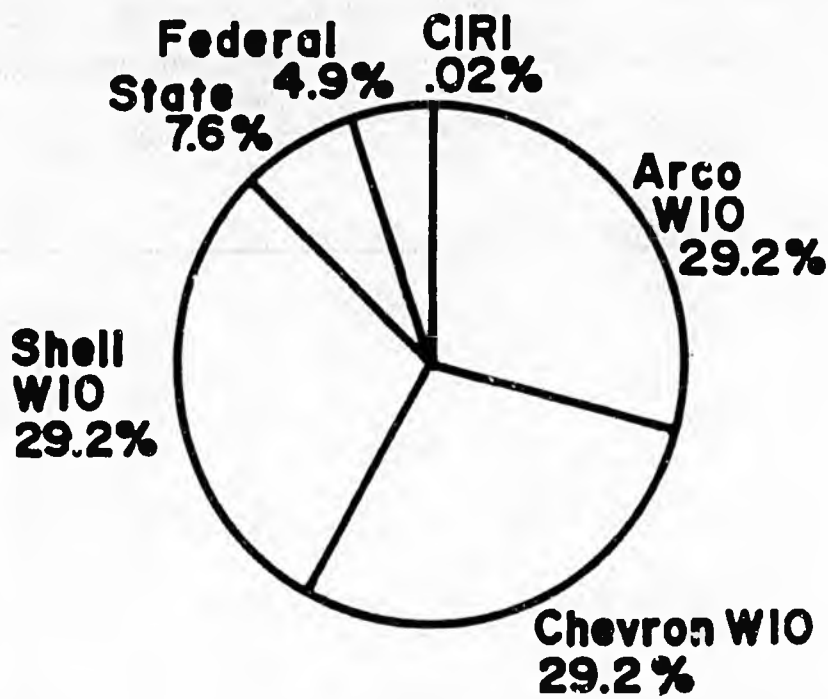


## State Royalty Disposition



# BELUGA FIELD

## Royalty And Working Interest Ownership

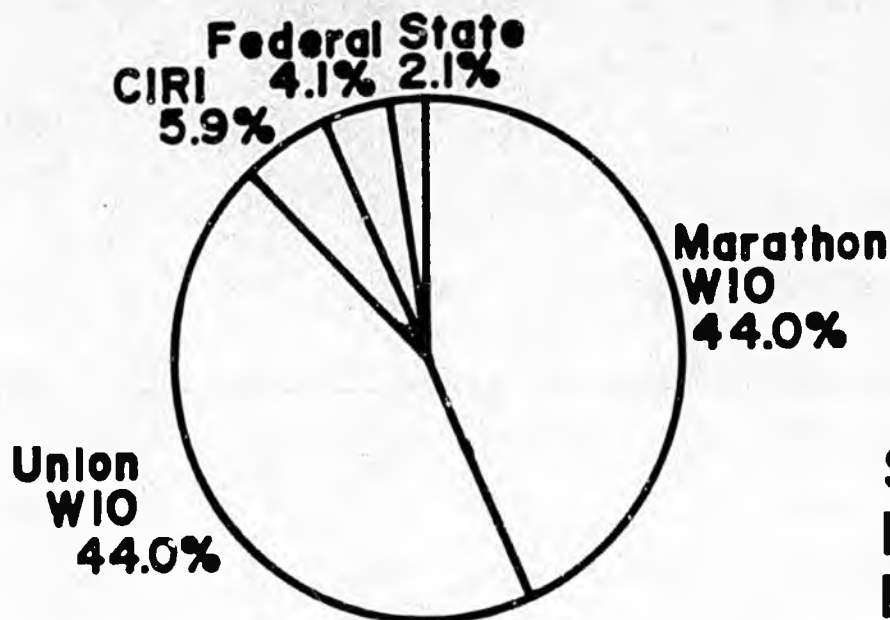


## State Royalty Disposition

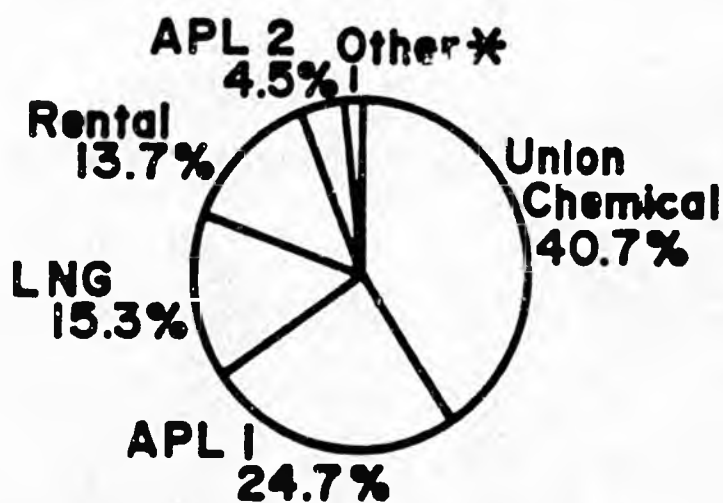


# KENAI FIELD

## Royalty And Working Interest Ownership



## State Royalty Disposition



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

COOK INLET GAS PRODUCTION  
(For 1984)

	Total MMCF/Month	State Royalty MMCF/Month
<b>Beluga River Field</b>		
For: Chugach	1673	125
Enstar	<u>121</u>	<u>9</u>
Total	1794	134
<b>Kenai Field</b>		
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	<u>1261</u>	<u>25</u>
Total	8229	168
<b>McArthur River Field</b>		
For: Rental gas and ammonia-urea	355	44
<b>Beaver Creek Field</b>		
For: APL 2	789	0
<b>Lewis River Field</b>		
For: APL 2	153	19
<b>North Cook Inlet Field</b>		
For: LNG	<u>3932</u>	<u>491</u>
<b>GRAND TOTAL</b>	<b>15,250</b>	<b>856</b>

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

	<u>Purchaser</u>	<u>Field or Seller</u>	<u>Starting Base Price</u>
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	HL&P (Anchorage)	Enstar	\$1.60

ALLOCATION OF GAS SOLD FOR CONSUMER USE  
(Assuming the State Prevails in the Pricing Dispute)

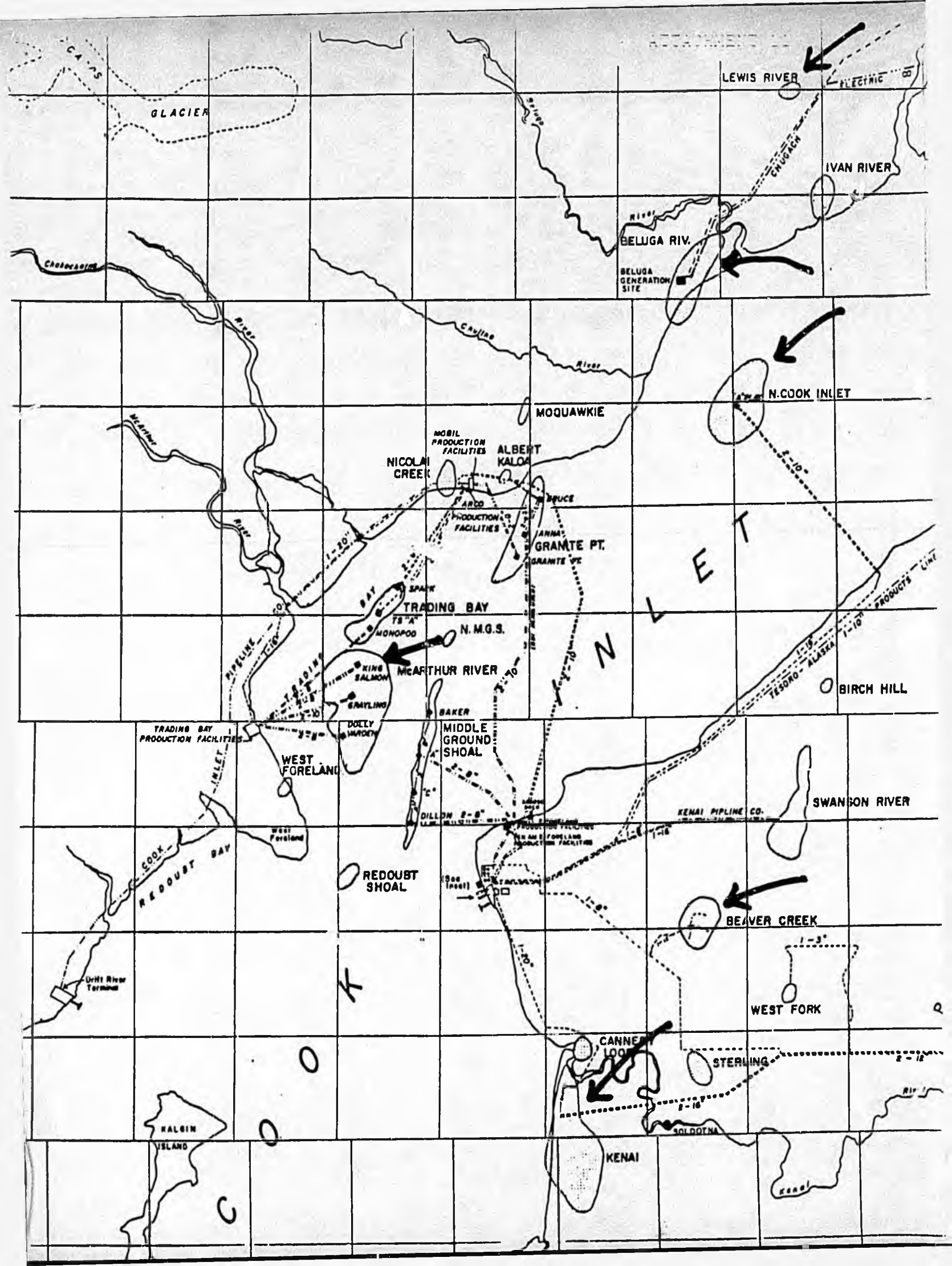
	<u>TOTAL MMCF/MONTH</u>	<u>STATE ROYALTY SHARE MMCF/MONTH</u>
<b>Beluga River Field</b>		
Chugach - low priced	1548	0
- high priced	125	125
Enstar - high priced	121	9
<b>Kenai Field</b>		
Enstar (APL 1) - low priced	1776	0
- high priced	254	42
Enstar (APL 2) - high priced	368	8
Enstar (Nikiski) - low priced	32	1
Enstar (City of Kenai) - low priced	41	1
<b>Beaver Creek Field</b>		
Enstar - high priced	789	0
<b>Lewis River Field</b>		
Enstar - high priced	153	19
Subtotal - low priced	3397	2
Subtotal - high priced	1810	203
GRAND TOTAL - all prices	5207	205

2/5/86

COOK INLET GAS ROYALTY CHRONOLOG

<u>Month</u>	<u>Year</u>	<u>Description of Event</u>
March	1964	<u>Foster v. Atlantic Refining Company</u> , 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	<u>Piney Woods County Life School v. Shell Oil Company</u> , 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 <u>Foster</u> , 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.



IMPACTS OF STATE ROYALTY GAS INCREASE ON RAILBELT CONSUMERS

Alaskans from Fairbanks to Homer face utility bill increases as a result of the Alaska Department of Natural Resources' decision to drastically raise the price of royalty gas in Cook Inlet. For Chugach Electric Association consumers in the Anchorage area, the impacts will be nearly \$3 million a year.

DNR's action was taken with virtually no advance notice to the parties involved, to the public or to the State Legislature. Litigation was initiated by the three producers against DNR on the revaluation in April 1985. Chugach is also involved in the litigation.

There are two major aspects of this issue: The additional costs to utility consumers of DNR's actions and, perhaps more important, the fundamental policy question of how royalty valuation is established.

On March 18, 1985, the Department of Natural Resources (DNR) issued a formal notice to the three Beluga River gas field producers -- ARCO, Shell and Chevron -- informing them that DNR would no longer accept royalty payments based on long-term contract price but would require payments based on the "prevailing market value."

This value was initially determined by DNR to be \$2.05 per thousand cubic feet (mcf), based on a Shell-ENSTAR (APL II) contract signed in December 1982. By contrast, Chugach currently pays \$.26/mcf for its Beluga gas, under long-term contracts on which the DNR had based its royalty price for the past 17 years.

Based on the \$2.05/mcf figure, the annual increase to Chugach retail and wholesale consumers would be approximately \$2.8 million. Even under a recent settlement offer by the state which would value the royalty gas at \$1.50/mcf, the impact would be approximately \$1.9 million annually.

Chugach negotiated its Beluga contracts in good faith and at arms length in 1965, and renegotiated with the producers in 1973. The contracts extend to 1998 or whenever 373 billion cubic feet (bcf) of gas is used, whichever comes first. That means the overall impact of the Beluga royalty revaluation alone could total more than \$30 million to consumers.

Additional financial impacts on Chugach consumers have resulted or could result from actions similar to or related to the Beluga royalty revaluation. Those actions are:

- a possible revaluation, identical to the state's, by the other Beluga royalty gas owners (the federal government and Cook Inlet Region, Inc.);
- the recent \$8.5 million settlement by ENSTAR relative to royalty gas from the Kenai field (raising ENSTAR's Kenai royalty price from \$.66 to \$1.95, and including retroactive payments);
- an increase in the cost of power purchased from Anchorage Municipal Light & Power, which was substantially impacted by the ENSTAR increase, and
- a possible increase in state gas severance taxes based on the Beluga royalty gas revaluation.

If all these actions occur, the impact on Chugach consumers would be approximately \$6 million annually -- the equivalent of about a 6 percent rate increase. Attachment A details the impacts.

Financial impacts also will be felt in the Fairbanks area, because Chugach has been selling wholesale power to Golden Valley Electric Association and Fairbanks Municipal Utility System over the Anchorage-Fairbanks intertie. ML&P also is selling power to Golden Valley. Golden Valley has estimated that its consumers will save more than \$600,000 this winter alone through purchases of power from Chugach and ML&P.

Copper Valley Electric Association also is concerned, because the Glennallen-based cooperative wants its consumers from Glennallen to Valdez to be intertied with the Railbelt utilities and reap the benefits of less expensive power.

Approximately three quarters of the state's estimated 560,000 residents live in the Railbelt between Fairbanks and Homer. Chugach serves nearly half the state's population through sales to its own retail consumers and those of Matanuska Electric Association, Homer Electric Association and the City of Seward. Thus, residents of the Matanuska and Susitna Valleys and on the Kenai Peninsula are directly affected.

In addition to the cost increases associated with the existing gas contracts, there is another major -- and perhaps even more important -- impact of DNR's royalty revaluation decision.

This is what could be called the uncertainty factor. If DNR is ultimately successful in setting royalty prices on what it determines to be the prevailing market value of a resource, utilities, producers and other purchasing parties will have no assurance of what future royalty gas components will be. This injects a real measure of insecurity into long-term gas contracts and, for Chugach at least, into power supply planning and ratemaking.

The uncertainty factor is an important public policy question for the state and is one that may well eclipse the cost-increase aspect of any given royalty lease revaluation. It could be argued that settling the price dispute over a specific revaluation without first resolving the underlying policy question is getting the horse before the cart.

It is important to note that although DNR's gas and oil lease form has given rise to dispute and litigation in many instances over the years, DNR has failed to propose regulations defining important lease terms. Proposed regulations would at least allow for a public discussion of the policy questions.

To resolve the problem raised by the state's royalty gas revaluation, Chugach is supporting passage of S.B. 309, or similar bills H.B. 403 and H.B. 425. Each of these bills would require DNR to tie royalty valuation to long-term contract price, thereby resolving the underlying policy question. A copy of each of the bills is attached.

Uncertainty in long-term price for royalty gas raises problems for Chugach and other utilities both in terms of long-term financing for generation projects and in efforts to ensure electric rate stability. Tying royalty price to long-term contract price allows DNR to continue to manage the state's resources for maximum value, while recognizing that these resources do not have a value independent of long-term contracts. DNR would still be permitted, on only six months' written notice, to take its royalty share in kind and sell it directly to a willing purchaser.

## ATTACHMENT A

CHUGACH ELECTRIC ASSOCIATION, INC.  
 Rate Impacts Due to Market Valuation of Royalty Gas

January 10, 1986

	<u>Retail:</u> <u>Dollars</u>	<u>Retail:</u> <u>Percent</u>	<u>Wholesale:</u> <u>Dollars</u>	<u>Wholesale:</u> <u>Percent</u>	<u>Total:</u> <u>Dollars</u>	<u>Total:</u> <u>Percent</u>
Current revenues	\$63,200,000		\$35,800,000		\$99,000,000	
Impacts:						
The state's Beluga royalty revaluation from \$.26/mcf to \$2.05/mcf	1,501,164	2.38	1,278,769	3.57	2,779,933	2.81
Possible federal/CIRI Beluga revaluation (based on state's \$2.05/mcf figure)	1,000,776	1.58	852,513	2.38	1,853,289	1.87
ENSTAR settlement	420,853	0.67	358,505	1.00	779,358	0.79
ML&P rate increase (resulting from ENSTAR settlement)	337,500	0.53	287,500	0.80	625,000	0.63
Possible state gas severance tax increase (based on state's Beluga royalty revaluation)	<u>87,100</u>	<u>0.14</u>	<u>74,196</u>	<u>0.21</u>	<u>161,296</u>	<u>0.16</u>
	\$3,347,393	5.30	\$2,851,483	7.97	\$6,198,876	6.26

## CASES ON ROYALTY VALUATION

(These cases are interpreting a variety of royalty valuation clauses. Both the actual lease terms and the facts of the particular case have an impact on the court's rulings.)

1. Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981)

The courts following Tara have reasoned that since the lessee has an obligation to develop the lease and market the gas, long-term contracts are essential to resource development. Establishing a royalty value higher than an arms-length contract price penalizes the parties to those contracts. States following Tara:

- a. Oklahoma: Tara (1981)
- b. Louisiana: Henry v. Ballard & Cordell Corp.  
418 So.2d 1334 (La. 1982)
- c. Arkansas: Hillard v. Stephens  
637 S.W.2d 581 (Ark. 1982)

2. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968)

In this line of cases, courts have held that the market value of royalty gas is to be established by reference to comparable sales of gas. States following Vela:

- a. Texas: Vela (1968)
- b. Montana: Montana Power Co. v. Kravik  
586 P.2d 298 (Mont. 1978)
- c. North Dakota: West v. Alpar Resources, Inc.  
298 N.W.2d 484 (N.D. 1980)
- d. Kansas: Lightcap v. Mobil Oil  
562 P.2d 1 (Kan. 1977)

3. Does an NGPA ceiling price establish "market value?"

The question addressed here is whether or not market value can exceed a price ceiling established by government regulation.

NGPA sets ceiling price: Texas: First National Bank v. Exxon Corp.  
622 S.W.2d 80 (Tex. 1981)  
Bowers v. Phillips Petroleum  
692 F.2d 1015 (5th Cir. 1982)

NGPA does not set ceiling price: Kansas: Lightcap v. Mobil Oil  
586 P.2d 1 (Kan. 1977)

BILL SHEFFIELD, GOVERNOR

REPLY TO:

1031 W 4th AVENUE  
SUITE 200  
ANCHORAGE, ALASKA 99501  
PHONE: (907) 276-3550

1st NATIONAL CENTER  
100 CUSHMAN ST.  
SUITE 400  
FAIRBANKS, ALASKA 99701  
PHONE: (907) 452-1568

POUCH K - STATE CAPITOL  
JUNEAU, ALASKA 99811  
PHONE: (907) 465-3600

**DEPARTMENT OF LAW**

OFFICE OF THE ATTORNEY GENERAL

January 14, 1986

Stephen M. Ellis, Esq.  
1007 West Third Avenue, Suite 400  
Anchorage, Alaska 99503

William B. Rozell, Esq.  
302 Gold Street  
Juneau, Alaska 99801-1150

James D. Linxwiler, Esq.  
510 L Street, Suite 700  
Anchorage, Alaska 99501

Beluga River gas royalty  
litigation: Chevron U.S.A., Inc.  
v. State, 3AN 85-7617 Civ.;  
ARCO Alaska Inc. v. State,  
3AN 85-6218 Civ.; and Shell  
Western E & P, Inc. v. State,  
3AN 85-7633 Civ.

Gentlemen:

This letter contains a settlement offer from the State of Alaska, Department of Natural Resources concerning the dispute regarding royalty production from state lessee in the Beluga River unit. As you know, the major portion of that dispute relates to the valuation for royalty purposes of gas sold under long-term contracts to Chugach Electric Association, Inc. ("Chugach"). The dispute for those royalties relates to the period commencing April 15, 1985 and into the future so long as gas is produced and disposed of under the long-term Chugach contracts. For the reasons stated below, the state is prepared to resolve this aspect of the dispute by valuing the royalty portion of the gas production attributed to the Chugach contracts at \$1.50 per mcf, to be adjusted annually in accordance with some objective measure of local energy values, such as the posted price for Tesoro Number 2 fuel oil. The balance of this letter will set forth the circumstances which have led us to conclude that this settlement would be fair to all parties to this dispute.

Stephen M. Ellis, Esq.  
William Rozell, Esq.  
James D. Linxwiler, Esq.

January 14, 1985  
Page 3

Later, starting November 1982, Chugach began entering into annual amendments to its 1973 contracts with Shell, ARCO and Chevron. These annual amendments allowed supplemental deliveries under the total volume commitment of the 1973 contract. The prices of gas under these supplemental agreements were, like the Pac LNG contracts, several times the price under the 1973 amendments to the 1985 Chugach contracts. Thus, the deliveries under the November 1982 and January 1983 contract supplements were at a base price of \$1.48 per million btu's (mmbtu) of heating value;  $\frac{1}{2}$  and the deliveries under the December 1983 supplements were at a base price of \$1.60 per mmbtu. Significantly, Chugach continued to reap the benefits of its bargain 20 cent per mcf gas on the large majority of the deliveries under the 1973 contract amendments, and only paid the 8-times higher price for the supplemental deliveries under the annual contract amendments.

With the exception of the Chugach contracts, the only gas sales contract for gas from the Beluga River unit which resulted in any delivery occurred on December 20, 1982. On that date Shell executed a contract with the Alaska Pipeline Company ("APL"), a wholly owned subsidiary of Enstar Natural Gas Company ("Enstar") for the sale of gas from the Beluga River field. (This contract will hereafter be referred to as the "APL II" contract). The APL II contract called for an initial base contract price of \$2.32 per mcf. Because the base price fluctuates with fuel oil prices, the 1986 base contract price under the APL II contract is \$2.03 per mcf, almost ten times the base price under the Chugach contract. Moreover, as you know, the base contract price does not reflect the entire amount of the consideration under the APL II contract. In particular, Shell is reimbursed for the oil and gas production taxes applicable to the gas sold under the contract. We estimate that the tax reimbursement feature of the contract is worth about 10 cents per mcf. This raises the total contract price under the APL II contract to about \$2.13 per mcf. Further, if certain conditions are met, a special deliverability fee of \$0.35 per mcf would also be received by Shell. This would raise the total consideration under APL II to approximately \$2.48 per mcf.

---

$\frac{1}{2}$  One mcf of Cook Inlet gas yields, as you know, approximately one mmbtu of heating value.

Stephen M. Ellis, Esq.  
William Rozell, Esq.  
James D. Linxwiler, Esq.

January 14, 1985  
Page 5

recovery from the Swanson River, and for gas it uses as feedstock for its urea and ammonia plant at Nikiski, Alaska. The reported royalties for this gas ranged between \$0.21 and \$0.62 prior to the settlement. Thus, recent gas sales contracts, Enstar's commercial service rates, and recent settlements all reflect a current gas value of between \$1.80 and \$2.32 per mcf.

#### Pertinent provisions of the lease

As you know, most of the state's royalty interest in Beluga River Unit production is under leases issued by the state under what is generally referred to as the state's competitive oil and gas lease form "DL-1." At the time the DL-1 leases were issued, the governing statute, AS 38.05.180(a), provided that the state's royalty share of gas production could "not be less than twelve and one-half percent in amount or value of the production removed or sold from the lease."

Several provisions of the lease form DL-1 give effect to the statutory provision calling for a minimum royalty of twelve and one-half percent of the value of the gas. Paragraph 11 provides for a royalty on gas production at the rate of twelve and one-half percent "in ... value of gas produced and saved and sold or used off said land...." Paragraph 15 of DL-1 expands upon that standard by specifying that the royalty value that lessee must pay is "field market price or value at the well." Paragraph 16 of DL-1 sets forth three nonexclusive valuation standards, and provides that the value of the gas for royalty purposes cannot be less (but could be higher) than the highest value obtained by applying the three alternative methodologies. The three paragraph 16 nonexclusive alternative minimum floor values are: (1) the price actually paid or agreed to be paid, if any; (2) the posted price in the field, if any; or (3) the prevailing price received by other producers in the field.

ARCO, Chevron, Shell and Chugach have contended that the royalty obligation under DL-1 for gas sold under long-term contracts with Chugach is properly calculated based solely upon the prices established in those contracts. This construction flies in the face of the unambiguous terms of the DL-1 lease form. The price actually received is but one of three, nonexclusive alternative floor value standards set forth in paragraph 16 of DL-1. When DL-1 was drafted, it was well-known and understood that one option was to create a "proceeds" lease form. As you know, a "proceeds" lease is one under which the royalty amount is determined solely on the basis of the amount received or realized by the lessee. Instead of a proceeds lease form, the state consciously chose a lease form which provided

Stephen M. Ellis, Esq.  
William Rozell, Esq.  
James D. Linxwiler, Esq.

January 14, 1985  
Page 7

prices being discussed may be somewhat lower than most of the recent contracts which have been negotiated in the Cook Inlet area. We are also aware that there is limited additional demand for gas in the Cook Inlet area, and that energy prices, and particularly gas prices, have fallen internationally within the last two years. These factors would indicate that the current market value of the gas may be lower than the recent contracts. We believe these factors support this settlement offer.

Third, the settlement figure proposed by the state includes some recognition of litigation risk. Although we are confident of the strength of our legal position, we understand the need to compromise from the higher value we might achieve in litigation in order to avoid the risks, costs and delays of litigation.

The settlement offer contained in this letter will remain open for a period of two weeks. Obviously, this letter does not comprehensively deal with all issues which must be dealt with in order to effect a comprehensive settlement. However, we believe it is most fruitful to agree first on the major issue, and then to work out the other details.

Thank you for your consideration of this offer.

Sincerely,

HAROLD M. BROWN  
ATTORNEY GENERAL

By: 

Mark P. Worcester  
Assistant Attorney General

MPW/ma

cc: Esther C. Wunnicke, Commissioner  
Department of Natural Resources

Lee G. Post  
Chevron, U.S.A., Inc.

Julie Simon, General Counsel  
Chugach Electric Association, Inc.

Daniel Rodgers  
ARCO Alaska, Inc.

D. Warren Hoff  
Legal Department  
Shell Oil Company



*Chugach* ELECTRIC ASSOCIATION, INC.

5601 MINNESOTA DRIVE • POUCH 6300 • ANCHORAGE, ALASKA 99502-0300 • PHONE 907-563-7494

TELEX: CHUGACH AHG  
(090) 25 265

FEB 4  
1986

January 28, 1986

Stephen M. Ellis, Esq.  
1007 West Third Avenue, Suite 400  
Anchorage, Alaska 99503

William B. Rozell, Esq.  
302 Gold Street  
Juneau, Alaska 99801-1150

James D. Linxwiler, Esq.  
510 "L" Street, Suite 700  
Anchorage, Alaska 99501

Re: Beluga River Gas Royalty Litigation  
Chevron U.S.A., Inc. v. State, 3AN-85-7617 Civil  
ARCO Alaska, Inc. v. State, 3AN-85-6218 Civil  
Shell Western E&P, Inc. v. State, 3AN-85-7633 Civil

Gentlemen:

In his letter of January 14, 1986, Assistant Attorney General Mark Worcester asserts that the State is entitled, by application of the "unambiguous" terms of the DL-1 lease form, to collect royalties on Beluga River gas at a "prevailing" price received by other producers, if this price is higher than actual contract or posted price. As explained below, this assertion is legally and factually inaccurate. Additionally, it raises serious policy concerns based on the State's recent actions.

For the reasons stated more specifically below, the settlement proposed by the State is not an acceptable resolution of the current litigation. First, while the settlement offer would lead one to believe that the State's legal position is firmly grounded, this is anything but the case. Second, even if it would be advantageous to settle the matter, the State's offer is far from being a suitable resolution of the matter. Therefore, Chugach would reject the offer and strongly encourage you to do the same. In any event, a settlement should not be concluded without Chugach's involvement.

Specifically, as you know, the DL-1 lease form contains several sections concerning royalty valuations. Contrary to Mr. Worcester's assertion that these provisions are unambiguous, virtually identical provisions have already given rise to dispute and litigation in other oil and gas fields. As evidence of this,

Stephen M. Ellis  
William Rozell  
James D. Linxwiler

-2-

January 28, 1986

it should be noted that Chugach views the terms of the lease as equally unambiguous in our favor.

Looking to the narrower language first, in contrast to the State's position that the three standards in Paragraph 16 of the leases are not exclusive in their applicability, both case law and existing industry practices at the time DL-1 lease form was drafted mandate that the three alternative price standards contained in Paragraph 16 of DL-1 were intended to cover different factual circumstances. The first standard, based on proceeds, would apply when there is, as in Chugach's case, an arm's-length sale "at the well." The second and third standards are keyed to indicia of value separate and apart from contract proceeds. These would be applicable only when there is no sale at the well by the lessee, or when that sale is a non-arm's-length transaction.

For instance, the second standard clearly is not applicable on its face; it looks to posted prices in the field, of which there are none. The third price standard, which the State is seeking to apply here, requires sales by "other producers." In its argument, the State is transposing "other sales" for "other producers," as there are no producers making sales from the Beluga field other than those selling to Chugach. Even if there were "other producers," the third standard still would not apply; it is designed to protect the State's interest when non-arm's-length sales are made. Such protection would be afforded by looking to sales by unaffiliated producers in order to determine royalty values. Here, Chugach and the producers entered into an arm's-length contract; there is no issue of affiliation.

In the more general royalty valuation clause (Paragraph 15) applicable, as here, when the State takes its royalty in value, the lessee is obligated to pay "the field market price or value." Although the line of cases following Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968), holds that market value should be determined based on sales contemporaneous with production, that line of cases is inapplicable here. In Vela, the lessee drafted the lease, providing adequate opportunity to protect himself. The DL-1 lease was drafted by the State, the lessor.

Additionally, the Vela case was decided subsequent to the creation of the DL-1 lease, which included the then-standard royalty valuation method: that proceeds would determine value unless the contracts were unreasonable when they were entered into or entered into at less than arm's-length, as is not the case here. When both the original and the 1973 Beluga gas contracts were entered into, they included escalator clauses that were comparable to the

Stephen M. Ellis  
William Rozell  
James D. Linxwiler

-3-

January 28, 1986

industry standard at the time; hence, the contracts were not unreasonable. Finally, a majority of the Vela jurisdictions limit the royalty value to proceeds when there is a Natural Gas Policy Act ceiling on the price the producers may collect, as there is here.

A more recent and better reasoned line of cases is set forth in Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981). This line of cases adopts arm's-length contracts as determinative of value for royalty purposes. Tara, and the cases which follow, are based on the proposition that the lessee is obligated to develop the lease, and thus, must market the gas. Because large quantities of gas cannot be marketed absent long-term commitment of supply, proceeds from an arm's-length contract should be respected as determinative of value. The Tara line of cases is better law and is also the line of cases most often followed by courts deciding the issue in the recent past.

It is also important to note here that, should the State at any time believe its gas to have a higher value than current contract price, it may, on only six months' notice, elect to take its royalty share in-kind and sell it directly to a willing purchaser.

Additionally, as a matter of long-term policy, the State's injection of a measure of uncertainty into long-term contracts raises serious concerns. The State's action here opens the door for revaluations in the future. This uncertainty factor is unacceptable to Chugach, both in terms of access to long-term financing for generation projects and for our ability to ensure rate stability for our members.

Ironically, the desirability of long-term stability to ensure resource development was a recognized priority of the State when the DL-1 leases were developed. Additionally, Chugach's need for stable royalty prices was addressed by the State, Chugach and the Producers prior to making the commitment to construct the Beluga power facilities, without which the Beluga gas field might still lie undeveloped. At that time, you made a firm commitment to resist efforts to increase royalty prices above contract price.

Disregarding for the moment the legal reasons that the State's settlement position is unacceptable, the terms of the settlement themselves raise grave concerns. First, the price is out of line with market realities. A \$1.50/Mcf price for Beluga gas is a multiple of the price that consultants engaged by Chugach have placed on the value of the remaining reserves in the field. It is also just marginally below the price presently being offered

Stephen M. Ellis  
William Rozell  
James D. Linxwiler

-4-

January 28, 1986

in areas of the lower 48 where there is access to existing integrated pipeline transmission systems. ENSTAR's willingness to pay a higher price for Beluga gas does not establish a market price.

Second, resolution of the price question still leaves open the uncertainty of future royalty revaluations. At this time, the State is unwilling to commit to negotiate a contract with substantially similar terms and conditions to one which Chugach may negotiate with the producers for additional gas. This again leaves the future price of royalty gas to Chugach in doubt, something that is as unacceptable now as it was when the Beluga contracts were initially executed.

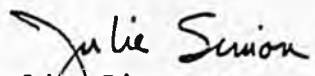
Moreover, the offer to peg future gas prices to No. 2 oil prices cannot be accepted. Unlike oil, which can be shipped to many markets in existing tankers for which there is presently a great oversupply, Beluga gas cannot presently be marketed in world markets without the construction of costly new LNG facilities. The failure of a prior attempt to market Beluga gas in such a manner attests to the problems inherent in that proposition. Additionally, Chugach is committed to rate stability, and oil, with its potential price fluctuations, is an inadequate measure for our gas prices. Chugach would insist on an index not directly tied to oil prices, such as the GNP price deflator, with a cap on annual escalation.

Although Chugach stands willing to negotiate a satisfactory resolution of pending litigation to avoid the costs, delays and risks of litigation, we do not believe, for the reasons discussed above, that the present settlement offer is acceptable.

Should you have further questions, please feel free to call to discuss this further.

Sincerely,

CHUGACH ELECTRIC ASSOCIATION, INC.

  
Julie Simon  
General Counsel

cc: D. Warren Hoff  
Lee Post  
Daniel Rodgers

012186/445-LTRS/jag



Official Business

# Alaska State Legislature

## Senate

Pouch V  
State Capitol  
Juneau, Alaska 99811

TO: ALL MEMBERS OF THE SENATE

FROM: SENATOR TIM KELLY  
CHAIRMAN  
RULES COMMITTEE

THE SENATE RULES COMMITTEE WILL MEET AT 10:30 A.M.,  
FRIDAY, FEBRUARY 28, 1986.

SB 309, "An Act relating to royalty gas contracts;  
and providing for an effective date", will be on  
the Committee Agenda.

No. Scope Gas v Pipelines. =  
Doesn't get into union/etc contracts - }

In November of 1984, the administration reevaluated the method which they used to value Cook Inlet Royalty gas. At that time they said this was the only fair and legally proper method of valuing the gas and that use of any other method would set dangerous legal precedents. At the end of last session, when the impact of this decision had become obvious to the public, a number of bills were introduced on the subject.

When SB 309 came before the Senate Resources Committee, we worked very hard in the limited amount of time available. We dealt with the issues before us in a responsible manner. With the active cooperation of all the involved parties, the committee achieved a compromise that protected the state's interests while providing long-term price stability for southcentral and railbelt electric consumers.

Based on the Senate Resource Committee Substitute, Chugach Electric and the State signed a settlement based on the passage of this bill. At the time, the committee was advised by the administration that any widening of the language would establish dangerous legal precedents, be bad public policy, and would be adamantly opposed.

After this bill passed out of Resources, I continued my involvement at the request of the interested parties and the administration. A new draft, which included state regulated private utilities and extended the bill's benefits to gas consumers, was worked out and the administration found that this draft was good public policy and did not set any dangerous legal precedents.

The administration again gave dire warnings that further widening of the language would be bad public policy and endanger other oil and gas litigation in which the state is involved. This morning the administration was still strongly opposing any widening of the language on grounds of public policy and legal precedent. However, once again at the last minute, new compromise language has emerged which the administration suddenly supports.

I am strongly in support of a gas pipeline. I am very glad we have been able to achieve solutions in this bill that will benefit utility consumers. I am deeply disturbed, however, by the shifting sands of the administration's position on this issue and more importantly by the shifting legal advice on how our actions may be affecting other important oil and gas litigation.

Page 3

If the proposed amendments can help a pipeline become a reality, without endangering existing oil and gas litigation, I want to help make that come true. I am disturbed, however, that we are considering voting on a major and complex piece of legislation and major amendments are surfacing just hours before the vote. I would strongly urge that we delay this item until Monday, so we may have time to analyze the effects of the offered language.

# STATE OF ALASKA

## DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

BILL SHEFFIELD, GOVERNOR

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

February 28, 1986

The Honorable Tim Kelly  
Chair, Rules Committee  
Alaska State Senate  
P.O. Box V  
Juneau, AK 99811

Dear Senator Kelly:

I am writing with regard to an amendment to CSSB 309 (Res) proposed in the Rules Committee yesterday by Senator Coghill.

The Sheffield Administration is strongly committed to the development of our North Slope gas resources. We are willing to work with the Legislature and all interested groups in enhancing the development of our North Slope gas resources. The most recent estimates indicate that there are about 36 trillion cubic feet of gas known to exist under state lands on the North Slope. The state's royalty share of this gas is estimated to be about 4.5 trillion cubic feet.

It would be an enormous achievement to bring this gas to markets somewhere in the world, and the state has worked closely with lessees and transportation entities to see this accomplished.

The amendment before you, however, would not accomplish this purpose only. It has several major problems:

- the amendment is not limited to arms'-length contracts;
- only the language regarding findings restricts the amendment to North Slope gas, and, therefore, the amendment might affect other state gas royalties;
- the amendment does not allow the state to assess the adequacy of the royalty value of a tremendously valuable public resource;

February 28, 1986

- there is no assurance in the amendment that a contract would be structured to reflect the true value of the gas and of the royalty share; and
- the amendment does not assure that the citizens of the state will receive maximum benefits from the agreement to use the contract value.

With these questions and issues remaining, it is my recommendation to the Rules Committee and to other members of the Senate that such an amendment not be included in this bill, which has been crafted painstakingly to address the concerns of railbelt energy consumers.

While I would prefer to see the issues raised by Senator Coghill addressed in a separate bill, I believe that the attached language drafted by our attorneys would be in the best interests of the state and could be added to SB 309.

Please contact me if you have questions or comments. I urge the Committee to pass out the draft Rules Committee Substitute for SB 309 including amendments relating to gas utility contracts, and to consider the language that I have attached to address the North Slope gas transportation issue.

Sincerely,



Esther C. Wunnicke  
Commissioner

cc: Senator Faiks  
Senator Coghill

Attachment

POSSIBLE AMENDMENT TO CS FOR SB 309

Add to section (1)(b) the following language at the end of the paragraph:

The legislature finds it is in the state's best interest to facilitate the financing and construction of a pipeline and increased gas production from the Alaska North Slope gas fields by establishing a procedure by which the state could commit itself to a royalty valuation methodology for so long as the state took its royalty share of gas production in value.

Add to section 2 a new subsection (bb):

In the event of a contract between parties which are unrelated in management, ownership, or other aspect for the sale of gas from Alaska's North Slope gas leases by means of delivery through a pipeline for export out of Alaska, within ninety days after the written request of a lessee of a lease issued under this section, unless the Commissioner makes a written finding that the contract price does not assure the maximum benefits to the people of Alaska in return for the state's gas resources, the Commissioner shall 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 contract. The lessee shall have the burden of providing all information necessary for the Commissioner to make an informed finding, and must

provide clear and convincing evidence that the value of the gas is reflected in the contract price rather than being attributed to transportation, marketing, or other profit or cost centers. For the purpose of this subsection, the term "price for 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 contract.

PRELIMINARY SETTLEMENT AGREEMENT

The State of Alaska, Department of Natural Resources (DNR) and Chugach Electric Association, Inc. (Chugach) enter into the following conditional agreement concerning pending disputes and litigation concerning the valuation of the State's royalty share of gas:

(1) DNR and Chugach will vigorously support passage of the CS for SB 309 Resources (a copy of which is attached) (the Legislation), subject to mutually agreed-to amendments;

(2) DNR and Chugach agree to resolve the disputes at issue in ARCO Alaska, Inc. v. State of Alaska, Department of Natural Resources, and Chugach Electric Association, Inc., Case No. 3AN-85-6218 Civil, Chevron U.S.A. Inc. v. State of Alaska, Department of Natural Resources, and Chugach Electric Association, Inc., Case No. 3AN-85-7617 Civil, and Shell Western E&P, Inc. v. State of Alaska, Department of Natural Resources, Case No. 3AN-85-7633 Civil (collectively, the "Beluga River gas royalty litigation") concerning the royalty valuation of gas sold under Chugach's 1973 contracts with ARCO Alaska, Inc. (ARCO). Chevron U.S.A. Inc. (Chevron) and Shell Western E&P, Inc. (SWEPI) in accordance with the following terms:

(a) Supplemental gas for peak supply periods: the contract price, including all forms of consideration;

(b) Non-supplemental gas volumes for gas produced on or after April 15, 1985: 75 cents per mcf during 1985 and 1986, subject to annual adjustment on the first day of each January in

proportion to the amount of increase or decrease in the United States of America GNP price deflator over the previous year. Payments for royalties from April 15, 1985 until the date of final settlement will be paid over three years plus interest subject to APUC approval;

(c) The dispute concerning royalty liability on tax reimbursement amounts on gas for the period prior to April 15, 1985: will be resolved in good faith negotiations between the DNR, Chugach and the Beluga River lessees (ARCO, Chevron and SWEPI);

(3) These agreements concerning settlement of the Beluga River gas royalty litigation are conditioned upon the following events:

- (a) Approval by the Chugach Board of Directors;
- (b) Passage of the Legislation;
- (c) Agreement with the Beluga River lessees (with regard to the post-April 15, 1985 royalty issues);
- (d) Court approval of the settlement; and

(4) Any remaining issues or disputes not specifically identified will be resolved by good faith negotiations.

CHUGACH ELECTRIC ASSOCIATION, INC.

Dated: 2/19/86

Joyce Murphy  
By: Joyce Murphy

President of the Board

ALASKA DEPARTMENT OF NATURAL RESOURCES

Dated: Feb 19, 1986

Esther C Wunnicke

By: Esther C. Wunnicke

Commissioner

2-24-86 2:00pm

IN THE LEGISLATURE OF THE STATE OF ALASKA  
FOURTEENTH LEGISLATURE - SECOND SESSION  
A BILL

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

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

\* Section 1. FINDINGS. (a) The legislature finds that the best interest of the state will be served if the commissioner of natural resources is authorized to establish the in value [FOR] royalty for gas [TAKEN IN VALUE BY THE STATE AND] sold to a [NONPROFIT] gas or electric utility by using the contract price between the lessee of the state and the [NONPROFIT] gas or electric utility, whether or not the [ROYALTY] gas lease [WITH THE STATE] establishes a different standard for the valuation and if the lessee and the [NONPROFIT] gas or electric utility are not related to each other. The legislature finds that this authorization should apply prospectively and does not intend the authorization to apply to the valuation for [OF] royalty purposes of gas [THAT IS] sold by a lessee [OF THE STATE] under a gas sales contract entered into

Ferry ?

[ before the effective date of this Act [WITH A NONPROFIT ELECTRIC UTILITY] ].

(b) The legislature finds that it is also in the best interest of the state to give the commissioner explicit discretionary authority to sell royalty gas received in kind by the state to [NONPROFIT] gas or electric utilities at a price that is below market value.

(c) The legislature finds that the proper exercise of the discretion conferred [BY THIS ACT] on the commissioner by this Act would support and complement the other programs that assist the citizens of the state with their long-term gas and electrical needs, including the power cost equalization program under AS 44.83.162 - 44.83.165 and hydroelectric and other programs for the generation of electricity.

(d) The legislature finds that the state should adopt a policy for the sale of royalty gas to [NONPROFIT] 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.

\* Sec. 2. AS 38.05.180 is amended by adding a new subsection to read:

(aa) Within 90 days after the written request of a lessee of a lease issued under this section, 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 for the gas established in the contract between the lessee and a gas or [NONPROFIT] electric utility, if the lessee and the utility are not related in management, ownership, or other aspect, as the value of the state's royalty share of gas production sold by the [A] lessee [OF THE STATE TO A NONPROFIT ELECTRIC UTILITY] under the contract. In this subsection

(1) "[NONPROFIT] gas or electric utility" includes an electric cooperative organized under AS 10.25 [AND] a municipal utility, and any gas or electric utility regulated under AS 42.05; and

(2) "price for the gas established in the contract" includes tax reimbursement amounts, deliverability and other charges, and other forms of

consideration paid by the [NONPROFIT] gas or electric utility under the contract.

\* Sec. 3. AS 38.05.183(h) is amended by adding a new subsection to read:

(h) The commissioner may enter into a contract to sell royalty gas taken in kind by the state to a [NONPROFIT] gas or electric utility at less than the market value of the royalty gas if the commissioner, after considering the ~~[residential]~~ consumer benefits, other benefits, and detriments of the sale, makes a written finding that the sale is in the best interest of the state. In this subsection, "[NONPROFIT] gas or electric utility" includes an electric cooperative organized under AS 10.25 [AND], a municipal utility, and any gas or electric utility regulated under AS 42.05.

[\* SEC. 4. AS 38.05.810(A) IS AMENDED TO READ:

(A) EXCEPT AS OTHERWISE PROVIDED IN AS 38.05.183(H), THE LEASE, SALE OR OTHER DISPOSAL OF STATE LAND OR RESOURCES MAY BE MADE TO A STATE OR FEDERAL AGENCY OR POLITICAL SUBDIVISION, OR THE LEASE, SALE, OR DISPOSAL OF COAL DEPOSITS SUITABLE FOR MINING MAY BE MADE TO A UTILITY OWNED AND OPERATED BY A GOVERNMENT AGENCY OR NONPROFIT COOPERATIVE ASSOCIATION ORGANIZED TO PARTICIPATE UNDER THE FEDERAL RURAL ELECTRIFICATION ACT FOR THE PURPOSE OF GENERATING

ELECTRIC POWER AND ENERGY OR THE PRODUCTION OF PROCESS STEAM, OR BOTH, FOR LESS THAN THE APPRAISED VALUE AS DETERMINED BY THE DIRECTOR AND APPROVED BY THE COMMISSIONER TO BE FAIR AND PROPER AND IN THE BEST INTERESTS OF THE PUBLIC, WITH DUE CONSIDERATION GIVEN TO THE NATURE OF THE PUBLIC SERVICES OR FUNCTION RENDERED BY THE AGENCY, SUBDIVISION, OR UTILITY MAKING APPLICATION, AND OF THE TERMS OF THE GRANT UNDER WHICH THE LAND WAS ACQUIRED BY THE STATE.]

\* Sec. [5]4. Section 2 of this Act applies to agreements to establish the in value royalties on gas production under a lease issued under AS 38.05.180 which is sold under a contract<sup>(s)</sup> entered into on or after the effective date of this Act between the state's lessee and [WITH] a gas or electric utility. [TO SELL TO NONPROFIT ELECTRIC UTILITIES GAS PRODUCED UNDER A LEASE ISSUED UNDER AS 38.05.180.

\* SEC. 6. SECTION 3 OF THIS ACT APPLIES TO CONTRACTS ENTERED INTO BY THE STATE ON OR AFTER THE EFFECTIVE DATE OF THIS ACT TO SELL NEW QUANTITIES OF ROYALTY GAS TO NONPROFIT ELECTRIC UTILITIES.]

\* Sec. [7]5. This Act takes effect immediately in accordance with AS 01.10.070(c).

The legislature further finds that proper exercise of the discretion conferred by this bill would support and complement other programs providing for the long-term electricity needs of the citizens of the state, including the power cost equalization program and hydro-electric and other electricity generation programs.

The legislature further finds that it should adopt a royalty policy for natural gas sold to electric utilities or cooperatives for instate electricity generation which is fundamentally different from the royalty policies for oil and for gas sold for export or for other instate uses.

Section 1. AS 38.05.180 is amended by adding a new subsection to read:

(aa) For the purpose of establishing the value of the state's royalty share of gas production sold by a state oil and gas lessee to an instate nonprofit electric utilities or cooperative, the commissioner may [enter into an agreement with the lessee to] use the arm's-length contract price, inclusive of tax reimbursement, deliverability and other charges, reimbursements or forms of consideration. This subsection applies only to the establishment of in value royalties for gas sold under contracts which are executed after ~~February 15, 1986~~. (for totally new quantities of gas).  
*effective date of this bill*

Section 3. AS 38.05.183 is amended by adding a new subsection to read:

Ned <sup>from</sup> -ECW

2/18/86

→ Kie Campbell  
Sen Storgi's ofc.  
5<sup>th</sup> Floor

CS for Senate Bill 309 (Resources)

For an Act entitled: "An act relating to the royalty value of natural gas under a state oil and gas lease, and royalty gas sales at less than market value; and providing for an effective date."

Section 1. Findings.

The legislature finds that the state's interest will be served if the commissioner is authorized to agree to value the state's royalty share of natural gas sold by the state's oil and gas lessees to instate nonprofit electric utilities or cooperatives based upon the arm's-length gas sales contract price, regardless of whether the pertinent lease terms set forth a different valuation standard. The legislature adopts this policy prospectively, and does not intend in any way to establish or affect the gas royalty value for gas sold by the state's oil and gas lessees under contracts entered into before February 15, 1986. [or for gas sold under existing contracts renegotiated after February 15, 1986.]

The legislature further finds that it is in the state's interest to give explicitly the commissioner the discretionary authority to sell in kind royalty gas to instate nonprofit electric utilities or cooperatives at a price which is below market value.

(g) The commissioner may enter into a contract for the sale of in kind royalty gas to an instate nonprofit electric utilities or cooperative at less than market value if the commissioner makes written finding that the sale is in the best interest of the state, with due consideration to the consumer benefits and other benefits and detriments of the sale.

Section 4. This Act shall take effect July 1, 1986.

Senators  
Vii Fisher  
276-7626

Wasted  
time

2/14/86 Joyce  
3/15-15/15

CS for Senate Bill 309 (Resources)

For an Act entitled: "An act relating to the royalty value of natural gas under a state oil and gas lease, and royalty gas sales at less than market value; and providing for an effective date."

Section 1. Findings.

The legislature finds that the state's interest will be served if the commissioner is authorized to agree to value the state's royalty share of natural gas sold by the state's oil and gas lessees to nonprofit electric cooperatives based upon the arm's-length gas sales contract price, regardless of whether the pertinent lease terms set forth a different valuation standard. The legislature adopts this policy prospectively, and does not intend in any way to establish or affect the gas royalty value for gas sold by the state's oil and gas lessees under contracts entered into before February 15, 1986 [ or for gas sold under existing contracts renegotiated after February 15, 1986. ]

The legislature further finds that it is in the state's interest to (explicitly) give the commissioner the discretionary authority to sell in kind royalty gas to nonprofit electric cooperatives at a price which is below market value.\*

The legislature further finds that proper exercise of the discretion conferred by this bill would support and complement other programs providing for the long-term electricity needs of the citizens of the state, including the power cost equalization program and hydroelectric and other electricity generation programs.

The legislature further finds that it should adopt a royalty policy for natural gas sold to electric cooperatives for instate electricity generation which is fundamentally different from

entirety of law

\* current market value provided that price is not below the long term contract value for the gas in question

the royalty policies for oil and for gas sold for export or for other instate uses.

Section 1. AS 38.05.180 is amended by adding a new subsection to read:

(aa) For the purpose of establishing the value of the state's royalty share of gas production sold by a state oil and gas lessee to a nonprofit electric cooperative, the commissioner may enter into an agreement with the lessee to use the arm's-length contract price, inclusive of tax reimbursement, deliverability and other charges, reimbursements or forms of consideration. This subsection applies only to the establishment of in value royalties for gas sold under contracts which are executed after February 15, 1986 for totally new quantities of gas.

Section 3. AS 38.05.183 is amended by adding a new subsection to read:

(g) The commissioner may enter into a contract for the sale of in kind royalty gas to a nonprofit electric cooperative at less than market value if the commissioner makes written finding that the sale is in the best interest of the state, with due consideration to the consumer benefits and other benefits and detriments of the sale.

Section 4. This Act shall take effect July 1, 1986.

Ned ~~XXXXXXXXXX~~

2/18/86

→ Kie Campbell  
Sen Sturgis's ofc.  
5<sup>m</sup> Floor

CS for Senate Bill 309 (Resources)

For an Act entitled: "An act relating to the royalty value of natural gas under a state oil and gas lease, and royalty gas sales at less than market value; and providing for an effective date."

Section 1. Findings.

The legislature finds that the state's interest will be served if the commissioner is authorized to agree to value the state's royalty share of natural gas sold by the state's oil and gas lessees to instate nonprofit electric utilities or cooperatives based upon the arm's-length gas sales contract price, regardless of whether the pertinent lease terms set forth a different valuation standard. The legislature adopts this policy prospectively, and does not intend in any way to establish or affect the gas royalty value for gas sold by the state's oil and gas lessees under contracts entered into before February 15, 1986. [or for gas sold under existing contracts renegotiated after February 15, 1986.]

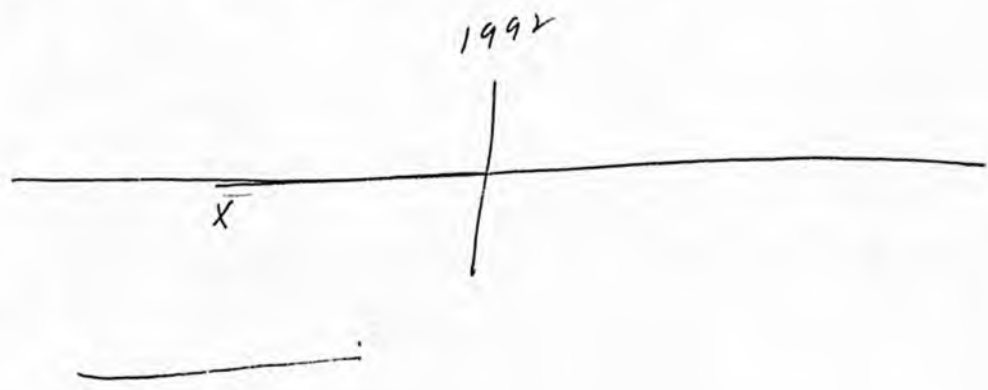
The legislature further finds that it is in the state's interest to give explicitly the commissioner the discretionary authority to sell in kind royalty gas to instate nonprofit electric utilities or cooperatives at a price which is below market value.

most other reasonable solutions  
local needs - statewide conduct  
anything harder - just won't get any plan  
w/ Esther's help shared be possible  
& more. w/o Esther's support

Esther ret of Board

Inform - Consumers

Mrs Paulina Z Vie - more explicit -



The legislature further finds that proper exercise of the discretion conferred by this bill would support and complement other programs providing for the long-term electricity needs of the citizens of the state, including the power cost equalization program and hydro-electric and other electricity generation programs.

The legislature further finds that it should adopt a royalty policy for natural gas sold to electric utilities or cooperatives for instate electricity generation which is fundamentally different from the royalty policies for oil and for gas sold for export or for other instate uses.

Section 1. AS 38.05.180 is amended by adding a new subsection to read:

(aa) For the purpose of establishing the value of the state's royalty share of gas production sold by a state oil and gas lessee to an instate nonprofit electric utilities or cooperative, the commissioner may [enter into an agreement with the lessee to] use the arm's-length contract price, inclusive of tax reimbursement, deliverability and other charges, reimbursements or forms of consideration. This subsection applies only to the establishment of in value royalties for gas sold under contracts which are executed after February 15, 1986. (for totally new quantities of gas).

Section 3. AS 38.05.183 is amended by adding a new subsection to read:

(g) The commissioner may enter into a contract for the sale of in kind royalty gas to an instate nonprofit electric utilities or cooperative at less than market value if the commissioner makes written finding that the sale is in the best interest of the state, with due consideration to the consumer benefits and other benefits and detriments of the sale.

Section 4. This Act shall take effect July 1, 1986.

① Inappropriateness of policy  
Sanctity of contracts

② Excludes Endors

③ Patched effect on law

State Resources Committee  
2/19/86

ORIGINAL

R.D.C. → original drafted

CS for SB 309 (Resources)

For an Act entitled: "An Act relating to the royalty value of natural gas under a state oil and gas lease, and royalty gas sales at less than market value; and providing for an effective date."

Section 1. FINDINGS. The legislature finds that the state's interest will be served if the commissioner is authorized to value the state's royalty share of natural gas sold by the state's oil and gas lessees to instate nonprofit or government-owned utilities or cooperatives based upon the arms-length gas sales contract price, regardless of whether the pertinent lease terms set forth a different valuation standard. The legislature adopts this policy prospectively, and does not intend in any way to establish or affect the gas royalty value for gas sold by the state's oil and gas lessees under contracts entered into before the effective date of this Act.

The legislature further finds that it is in the state's interest explicitly to give the commissioner discretionary authority to sell in kind royalty gas to instate nonprofit or government-owned utilities or cooperatives at a price which is below market value.

The legislature further finds that proper exercise of the discretion conferred by this bill would support and

eliminate hidden subsidies - then compensate.

complement other programs providing for the long-term electricity needs of the citizens of the state, including the power cost equalization program and other electricity generation programs.

The legislature further finds that it should adopt a royalty policy for natural gas sold to nonprofit or government-owned electric utilities or electric cooperatives for instate electricity generation which is fundamentally different from the royalty policies for oil and for gas sold for export or for other instate uses.

Sec. 2. AS 38.05.180 is amended by adding a new subsection to read:

(aa) Upon the written request of a lessee, the commissioner shall within 90 days after the request enter into an agreement to use the contract price, inclusive of tax reimbursement amounts, deliverability charges and other forms of consideration, as establishing the in value royalty value during the life of the contract for the state's share of gas production sold under an arm's-length contract to an instate nonprofit or government-owned electric utility or <sup>electric</sup> cooperative, unless the commissioner makes a written finding based upon clear and convincing evidence that the contract price is unreasonably low and that any prospective reduction in royalty receipts would not be balanced by

increased benefits to electric consumers. This subsection applies only to the establishment of in value royalties for gas sold under contracts executed after the effective date of this Act for ~~total~~ new quantities of gas.

Sec. 3. AS 38.05.183 is amended by adding a new subsection to read:

(g) The commissioner may enter into a contract for the sale of in kind royalty gas to an instate nonprofit or government-owned electric utility or electric cooperative at less than market value if the commissioner makes a written finding that the sale is in the best interest of the state, with due consideration to the consumer benefits and other benefits and detriments of the sale.

Sec. 4. This Act shall take effect immediately.



Legislative  
Information and  
Teleconference Networks

SIGN-IN SHEET

Date:

Site/Location:

Sponsor/Subject:

Joyce Murphy  
Com. Unconite

Name/Representing	Address	Phone	Here to Testify	Here to Observe
<i>Anchorage</i>				
<i>OK Mike Abbott</i>	<i>Resource Council</i>			
<i>OK Dale Teal</i>	<i>En Star</i>			
<i>Fairbanks</i>				
<i>OK Vayle Volonell</i>	<i>Mike Kelly - Golden Valley -</i>			
<i>OK Vayle Palaspic</i>	<i>FHS Muni System -</i>			
<i>Kodiak</i>				
<i>OK David Neese</i>	<i>Kodiak Electric</i>			

2/14/86

CS for Senate Bill 309 (Resources)

For an Act entitled: "An act relating to the royalty value of natural gas under a state oil and gas lease, and royalty gas sales at less than market value; and providing for an effective date."

Section 1. Findings.

The legislature finds that the state's interest will be served if the commissioner is authorized to agree to value the state's royalty share of natural gas sold by the state's oil and gas lessees to nonprofit electric cooperatives based upon the arm's-length gas sales contract price, regardless of whether the pertinent lease terms set forth a different valuation standard. The legislature adopts this policy prospectively, and does not intend in any way to establish or affect the gas royalty value for gas sold by the state's oil and gas lessees under contracts entered into before February 15, 1986, ~~for for gas sold under existing contracts renegotiated after February 15, 1986.~~

The legislature further finds that it is in the state's interest to explicitly give the commissioner the discretionary authority to sell in kind royalty gas to nonprofit electric cooperatives at a price which is below market value.

The legislature further finds that proper exercise of the discretion conferred by this bill would support and complement other programs providing for the long-term electricity needs of the citizens of the state, including the power cost equalization program and hydroelectric and other electricity generation programs.

The legislature further finds that it should adopt a royalty policy for natural gas sold to <sup>non profit</sup> electric <sup>utilities or</sup> cooperatives for instate electricity generation which is fundamentally different from

the royalty policies for oil and for gas sold for export or for other instance uses.

Section 1. AS 38.05.180 is amended by adding a new subsection to read:

(aa) For the purpose of establishing the value of the state's royalty share of gas production sold by a state oil and gas lessee to a nonprofit electric cooperative, the commissioner may ~~enter into an agreement with the lessee to~~ use the arm's-length contract price, inclusive of tax reimbursement, deliverability and other charges, reimbursements or forms of consideration. This subsection applies only to the establishment of in value royalties for gas sold under contracts which are executed after February 15, 1986 [for totally new quantities of gas].

Section 3. AS 38.05.183 is amended by adding a new subsection to read:

(g) The commissioner may enter into a contract for the sale of in kind royalty gas to a nonprofit electric cooperative at less than market value if the commissioner makes written finding that the sale is in the best interest of the state, with due consideration to the consumer benefits and other benefits and detriments of the sale.

Section 4. This Act shall take effect July 1, 1986.

DELIVER TO: <u>Lay Brown</u>	LOCATION: <u>OKH - Akub</u>
FROM: <u>Mark Wakester</u>	LOCATION: <u>Jan 0</u>
TELEPHONE/TELECOPIER # _____	TOTAL NUMBER OF PAGES: <u>3</u>
TRANSMITTING ON/SPEED _____	DATE: <u>9/12</u> TIME: <u>3:25 PM</u>
PHONE FOR PROBLEMS-NAME/NUMBER: <u>Marisa 465-2400</u>	
COMMENTS _____	

CS for Senate Bill 309 (Resources)

For an Act entitled: "An act relating to the royalty value of a natural gas lease on state land, and royalty gas sales at less than market value; and providing for an effective date."

Section 1. Findings.

The legislature finds that the state's interest will be served if ~~[the commissioner is authorized to agree to value]~~ the state's in value royalty share of the natural gas sold by the state's lessees to nonprofit electric utilities and cooperatives <sup>is</sup> based upon the contract price, regardless of whether the pertinent lease terms set forth a different valuation standard. The legislature adopts this policy prospectively, and does not intend in any way to establish or affect the in value gas royalty value for gas sold by the state's oil and gas lessees under contracts entered into before February 15, 1986 ~~[or for gas sold under preexisting contracts renegotiated after February 15, 1986.]~~

~~[The legislature further finds that it is in the state's best interest to explicitly provide for the discretionary authority of the commissioner to sell in kind royalty gas to nonprofit electric utilities or cooperatives at a price which is below market value.]~~

The legislature further finds that this bill will support and complement the other programs of the state, including its electric power cost assistance program and

DNR points  
- settle -

hydroelectric and other electrical generation programs, to provide for the long-term electrical needs of all the citizens of the state.

The legislature adopts these findings recognizing that the policy for royalty valuation of natural gas sold to nonprofit electric utilities and cooperatives for instate electric generation is fundamentally different from the policy for royalty valuation of oil or for gas sold for export or for other instate uses.

Section 2. AS 38.05.180 is amended by adding a new subsection to read:

(aa) For the purpose of establishing the value of the state's in value royalty share of gas production sold by a lessee to a nonprofit electric utility or cooperative, <sup>for instate use</sup> the commissioner <sup>shall</sup> ~~may~~ [enter into an agreement with the lessee to] use the arms'-length contract price, inclusive of tax reimbursement, deliverability and other charges or forms of consideration. This act applies only for establishment of in value royalties for gas sold under ~~new~~ <sup>new</sup> contracts [for ~~totally new supplies of gas which are~~] executed after February 15, 1986.

[Section 3. AS 38.05.183 is amended by adding a new subsection to read:

(g) The commissioner may enter into a contract for the sale of in kind royalty gas to a nonprofit electric utility or cooperative at less than market value, if the commissioner makes a written finding that the sale is in the

best interest of the state, with due consideration to the  
consumer and other benefits of the sale.]

Effective Date . . .

CS for Senate Bill 309 (Resources)

.....

Section 1. Findings.

*in state non profit*

The legislature finds that the state's interest will generally be served if the commissioner is authorized to agree to value the state's in value royalty share of the natural gas sold by the state's lessees to nonprofit electric utilities and cooperatives based upon the contract price, regardless of whether the pertinent lease terms set forth a different valuation standard. The legislature adopts this policy prospectively, and does not intend in any way to establish or affect the in value gas royalty value for gas sold by the state's oil and gas lessees under contracts entered into before February 15, 1986, or for gas sold under preexisting contracts renegotiated after February 15, 1986. The legislature adopts this policy recognizing that the policy for royalty valuation of natural gas sold to nonprofit electric utilities and cooperatives for instate electric generation is fundamentally different from the policy for royalty valuation of oil or for gas sold for export or for other instate uses.

2400	<div data-bbox="267 1342 1445 1778" data-label="Text"> <p>sol</p> </div>
3600	

*Much cleaner if you remove this*

*than you can also remove marked language on 2nd page*

Section 2. AS 38.05.180 is amended by adding a new subsection to read:

(a.) For the purpose of establishing the value of the state's in value royalty share of gas production sold by a lessee to a nonprofit electric utility or cooperative, the commissioner <sup>shall?</sup> may enter into an agreement with the lessee to use the arms'-length contract price, inclusive of tax reimbursement, deliverability and other charges or forms of consideration. This act applies only for establishment of in value royalties for gas <sup>which has not been subject to any previous</sup> ~~contract and is sold under a new contract~~ ~~for~~ ~~totally new supplies of gas which are~~ ~~executed after~~ *cooperative*  
February 15, 1986.

Section 3. AS 38.05.183 is amended by adding a new subsection to read:

(g) The commissioner may enter into a contract for the sale of in kind royalty gas to a nonprofit electric utility or cooperative at less than market value, if the commissioner makes a written finding that the sale is in the best interest of the state, with due consideration to the consumer and other benefits of the sale.

Kie

*must work*

CS for Senate Bill 309 (Resources)

.....

Section 1. Findings.

The legislature finds that the state's interest will generally be served if the commissioner is authorized to agree to value the state's in value royalty share of the natural gas sold by the state's lessees to nonprofit electric utilities and cooperatives based upon the contract price, regardless of whether the pertinent lease terms set forth a different valuation standard. The legislature adopts this policy prospectively, and does not intend in any way to establish or affect the in value gas royalty value for gas sold by the state's oil and gas lessees under contracts entered into before February 15, 1986, or for gas sold under preexisting contracts renegotiated after February 15, 1986. The legislature adopts this policy recognizing that the policy for royalty valuation of natural gas sold to nonprofit electric utilities and cooperatives for instate electric generation is fundamentally different from the policy for royalty valuation of oil or for gas sold for export or for other instate uses.

*Protect  
 late gas  
 affects litigation  
 up through  
 value 21 & v.P.  
 current. Down  
 affects*

←

Section 2. AS 38.05.180 is amended by adding a new subsection to read:

(aa) For the purpose of establishing the value of the state's in value royalty share of gas production sold by a lessee to a nonprofit electric utility or cooperative, the commissioner <sup>shall</sup> ~~may~~ enter into an agreement with the lessee to use the arms'-length contract price, inclusive of tax reimbursement, deliverability and other charges or forms of consideration. This act applies only for establishment of in value royalties for gas sold under new contracts <sup>\*</sup> ~~for~~ ~~totally new supplies of gas which are~~ executed after February 15, 1986.

*new rules*  
*new rules*

Section 3. AS 38.05.183 is amended by adding a new subsection to read:

(g) The commissioner may enter into a contract for the sale of in kind royalty gas to a nonprofit electric utility or cooperative at less than market value, if the commissioner makes a written finding that the sale is in the best interest of the state, with due consideration to the consumer and other benefits of the sale.

*Clarification*

*which has not been subject to any previous contract & is sold under a new contract*

VF 2-11-86

ROYALTY GAS -- COMPROMISE PROPOSAL

For purposes of establishing a royalty value for gas sold to or used by a nonprofit electric utility or cooperative, the Commissioner shall either

1. use the contract sale price of gas produced under any new arms-length, long-term contract between a lessee and such utility or cooperative, or
2. enter into a contract for sale of in-kind gas at less than market value to such utility or cooperative.

DNR favoring points

1. prospective only (no impact on past or present settlement negotiations)
2. gas only
3. electric coop or munis only
4. arms length only
5. DNR has choice of in value or in kind approach
6. DNR or state right to take in kind & sell for any price unimpaired

*Stump  
White*

CS for Senate Bill No. 309 (Resources)

For an Act entitled: "An Act relating to the royalty value of a natural gas lease on state land; and providing for an effective date."

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

Section 1. FINDING. The legislature finds that to provide for the utilization, development and conservation of gas resources for the maximum benefit of the people of the state, the value of production of gas used by electric cooperatives and municipal electric utilities must be based primarily on the contract price of gas rather than the current market value of the gas. This will encourage stable markets and electric rates, promote investment, assure reasonable energy prices and provide the maximum benefit to the people of the state.

Section ~~2~~ AS 30.05.180 is amended by adding a new subsection to read:

(aa) For the purpose of determining the value of the state's royalty share of gas taken in value and sold by the lessee pursuant to a long term contract to an electric cooperative organized under AS 10.25 or to a municipal utility, the Commissioner shall apply said contract price.

(bb) The state may elect on no less than six months notice to take its royalty gas in kind for sale or other disposal as the state may see fit.

(cc) Nothing in this section shall be construed to affect the method of determining the value of the state's royalty share of oil taken in value or in kind.

Section 3. This Act applies to leases issued before or after the effective date of this Act.

Section 4. This Act takes effect immediately in accordance with AS 01.10.070(c).

CS for Senate Bill 309 (Resources)

.....

Section 1. Findings.

The legislature finds that the state's interest will generally be served if the commissioner is authorized to agree to value the state's in value royalty share of the natural gas sold by the state's lessees to nonprofit electric utilities and cooperatives based upon the contract price, regardless of whether the pertinent lease terms set forth a different valuation standard. The legislature adopts this policy prospectively, and does not intend in any way to establish or affect the in value gas royalty value for gas sold by the state's oil and gas lessees under contracts entered into before February 15, 1986, or for gas sold under preexisting contracts renegotiated after February 15, 1986. The legislature adopts this policy recognizing that the policy for royalty valuation of natural gas sold to nonprofit electric utilities and cooperatives for instate electric generation is fundamentally different from the policy for royalty valuation of oil or for gas sold for export or for other instate uses.

Section 2. AS 38.05.180 is amended by adding a new subsection to read:

(aa) For the purpose of establishing the value of the state's in value royalty share of gas production sold by a lessee to a nonprofit electric utility or cooperative, the commissioner may enter into an agreement with the lessee to use the arms'-length contract price, inclusive of tax reimbursement, deliverability and other charges or forms of consideration. This act applies only for establishment of in value royalties for gas sold under new contracts for totally new supplies of gas which are executed after February 15, 1986.

Section 3. AS 38.05.183 is amended by adding a new subsection to read:

(g) The commissioner may enter into a contract for the sale of in kind royalty gas to a nonprofit electric utility or cooperative at less than market value, if the commissioner makes a written finding that the sale is in the best interest of the state, with due consideration to the consumer and other benefits of the sale.

Introduced: 5/4/85  
Referred: Resources

*Retro  
all mandates  
Bundren in state*

1 IN THE SENATE

BY FAIKS, KELLY AND V.FISCHER

2

SENATE BILL NO. 309

3

IN THE LEGISLATURE OF THE STATE OF ALASKA

4

FOURTEENTH LEGISLATURE - FIRST SESSION

5

A BILL

6 For an Act entitled: "An Act relating to the royalty value of a natural  
7 gas lease on state land; and providing for an effective date."  
8

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

10 \* Section 1. FINDING. The legislature finds that to provide for the  
11 utilization, development and conservation of gas resources for the maximum  
12 benefit of the people of the state, the value of production of gas for  
13 purposes of computing the royalty reserved to the state must be based  
14 primarily on the contract price of gas rather than the current market value  
15 of the gas. This will encourage stable markets, promote investment, assure  
16 reasonable energy prices and provide the maximum benefit to the people of  
17 the state.

18 \* Sec. 2. AS 38.05.180 is amended by adding a new subsection to read:

19 (aa) Notwithstanding other provisions of this section, if the  
20 royalty share of natural gas reserved to the state under a lease  
21 issued under (f) of this section is taken in value, the value of  
22 production sold under a long-term sales contract may not be greater  
23 than the price received for the production under the long-term sales  
24 contract unless it is shown by clear and convincing evidence that the  
25 long-term contract price was unreasonably low at the time of contract.

26 \* Sec. 3. This Act applies to leases issued before or after the effective  
27 date of this Act.

28 \* Sec. 4. This Act takes effect immediately in accordance with AS 01.-  
29 10.070(c).

The issue today is how the state should determine the value of its royalty share of natural gas on state lands. In the past this determination has been based on long-term contract prices. In November of 1984, the Administration switched to determining the fair market value of its royalty share by comparison with other recent gas sales in Cook Inlet.

The lease language, unfortunately, is sufficiently ambiguous that legal arguments can be made to support both methods. Our job is not to offer legal interpretation, but to consider what public policy makes the best sense for Alaska.

To make that determination we need to get answers to some questions today.

- 1 - What will be the impact on consumers of gas and gas generated electricity?
- 2 - What will be the impact on state revenue?
- 3 - What will be the effect of the relative future certainty or uncertainty of gas prices that different methods of valuation may result in?
- 4 - How will our decision effect other purchasers of natural gas for uses such as LNG or urea?
- 5 - What will be the effect on oil and gas companies and future exploration and production decisions?
- 6 - What effect will there be on other ongoing royalty suits?
- 7 - What will be the impact of our decisions on use of North Slope gas, both for instate energy use and for possible exportation as LNG?

We have all the parties assembled here today. I hope that they can answer these and a number of other questions on the issue. After the public testimony, I plan to bring these bills back to the committee on Wednesday, February 19th for action.

1010

STATE OF ALASKA 1986 LEGISLATIVE SESSION  
FISCAL NOTE

Revision Date : \_\_\_\_\_

**REQUEST**

Bill/Resolution No. : SB 309  
Title : Royalty value of a natural gas lease on state land  
Sponsor : Faiks  
Requestor : Senate Resources  
Date of Request : 2/10/86

**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						

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 Phone : 465-2400  
Division : Commissioner's Office Date : Feb. 9, 1986

Approved by Commissioner : [Signature] Date : Feb. 10, 1986  
Agency : Natural Resources

Distribution (by Agency preparing fiscal note) :

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

Fiscal Note Background  
for SB 309

Passage of SB 309 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.

# STATE OF ALASKA 1986 LEGISLATIVE SESSION FISCAL NOTE

Revision Date : \_\_\_\_\_

**REQUEST**

Bill/Resolution No. : SB 309  
 Title : Royalty value of a natural gas lease on state land  
 Sponsor : Faiks  
 Requestor : Senate Resources  
 Date of Request : 2/10/86

**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						
<b>TOTAL OPERATING</b>						

CAPITAL						
---------	--	--	--	--	--	--

REVENUE	(2,300)	(1,900)	(1,900)	(1,900)	(1,900)	(1,900)
---------	---------	---------	---------	---------	---------	---------

**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

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

Prepared by : Ned Farquhar NF Phone : 465-2400  
 Division : Commissioner's Office Date : Feb. 9, 1986

Approved by Commissioner : *Esther C. Wunniche* Date : Feb. 10, 1986  
 Agency : Natural Resources

Distribution (by Agency preparing fiscal note) :

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

Fiscal Note Background  
for SB 309

Passage of SB 309 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.

Introduced: 4/10/85  
Referred: Resources

1 IN THE SENATE

BY P.FISCHER AND KELLY

2

SENATE BILL NO. 276

3

IN THE LEGISLATURE OF THE STATE OF ALASKA

4

FOURTEENTH LEGISLATURE - FIRST SESSION

5

A BILL

6

For an Act entitled: "An Act relating to the lease, sale, or disposal of  
7 natural gas for a public use."

7

8

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

9

\* Section 1. AS 38.05.810(a) is amended to read:

10

(a) The lease, sale, or other disposal of state land or re-

11

sources may be made to a state or federal agency or political subdivi-

12

sion, or the lease, sale, or disposal of coal deposits suitable for

13

mining or of natural gas may be made to a utility owned and operated

14

by a government agency or nonprofit cooperative association organized

15

to participate under the Federal Rural Electrification Act for the

16

purpose of generating electric power and energy or the production of

17

process steam, or both, for less than the appraised value as deter-

18

mined by the director and approved by the commissioner to be fair and

19

proper and in the best interests of the public, with due consideration

20

given to the nature of the public services or function rendered by the

21

agency, subdivision, or utility making applicator, and of the terms

22

of the grant under which the land was acquired by the state.



FEB 7 1986

**Homer Electric Association, Inc.**

CENTRAL OFFICE: 3977 LAKE STREET • HOMER, ALASKA 99603 • (907) 235-8167

February 3, 1986

Senator Arliss Sturgulewski  
Chairman, Senate Resources Committee  
Alaska State Legislature  
Pouch A (MS 3100)  
Juneau, Alaska 99811

Dear Senator Sturgulewski:

In early 1985 the Alaska Department of Natural Resources made a decision to increase the price of Royalty Gas in Cook Inlet. This action, on the surface, appeared to be a good decision in that it provided additional money to the State.

After further review, however, this action will have a serious negative impact on Alaskan's living in the Railbelt Area. The increased price for Royalty Gas will be, unfortunately, passed on through to those people that buy gas directly from Enstar and others for home heating, and also those people that use electricity, as most of the electricity in the Railbelt is generated using natural gas.

Chugach Electric, who utilizes much of this gas, will feel a significant impact, which will be shared by all of its members, including Homer Electric consumers. Chugach currently pays 26¢ per MCF for its Beluga gas. The market value of that gas as determined initially by DNR would be \$2.05 per MCF. The impact of the increase in gas prices passed on to Chugach customers, including Homer Electric members, would be \$2.8 million per year. Homer Electric customers would pay for their fair share of that increase. In addition to that Homer Electric will be purchasing additional electricity from the Alaska Electric Generation and Transmission Cooperative, which purchases gas from Enstar.

It appears the bottom line is if the DNR decision holds and the gas prices for Royalty Gas increases to market, the impact on Homer Electric customers will be an additional 2% to 5% increase in rates, depending upon numerous factors.

Attached is a very comprehensive summary prepared by Chugach Electric which itemizes these increases. Attachment "A" to that summary shows "wholesale percent." The resultant cost to our members would be one-half of that since wholesale power costs are one-half of our retail rates.

We understand the logic of increasing the Royalty Gas prices to market rates; however, we are concerned over the negative impact on electric rate payers and gas rate payers that will result in the Railbelt Area.


ALREADY  
INCLUDED  
IN  
PACKET

Homer Electric supports Senate Bill 309, House Bill 403, or House Bill 425, copies of which are attached. We are furthermore open to any suggestions that you might have which provide for the increased revenue to the State, yet, hopefully, minimizing any negative impact on the people living in the Railbelt Area.

Please let me know if you have any questions, or if I can be of assistance. Thank you.

Sincerely yours,

HOMER ELECTRIC ASSOCIATION, INC.



B. Kent Wick  
General Manager

BKW:em  
Encl.

*Arless*

**INTERIM REPORT OF THE  
HOUSE FINANCE SUBCOMMITTEE ON OIL AND GAS**

Prepared by

Louann Cutler, Staff  
Representative Al Adams

and

Sharman Piper, Staff  
Representative Sam Cotten

at the direction of

Rep. Sam Cotten, Chairman  
House Finance Subcommittee on Oil and Gas

January 17, 1986

REPRESENTATIVE  
SAM COTTEN  
DISTRICT 13



P.O. BOX 296, EAGLE RIVER, AK 99577  
POUCH V. JUNEAU, AK 99811

ALASKA STATE LEGISLATURE  
HOUSE OF REPRESENTATIVES

MEMORANDUM

FROM: Representative Sam Cotten *Sam Cotten*  
Chairman, House Finance Subcommittee on Oil and Gas

TO: Members of the Alaska State Legislature

RE: Interim Report of the House Finance Subcommittee  
on Oil and Gas

DATE: January 17, 1986

---

One of the most important aspects of Alaska public policy is our treatment of the oil and gas industry. Formulating oil and gas policy is difficult because of the huge amounts of money involved and because the state and the industry have different points of view. The industry is naturally interested in maximizing its profits. State government is concerned with adequately providing for the health, education and welfare of all Alaskans as well as developing its natural resources in a manner consistent with the public interest. Even though the state and the industry are united in our desire to promote oil and gas development, multi-million dollar disputes over fair tax policy and proper valuation of North Slope oil divide us.

Currently facing us is whether to reinstate separate accounting, proposed in House Bill 353, introduced last session by the House Finance Committee. The oil corporations have widely advertised their opposition to the bill throughout the state. Ironically, while they resist the tax changes embodied in HB 353, they have not paid taxes due the state from past tax years, choosing instead to dispute these taxes through established channels. Recent figures from the Department of Revenue (DOR) show the oil companies are hundreds of millions of dollars behind in tax payments to the state, under former and existing tax laws.

During the interim I examined these tax issues and other areas of dispute in order to suggest improvements to state policy, increase our understanding of the issues involved,

and improve our relationship with this vital Alaskan industry.

We depend on an unstable entity -- world oil prices -- for the bulk of our state revenues and this makes it difficult to plan. But even with this uncertainty, Alaska can implement smart business practices. For example, we can't let the oil and gas industry write its own tax laws. On the other hand, we need a policy that encourages exploration and development. We also have to be realistic and realize that state tax incentives alone cannot overcome the current world-wide slump in oil prices.

We need to spend less on government operations and broaden our economic base. Our policies should focus on the decline in Prudhoe production, which will start occurring in the next few years, and the inability of subsequent oil fields to come close to equalling Prudhoe's output. In other words, our present generous level of oil revenues is short-lived. Our goals should be to maximize our benefits now from this non-renewable resource and to encourage additional exploration and production so that we can prepare for a future without as many oil dollars.

It is my hope that this report will help provide a framework for our continuing relationship with the oil industry. Some of the issues discussed here include recommendations for legislation, others are offered as background information.

The topics discussed in the report are as follows: 1) prepayment of disputed taxes; 2) an examination of the issues having to do with separate accounting (HB 353); 3) a discussion of the severance tax and the economic limit factor; 4) an overview of the major oil litigation.

#### **I. Prepayment of Disputed Taxes**

One of the most disturbing developments to surface during the interim was the discovery that the oil companies are \$908 million behind in tax payments to the state as of January 6, 1986. Confidentiality statutes prevent disclosing the names of the corporations and exactly how much each owes, but the large sums and statutes involved make it obvious that the major North Slope producers -- Arco, Exxon, Sohio -- are some of the taxpayers whose accounts are at issue. Furthermore, current law offers little incentive for them to pay in a timely manner.

Properly written statutes could have the companies prepay assessed amounts at a set point in the appeals process -- late enough to protect the taxpayers from auditing errors yet early enough to ensure that the taxes are collected in a timely manner.

Additionally, the Legislative Budget and Audit Committee has requested an opinion from the attorney

general's office on the constitutionality of revealing the names of taxpayers whose accounts are past due.

## II. The Issues Pertaining to Separate Accounting -- HB 353

HB 353 would reinstate separate accounting as the method used to calculate the oil industry's tax liability. It would also reduce the severance tax from 15% to 12.25%, a substantial incentive to smaller fields. Industry protests about the bill obscure the fact that it is a fairer tax because it lowers the income tax on less profitable ventures, like marginal fields, and puts the tax burden on the most profitable developments, such as Prudhoe Bay and Kuparuk.

HB 353 would ensure that the state receives its fair share of Alaskan oil wealth. On Jan. 13, 1986 the U.S. Supreme Court agreed with the Alaska Supreme Court that separate accounting is constitutional. Furthermore, the state supreme court said that separate accounting is the prevailing method used throughout the United States for reporting income from oil production because it conforms more to an oil company's financial accounting procedures and "more accurately reflects income than formula apportionment".

Under pressure from important US trading partners, President Reagan has asked Congress to force states to abandon worldwide combination formula apportionment.

Whether or not we decide this session to return the former tax law to the books, it's important to understand the basic issues involved and let our decisions on tax policy be guided by facts, not by high-priced media campaigns aimed at our emotions.

## III. The Severance Tax and the Economic Limit Factor

This is an issue that needs to be addressed this session because state revenues from severance taxes will be severely reduced beginning in FY 88 if the ELF law isn't changed. The ELF is a statutory reduction to the severance tax, created to extend production on marginal fields, but it is not working as well as it could. Two problems with present law are: 1) it doesn't give marginal fields enough of a tax break; and 2) it will provide Prudhoe with a premature tax reduction decades before it can be considered marginal. A simple change in the ELF law could solve both these problems.

## IV. Major Oil Litigation with the Oil and Gas Industry

The amounts at issue in the state's oil and gas litigation are at least \$15 to 20 billion dollars and the state has spent millions of dollars so far to pursue these cases. Major litigation with the oil industry highlights the many points during the production and marketing process that provide profit-making opportunities for the industry and revenue opportunities for the state.

This chapter of the report highlights two major cases that affect the value of the oil and revenues to the state. The cases are the Amerada Hess royalty case and the TAPS tariff case. While the issues involved are in litigation and therefore out of the legislature's immediate realm of influence, I believe knowing more about the nature of the disputes adds to our overall understanding of the subject. Fair prices for the oil and fair charges for transportation costs are the key areas in which the state and oil companies disagree.

The issues summarized above constitute this interim report. It is my hope that the information will be of use to you as we begin the 1986 session. The report does not attempt to address all the facets of the state's complex relationship with the oil and gas industry, but it does touch on some of the important points. I believe staying abreast of the industry and its goals will enhance the quality of state government, because without this knowledge it will be difficult to maintain our positions as the real policymakers of Alaska.

INTERIM REPORT OF THE HOUSE FINANCE SUBCOMMITTEE  
ON OIL AND GAS

TABLE OF CONTENTS

Memorandum from Representative Cotten .....	p. 1
Chapter I: Prepayment of Disputed Taxes .....	p. 5
Chapter II: Overview of Issues Pertaining to HB 353 ..	p. 14
Chapter III: The Severance Tax and the Economic Limit Factor .....	p. 29
Chapter IV: Major Litigation with the Oil and Gas Industry .....	p. 36

I.

**PREPAYMENT OF DISPUTED TAXES**

I. The Problem

As of January 6, 1986, the oil companies owed the state \$908 million in disputed taxes. Due to the ARCO settlement of \$243 million on January 13, 1986, this total will be adjusted (new figures from DOR are expected next week). Since \$243 million is the amount of the settlement, it may not be the exact amount of taxes previously in dispute between ARCO and the state. The phrase "disputed taxes" refers to audited tax amounts contested by the companies, plus interest and penalties. Unfortunately, existing state law does not encourage speedy resolution of these cases and some of the disputes go back as far as 15 years.

The total reported by DOR to be disputed on Jan. 6, 1986 was \$908,293,008.61. The total amount varies from month to month due to such causes as interest charges and settlement of some of the disputes. For a schedule of all tax accounts receivable, see Attachment A. Here is a breakdown of what is owed:

-- Approximately \$524 million of the total is owed under the former separate accounting oil and gas corporate income tax for the years 1979 to 1981. (AS 43.21)

-- Approximately \$322 million is owed under the severance tax for the years 1976 to 1982. (AS 43.55)

-- The balance of about \$62 million is owed under the income tax statute for all corporate taxpayers.<sup>1</sup> (AS 43.20) While the \$62 million includes contested taxes for all corporate taxpayers, it is estimated that almost all of this amount is owed by the oil and gas corporations.

The main reason the taxes have not been paid is because the oil companies disagree with the state over the amount of their tax liability. They are contesting the tax assessments through established administrative channels in the Department of Revenue. At issue is the methodology for calculating certain revenues and expenses in order to determine the amount of tax owed to the state.

A second reason the taxes have not been paid is that many of the issues involved in the tax disputes are the subjects of major oil and gas litigation between the companies and the state.

A third reason the taxes have not been paid is that the companies appear to have little incentive to do so. Although interest rates on disputed tax liability (12% per AS 43.05.225) may currently be higher than commercial interest rates, it is clearly in the taxpayers' interest to

---

<sup>1</sup>Before 1979 oil and gas companies paid income taxes under AS 43.20, like all other corporate taxpayers. Between 1979 and 1981 they paid income taxes under the separate accounting statute, AS 43.21, and also paid income tax for their non-oil and gas activities under AS 43.20. From 1982 to now, the companies again pay all their income tax under AS 43.20.

I. The Problem

As of January 6, 1986, the oil companies owed the state \$908 million in disputed taxes. Due to the ARCO settlement of \$243 million on January 13, 1986, this total will be adjusted (new figures from DOR are expected next week). Since \$243 million is the amount of the settlement, it may not be the exact amount of taxes previously in dispute between ARCO and the state. The phrase "disputed taxes" refers to audited tax amounts contested by the companies, plus interest and penalties. Unfortunately, existing state law does not encourage speedy resolution of these cases and some of the disputes go back as far as 15 years.

The total reported by DOR to be disputed on Jan. 6, 1986 was \$908,293,008.61. The total amount varies from month to month due to such causes as interest charges and settlement of some of the disputes. For a schedule of all tax accounts receivable, see Attachment A. Here is a breakdown of what is owed:

-- Approximately \$524 million of the total is owed under the former separate accounting oil and gas corporate income tax for the years 1979 to 1981. (AS 43.21)

-- Approximately \$322 million is owed under the severance tax for the years 1976 to 1982. (AS 43.55)

prolong the tax disputes and avoid payment for as long as possible. They may also hope for a settlement with the state in which they ultimately pay a smaller amount than originally assessed.

## II. The Disputed Issues

The major severance tax issues are similar to those involved in the State v. Amerada Hess, et. al case, though resolution of the tax issues may well be different than the case itself. (The last chapter in this report discusses this case in more detail.) The amount of our royalty share is in question in this lawsuit because of a dispute over the wellhead value of the oil. The wellhead value is determined by the destination price of the oil minus the transportation costs -- primarily pipeline tariffs and tanker charges. The tanker charges and destination price are at issue in the Amerada Hess case and about 95 percent of the total disputed taxes owed under the severance tax law involve these issues.

The remaining severance tax disputes primarily involve: 1) what production expenses can be deducted; 2) the computation of pipeline income; 3) what income and expenses are non-oil related and should be taxed under the income tax statutes; and 4) proper pipeline tariffs for non-TAPS pipelines, such as the Kuparuk pipeline and the Panama Canal pipeline.

Roughly half of the separate accounting disputes involve all the issues involved in the severance tax

disputes. The other half of the separate accounting disputes involves these major issues: 1) how to compute production expenses; 2) how to compute pipeline income; 3) income and expenses that should be apportioned to AS 43.20; 4) appropriate pipeline tariff charges; 5) how much should be spent for the eventual closing down of the pipeline; and 6) how much value should be placed on recoverable reserves.

The separate accounting tax disputes are also similar to those in Arco, et. al. v. State, the lawsuit over the state's former separate accounting law (described in the second chapter of this report). Now that separate accounting has been upheld at every level of court review -- most recently by the US Supreme Court this past Monday when it dismissed the oil companies' appeal -- the Department of Revenue expects these tax disputes to progress further.

### III. Existing Process for Resolving Tax Disputes

After an oil and gas corporation submits a tax return it is audited by the Department of Revenue. Generally speaking, the audit shows that the taxpayer owes more than the taxpayer's return says. The taxpayer is then assessed the audited amount. Again, generally speaking, the taxpayer contests the audit and the arduous process of resolving the dispute begins.

The first stage of the resolution process is referred to as the informal conference stage and almost 90 percent of currently disputed taxes are in this stage. This is when

DOR and the taxpayer try to resolve factual issues and agree on the amount of tax owed, a process that can take several years. If the dispute is resolved, the taxpayer pays the additional amount and the case is closed. (In some rare instances, the informal conference is skipped and the dispute is taken up immediately at the formal hearing level.)

If it is not resolved, the case moves along to the formal hearing stage. A DOR hearing examiner essentially acts in the capacity of a judge and decides the case. This stage can also take years. The Commissioner can either adopt or reject the decision, although all decisions ever issued have all been adopted.

After adoption of the decision, the taxpayer is required to pay the tax if no appeal is filed in the superior court. If the taxpayer pursues the dispute by appealing to court, then the court will require that a bond be posted in order to continue contesting DOR's decision.

#### IV. Inadequacy of the current resolution process

Because of our current dispute resolution process, it may take years before the taxpayers will settle or be required to pay the audited tax amounts. Some of the disputes concern taxes that were owed as far back as 1970 although in certain instances, audits may not have been performed until years after a return is filed because the assessment period has been waived.

The taxpayer then has no incentive to resolve the matter since he is not required to pay the audited tax until all the administrative and judicial channels to overturn the audit have been exhausted. By allowing the taxpayer to keep the disputed amounts for so long, current laws appear to encourage the taxpayer to prolong the dispute. Thus the taxpayer will have the disputed funds to invest and earn interest on, or to use for other purposes.

**V. A Solution: Prepayment of Assessed Tax Amounts**

In order for the state to collect taxes in a more reasonable time frame, the oil companies should be required to prepay the audited amount at some point in the dispute resolution process.

Prepayment could be required after the informal conference stage. At this point the taxpayer and the state have been negotiating and fine-tuning the tax liability for some time. Errors and omissions by the taxpayer and auditor are likely to have been corrected.

Alternatively, prepayment could be required after the formal hearing. The dispute has been reviewed by the entire DOR hierarchy and the Commissioner has adopted a decision. If prepayment is not required until after the formal hearing, specific time frames could be provided in law for each stage of the resolution process. Once the taxpayer has been assessed the audited amount, both the informal conference and formal hearing stages would have to be

completed within a certain number of years established in statute. This would guard against continued prolonging of disputes since prepayment would not be required until the end point of the department's internal review.

It makes fiscal sense to put some or all of the prepayments in escrow until the dispute is finally resolved. The escrow account could be viewed as a form of state savings, since it could still be several years until a particular dispute is finally resolved. In the meantime, the escrowed amounts could earn be invested and earn additional income. This would allow the state to save for the future and also provide protection in the event that the disputed tax liability would be resolved in the taxpayer's favor.

The prepayment requirement should also be applied to amounts owed for prior tax years. Applying the prepayment requirement to past years is essential in order to bring about faster resolution of the current tax disputes, since these disputes involve tax liabilities for earlier years.

Prepayment has precedents at both the state and federal levels. It is currently required by the IRS if the taxpayer decides to appeal to the federal district court or court of claims rather than to tax court. In fact, DOR currently has a prepayment regulation on the books that requires payment of estimated severance taxes but it only applies to the returns for the years after 1984 (14 AAC 55.165). (It also only addresses the issue of oil valuation, not

transportation assessments.) The regulation requires prepayment of an average amount owed by all taxpayers; it does not relate to actual assessed tax liability. This regulation only applies to the severance tax and does not capture back taxes owed under the two corporate income taxes.

A form of prepayment was also a provision of the state's former separate accounting law (in effect for the years 1979-1981). Since the language was vague on whether audited amounts were covered, DOR never enforced the statutory prepayment requirement for the assessed amounts. In enacting this prepayment provision, it is likely that the legislature did not foresee the need for extensive audits and the resultant lengthy dispute resolution process. However, the former prepayment provision can certainly be thought of as a precedent for the kind of prepayment advocated here, especially since the language was never contested by the taxpayers.

The Department of Law has informally advised that there are no legal problems with prepayment. A comprehensive and formal opinion, prepared by both the attorney general's office and the Department of Revenue, is expected early next week.

## VI. Conclusion

The legislature should provide by statute for prepayment of audited tax amounts at a set point in the resolution process. This will insure the state receives its

share of oil revenues in a more timely manner and also protect the taxpayers from any initial auditing errors.

Such a prepayment requirement should not be viewed as an additional burden to the oil companies since the revenue that could be raised does not come from implementing new taxes; rather, it is revenue the state should have already received.

ALASKA DEPARTMENT OF REVENUE  
APPEALED TAX ASSESSMENTS BY APPEAL LEVEL

January 6, 1986

TAX TYPE	STATUTE	VALUE			
		OF ACCOUNTS	CONFERENCE	FORMAL	COURT
OIL & GAS CORP INC	AS 43.21	\$524,163,096.65	\$438,358,422.69	\$85,804,673.96	\$ .00
OIL & GAS PRODUCTION	AS 43.55	321,697,462.15	300,848,926.97	20,848,535.18	.00
CORPORATE INCOME	AS 43.20	62,432,449.81	47,639,282.76	13,773,965.93	1,019,181.12
INDIVIDUAL INCOME	AS 43.20	2,844,081.31	2,828,965.29	15,116.02	.00
BUSINESS LIC GR RCPT	AS 43.70	2,686,323.31	1,777,731.64	524,300.37	384,211.30
FISHERIES	AS 43.75	1,925,335.87	1,150,173.69	775,162.18	.00
MOTOR FUEL	AS 43.40	1,525,206.60	970,498.59	554,708.01	.00
MINING	AS 43.65	828,697.24	828,697.24	.00	.00
OIL & GAS PROPERTY	AS 43.56	385,779.18	9,321.98	.00	376,457.20
FIDUCIARY INCOME	AS 43.20	183,636.52	183,636.52	.00	.00
SALMON ENHANCEMENT	AS 43.76	42,535.97	29,618.97	12,917.00	.00
ESTATE	AS 43.31	30,840.49	30,840.49	.00	.00
SEAFOOD MARKETING	AS 16.51	8,119.55	8,119.55	.00	.00
INDIVIDUAL WITHHOLD	AS 43.20	7,610.85	7,610.85	.00	.00
TOBACCO (CIGARETTE)	AS 43.50	4,487.22	4,487.22	.00	.00
WHSL CANNED SALMON	AS 43.80	2,250.00	2,250.00	.00	.00
LIQUOR EXCISE	AS 43.60	485.13	485.13	.00	.00
COIN OPERATED DEVICE	AS 43.35	.00	.00	.00	.00
<b>TOTAL TAX ACCOUNTS RECEIVABLE</b>		<b><u>\$918,768,397.85</u></b>	<b><u>\$794,679,069.58</u></b>	<b><u>\$122,309,478.65</u></b>	<b><u>\$1,779,849.62</u></b>
PERCENT OF TOTAL VALUE		100.00%	86.49%	13.31%	0.20%

TAX TYPE	STATUTE	NUMBER			
		OF ACCOUNTS	CONFERENCE	FORMAL	COURT
OIL & GAS PRODUCTION	AS 43.55	496	413	83	0
CORPORATE INCOME	AS 43.20	405	314	82	9
INDIVIDUAL INCOME	AS 43.20	253	243	10	0
MOTOR FUEL	AS 43.40	153	92	61	0
FISHERIES	AS 43.75	54	41	13	0
BUSINESS LIC GR RCPT	AS 43.70	42	32	8	2
OIL & GAS CORP INC	AS 43.21	36	21	15	0
SALMON ENHANCEMENT	AS 43.76	20	18	2	0
MINING	AS 43.65	8	8	0	0
SEAFOOD MARKETING	AS 16.51	7	7	0	0
FIDUCIARY INCOME	AS 43.20	7	7	0	0
INDIVIDUAL WITHHOLD	AS 43.20	5	5	0	0
OIL & GAS PROPERTY	AS 43.56	5	4	0	1
WHSL CANNED SALMON	AS 43.80	3	3	0	0
TOBACCO (CIGARETTE)	AS 43.50	2	2	0	0
ESTATE	AS 43.31	2	2	0	0
LIQUOR EXCISE	AS 43.60	1	1	0	0
COIN OPERATED DEVICE	AS 43.35	0	0	0	0
<b>TOTAL TAX ACCOUNTS</b>		<b><u>1,499</u></b>	<b><u>1,213</u></b>	<b><u>274</u></b>	<b><u>12</u></b>
PERCENT OF TOTAL ACCOUNTS		100.00%	80.92%	18.28%	0.80%

II.

OVERVIEW OF ISSUES  
PERTAINING TO HB 353

### I. What does HB 353 do?

- A. HB 353 would reinstate separate accounting as the method that the oil industry must use to compute income earned in Alaska to determine its income tax liability to the state.
- B. HB 353 returns the nominal severance tax rate from 15% to its pre-1981 level of 12.25%. The nominal rate was raised in 1981 at the same time that separate accounting was repealed in order to compensate for the loss in tax revenue anticipated at the time due to implementation of modified apportionment.

### II. Summary

- A. HB 353 will insure that the state receives its fair share of Alaskan oil wealth. The industry's share has increased since the 1981 tax changes while the state's share has decreased. The changeover has cost the state approximately \$850 million from FY82 through FY86 and an additional \$1.4 billion can be raised from FY87 through FY2005 if the state returns to its pre-1981 tax structure.
- B. The Alaska Supreme Court has found that separate accounting is constitutional in every respect. The court even declared that it is a better measure of oil industry income in Alaska than formula apportionment. The US Supreme Court essentially concurred in this decision on January 13, 1986, when it refused to review the industry's appeal of the state court's ruling.
- C. Separate accounting is a fairer tax because it will lower the income tax on less profitable investments like marginal field exploration and development and raise the income tax on highly profitable fields like Prudhoe Bay (i.e., conventional recovery in the Sadlerochit reservoir). The industry can afford a higher income tax on Prudhoe because it made as much in FY 85 as it made in FY 82 (about \$6 billion in real terms) even with the downward price spiral. Additionally, the income tax increase on Prudhoe would be coupled with a 22% severance tax decrease under HB 353.
- D. Future tax policy should be directed by the overwhelming importance of Prudhoe Bay to our revenue stability. Even with marginal field development, Prudhoe is still expected to provide almost 80% of production through 2010. Almost two thirds of recoverable reserves in Alaska are found in Prudhoe.

### III. Background

- A. After four years of comprehensive study, the 1978 legislature changed the method of accounting that oil companies must use to compute their corporate income tax liability from formula apportionment to separate accounting.

It was determined that separate accounting would more accurately reflect how much of an oil company's income is earned in Alaska.

B. The constitutionality of separate accounting was quickly challenged by the major oil companies in Arco v. State. The 1981 legislature was faced with the threat of having to refund about \$9 billion in 1985 when resolution of the litigation was expected. In response to this threat, the legislature repealed separate accounting and enacted modified apportionment in its place. In 1983, an Anchorage superior court judge ruled that separate accounting is constitutional. This decision was unanimously upheld by the Alaska Supreme Court in August, 1985. It was again upheld this past Monday, January 13, 1986, when the US Supreme Court refused to review the industry's appeal of the state supreme court's ruling, thus ending the lawsuit.

C. Definitions:

1. Formula apportionment: If a firm operates in several states and one of the states wishes to tax its income, a method must be chosen to determine how much income was actually earned in the taxing state. The formula apportionment method looks at the firm's worldwide income and, by use of a formula, attributes part of it to the taxing state. The standard formula uses three indicators of business presence in the state: payroll, property and sales.
2. Modified apportionment: This is a modified version of formula apportionment. It is different because of the substitution of the extraction factor for the payroll factor since the former is a better indicator of oil industry presence in Alaska. The extraction factor helps to determine income from oil production by measuring the amount of a company's in-state production activity. Since in Alaska production is far more prevalent than marketing and refining, modified apportionment more accurately determines oil company income and profitability in Alaska than does the standard formula apportionment method.
3. Separate accounting: This method does not use a formula to carve out a portion of worldwide income and attribute it to Alaska. Instead, it takes the wellhead value of oil (gross income) in Alaska and deducts from it all the costs of production to arrive at net income. This amount is then taxed at the same corporate income tax rate that all other non-oil businesses pay. Because it is considered by many to be the most accurate way to measure the value of oil production activity it comes closest to measuring income earned only in Alaska, and therefore, the income of oil companies directly attributable to business activities in Alaska.

IV. What important issues are involved in deciding whether to enact HB 353?

- A. Is separate accounting a better, fairer way to tax the oil

industry in Alaska?

- B. Will HB 353 discourage further exploration and development of new oil fields in Alaska?
- C. Will HB 353 destabilize Alaska's business climate?
- D. How will a return to separate accounting affect our tax revenues?
- E. How will a reduction in the severance tax affect our tax revenues?
- F. How will the inevitable decline in Prudhoe Bay production affect Alaska's revenue picture?
- G. Should the legislature consider any other changes to our oil & gas tax structure?
- H. What is the current status of Arco v. State?
- I. Was there a conspiracy in 1981?
- J. How healthy is the oil industry at present?
- K. How does taxation of the oil industry in Alaska compare to taxation of the industry in other states and at the federal level?

These questions are answered in the following sections.

V. Is separate accounting a better and fairer tax accounting method for Alaska?

- A. This issue poses two major questions: (1) Which method -- separate accounting or formula apportionment type of accounting -- best measures the amount of income earned within the taxing state? A fair tax will only apply to income earned in that particular state. (2) What is Alaska's "fair share" of the oil wealth provided by our oil resources?
- B. Question #1 was answered by the legislature in 1978, again by Alaska courts in both 1983 and 1985, and again by the US Supreme Court last Monday. In August, '85, the Alaska Supreme Court stated that separate accounting is the prevailing method throughout the United States for reporting income from oil production because it conforms more to an oil company's financial accounting procedures and "more accurately reflects income than formula apportionment. ...[T]he Alaska legislature turned to separate accounting for oil producing businesses only after it determined that the use of formula apportionment to compute Alaska's share of oil production income would

seriously underestimate the production income that was rightly subject to taxation by this state (emphasis added)." The Court noted further that the case of Sohio is the best illustration of the superiority of separate accounting as a means of allocating income earned in a particular jurisdiction. During the period 1978-80, Sohio maintained that only 10% of its payroll, 12% of its sales and 50% of its property were in Alaska. Yet its 1980 annual report states that over 90% of its total oil production derived from reserves in Alaska. Additionally, documents submitted to the Court (and not disputed by the companies) indicate that Sohio's earnings had elevated it from 17th to 7th industrywide. So, the Court concluded, "... the traditional formula apportionment method would inadequately reflect the phenomenal value of the companies' oil reserves in Alaska."

C. Separate accounting is also superior to modified apportionment because it taxes conventional recovery at Prudhoe Bay more heavily than less profitable ventures, such as new technology applications at Prudhoe, and exploration and development in marginal fields. These less profitable ventures will actually experience an income tax reduction under separate accounting, just as Prudhoe will experience a tax increase. Prudhoe can afford to pay more taxes and still be highly profitable. A 1984 Institute of Social & Economic Research (ISER) study found that Prudhoe had made the companies about \$9 billion in net profits and that its 1982 profit rate hovered around 25%. But some of the riskier investments that industry is making in Alaska that are expected to yield a less-than-average profit could use an additional tax break. This would be a much more equitable approach than modified apportionment which taxes all industry activities at approximately the same rate regardless of risk and expected profit.

D. With regard to question #2, Alaska's fair share should be thought of principally in philosophical terms rather than only in terms of numbers. The following comments were made in a joint statement from the Governor and the legislative leadership in March, 1981: "[A]ny significant decreases in State oil and gas revenues appear both unwarranted and unsupported by the majority of Alaskans. The State's current level of taxation ... provides that both the oil companies and the federal government will receive greater shares of Alaska's wealth than will Alaskans. Accordingly, any greater percentage granted the former at the expense of the latter would be inequitable ... All agree that any changes [to the tax code] that would give large sums of money to the oil industry at the expense of the people of Alaska are unacceptable." These statements express the philosophy behind Alaska's oil and gas tax code and provide a framework for determining if Alaska receives its fair share of the oil wealth. They continue to be relevant in 1986.

E. With this philosophy firmly in mind, consider a "shares" analysis prepared by economist Eban Goodstein in mid 1985. He found that in FY82, shares of oil wealth in Alaska were divided as follows: industry - 41%, federal government - 30%, and state government - 29%. By FY85, the shares had shifted such that industry received 50%, the federal government received 22% and the state received 27%.

F. Alaska is not receiving its fair share as defined by the Governor and the legislature in 1981 because its share has declined while the oil industry's share has increased. Goodstein's analysis further suggests that the change from separate accounting to modified apportionment was one of the reasons why Alaska's share diminished and the industry's share increased. His study concludes that if separate accounting had not been repealed, the FY82 shares would have been 42% industry, 30% federal government and 28% state government while the FY85 shares would have been 47% industry, 21% federal government and 33% state government. A shares analysis prepared by the House Research Agency in December, 1985, compares closely with the Goodstein analysis for the years FY82 through FY85.

#### VI. Will HB 353 discourage exploration and development?

A. The major determinants of a company's decision to explore and develop a particular oil field are availability of the oil, the price of oil, and the cost of production in that particular field. These factors determine the rate of return which in turn determines whether or not a field will be explored or developed. Since a state's tax rate is only one aspect of the cost of production, and the cost of production is only one factor in the rate of return equation, it follows that the tax rate can only play a small role in the company's final decision to explore or develop. Although taxation may have a psychological affect on a company's decision, it will rarely be the principal factor in the decision making process. The overall rate of return is the ultimate decision maker and the rate of taxation plays only a small part in determining that rate of return. As the ISER report states: "[F]our factors are typically more important than state tax rates in shaping the pattern of resource development." These factors are described as geologic good fortune, ownership of the mineral rights, cost environment and world energy prices.

B. Unlike formula or modified formula apportionment, separate accounting only taxes a company on profits made in Alaska. In fact, a company will only pay a tax on profitable fields in Alaska so that if it has production activity at Prudhoe Bay and exploratory activities elsewhere, it will only pay taxes on the Prudhoe production activity because it does not yet derive any income from its exploratory work. Moreover, separate accounting would allow the company to deduct its

exploratory expenses from its Prudhoe tax liability. Apportionment, on the other hand, taxes a portion of a company's worldwide income so the company will pay taxes in Alaska even if all its profits were made elsewhere and even if its Alaskan activities operate at a loss. Separate accounting, then, is a better incentive for exploration and development since a company will not pay taxes until the field it is exploring or developing starts to produce and generates a profit. In a letter to the House Finance Committee, ISER economics professor Matthew Berman explained this effect as follows: "[S]eparate accounting...has virtually no adverse effect on development of marginal fields. A firm ...will make the investment only if it expects such development to be profitable after subtracting all taxes. Under... separate accounting... the proposed investment...will generate a tax liability...only if the investment is profitable anyway." Berman continues, "Corporate income taxes assessed under the modified apportionment system... may have some adverse effects [because] any investment, profitable or not, will generate an Alaska income tax liability." Berman reaches the same conclusion for exploration of marginal fields. A mid 1985 issue of Pacific OCS News, a trade journal, made a similar observation about Conoco's development of Milne Point: "The start up of this field begins a new era of marginal, N. Slope projects ... If the state returns to the pre-1982 'separate accounting' tax methods, it could offer a significant incentive to this type of small development, because it would be taxed on its own profitability and not on the companies' national profit base."

C. Exploration and development takes place in many jurisdictions that require separate accounting. Foreign nations, the US Government, Oklahoma, Louisiana and Mississippi all utilize separate accounting and all have experienced exploration and development activity.

D. Although the industry indicated to the legislature last session that a return to separate accounting would hamper their exploration and development activities in Alaska, their annual reports appear to lead their shareholders to a much different conclusion. Take, for example, the annual reports of ARCO from 1978 to 1981, the years that separate accounting was on the books. In 1978, ARCO's earnings were up 15%; in 1979, they were up 45%; in 1980, they were up 42%; and in 1981, they were up slightly again. "As it was in 1978", ARCO informed its shareholders, "the North Slope of Alaska was a prime source of the Company's earnings improvement in 1979." Clearly, separate accounting did not interfere with its earnings nor its exploration and development plans. These plans were in fact expanded dramatically during the separate accounting years. The 1979 annual report states: "For its part, Atlantic Richfield has dramatically intensified its search for new domestic reserves of oil and gas." Exploration and development occurred within Alaska during

these years. For example, Kuparuk development was started in 1979 and completed in 1981, "three months ahead of schedule", according to the 1981 ARCO annual report. Surprisingly, the first year that ARCO complains about its tax burden to its shareholders is 1982 -- a full year after Alaska repealed its separate accounting statute.

E. According to economist Goodstein, the oil companies made so much money in Alaska between 1982 and 1985 that \$24 billion in profits went outside. According to ARCO Alaska president Harold Heinze's remarks to the Committee last spring, the industry has invested about \$6 billion in Alaska during this period. Perhaps more of the \$24 billion that went outside would also have been invested in Alaska if separate accounting had been on the books to encourage marginal exploration and development without paying taxes.

F. HB 353 should also encourage exploration and development because it reduces the amount of severance tax that a company would pay. As Vince Wright with the Department of Revenue pointed out to the House Finance Committee in May, 1985, "On the severance tax side ... what you have done is lowered the rate from 15% to 12.25% so in fact ... this might be more of an inducement to expand exploration." For fields that have a 15% rate now, HB 353 would result in a 22.4% reduction in severance taxes.

VII. Will HB 353 create an unstable business climate for the oil industry in Alaska?

A. Since HB 353 will encourage exploration and development, it should make Alaska's business climate even more attractive to the industry.

B. Since 1955, the state's oil tax structure has been through eleven major changes. HB 353 must be viewed in this historical context. A state's tax code should be dynamic and flexible as well as a reflection of a state's changeable economic picture and public policy goals.

C. HB 353 does not create any new taxes. It merely reinstates taxes that were on the books before 1981. Moreover, separate accounting was repealed in 1981 largely because of the threat posed by the lawsuit. The US Supreme Court has laid that issue to rest and HB 353 merely returns our system to its pre-1981 state. The House floor debate on the 1981 amendments indicates that a bill like HB 353 was in fact anticipated. Consider the comments of the majority leader in the House at the time the amendments were enacted: "[B]y that time... we should have an answer to that lawsuit. And with that answer, we should be able to develop possibly a more consistent taxing policy at that time." Apparently it was expected that the legislature would reconsider its oil and gas tax structure

once the constitutional status of separate accounting was determined.

D. It is perhaps more appropriate to view the legislature's 1981 action as the one that created an unstable business climate. This is especially true in light of the fact that the 1981 revisions did create an entirely new method of accounting for income tax liability. Modified apportionment is not used by any other state that relies heavily on oil production activity. And, whereas separate accounting was adopted only after four years of careful, comprehensive study of all tax possibilities, modified apportionment was adopted with little analysis and hardly any debate.

E. Another way to look at stability is from the state's point of view. A stable revenue stream to provide necessary public services is just as important to Alaskans as maintaining a stable business climate. This is especially true in light of the fact that government dollars in large part determine the health of Alaska's economy. The 1981 amendments destabilized our revenue stream because they reduced our share of the oil money. HB 353 returns us to the old system, returns us to our pre-1981 share of the wealth, and, therefore, stabilizes our revenue stream.

#### VIII. How will a return to separate accounting affect our tax revenues?

A. The Department of Revenue's 10/31/85 fiscal analysis of HB 353 shows that, according to the mean revenue projections, the bill would increase our tax revenues by about \$1.4 billion between FY87 and FY2005. (A new fiscal analysis from DOR is expected in early 1986 that will analyze the impact of the TAPS settlement on the tax structure proposed in HB 353.) Beginning in FY2000, the DOR fiscal note predicts that the state would make less from separate accounting and the lowering of the severance tax than if the higher severance tax and modified apportionment were in effect. This is because of Prudhoe's decline in relation to profits companies will make elsewhere in the world.

B. It is disturbing to note that the Department's analysis shows that the 1981 tax changes have cost the state approximately \$850 million in tax revenues from FY82 through the end of the current fiscal year.

#### IX. How will the proposed severance tax affect our tax revenues?

A. Because HB 353 lowers the nominal severance tax rate from 15% to 12.25%, severance tax revenues are reduced. However, because of the separate accounting impact, overall tax revenues are increased (see previous section). The DOR fiscal note shows that if the nominal rate was not reduced in HB 353,

the state would gain an additional \$1.5 billion between FY87 and FY2005 or a total additional gain of approximately \$2.9 billion from reimposition of separate accounting and leaving the nominal severance tax rate at 15%.

B. It is important to understand another impact of reducing the nominal severance tax. The actual severance tax paid by the taxpayer depends on the economic limit factor (ELF). When applied to the nominal rate, the ELF reduces the effective rate and therefore the actual amount of severance tax that is paid to the state. Beginning in FY88 when Prudhoe production starts to decline, the ELF will cause our severance tax receipts to decline dramatically because it will lower our severance tax revenues from Prudhoe considerably. According to DOR's June 1985 revenue forecast, FY88 severance tax receipts will be \$230 million less than FY87 receipts. Since HB 353 drops the nominal rate, that change in combination with the ELF will increase the \$230 million drop by another \$143 million, according to calculations made from OMB data.

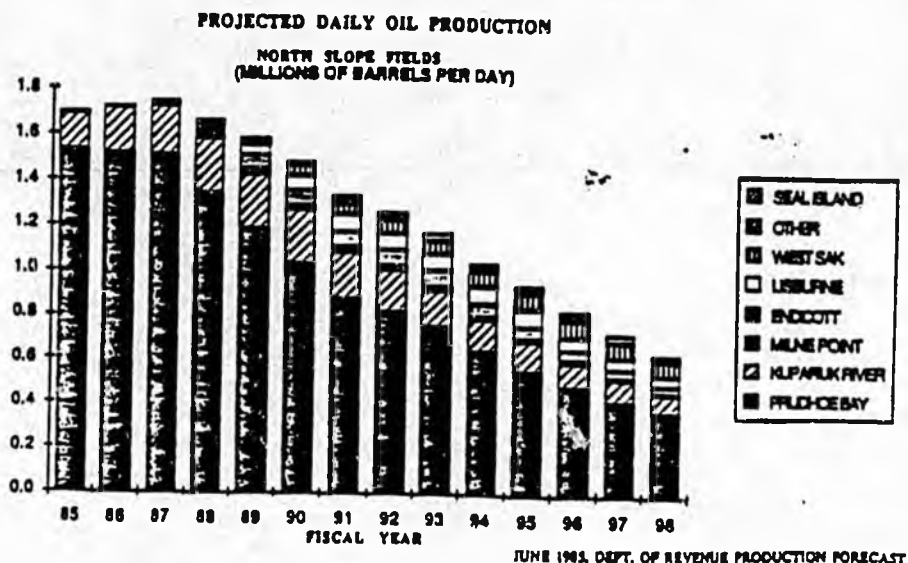
C. An OMB analysis indicates that repeal of the ELF could bring the state an additional \$2.4 billion in revenues from FY87 to FY94.

D. The ELF was developed because it was thought that the burden of the severance tax would tend to close a field down before all the oil was taken out of it. The ELF is designed to prolong the life of a field -- and therefore stretch oil revenues out further over time -- by lowering the tax burden when the field is not producing very much oil. But in its 1984 report, ISER concluded that the ELF does not do a very good job of stretching out our revenues; in fact it only adds an additional year or two to the revenue stream. However, the report does conclude that the ELF is valuable as an incentive to explore and develop marginal fields. This is because marginal fields generally have lower production rates per well, so that the ELF significantly lowers their actual severance tax burden. These conclusions suggest that further consideration of the ELF's impact on revenues and production is warranted and that it should be looked at on an individual field basis since it may encourage production where there otherwise might not be any, such as in a marginal field, but may not have its intended effect on a very profitable field, such as Prudhoe Bay. (Another chapter of this report deals specifically with this problem and proposes one solution to it.)

**X. How does the decline of Prudhoe Bay affect our revenues?**

A. Prudhoe Bay production to date far outweighs production from any other field in Alaska. The ISER study shows that of the 3.6 billion barrels of oil produced in Alaska from 1959 to 1983, about 3.2 billion of those barrels -- or 90.3% came out of Prudhoe even though the field did not start production

until 1977. ISER also forecast production in the future and found a similar pattern. Using ISER's base case assumptions (real wellhead price of \$17.50 per barrel, declining TAPS tariff, and no change in the federal or state tax structure), of the 8.9 billion barrels likely to be produced between 1983 and 2010, about 6.9 billion -- or 79.4% -- will come from Prudhoe. These figures show that the Prudhoe Bay field is extremely important to Alaska's revenue stability. One draws the same conclusion from the following chart, which depicts production for FY85 through FY98.



B. As Prudhoe declines then, so do our revenues. What is perhaps less apparent is that analysis of future oil production shows that even if all the currently known marginal fields are developed, their combined production cannot make up for the decline of Prudhoe. Lease, tax, and other revenue from development of these fields will not come close to providing Alaska with the wealth it now receives from Prudhoe Bay. As Kay Brown, Director of the Division of Oil & Gas stated to the Permanent Fund trustees, "[B]ased on current knowledge, it is unlikely that new oil and gas discoveries from state lands alone will be sufficient to offset the decline in the main Prudhoe Reservoir. Most of the remaining best prospects appear to be in federal waters and perhaps in the Arctic National Wildlife Refuge." The Division of Oil &

Gas estimates that about 62% of recoverable state reserves in Alaska are in the Sadlerochit (Prudhoe Bay) reservoir.

C. The importance of Prudhoe to our revenue stability should be a driving force in determining the future of Alaska's oil and gas tax structure. It is certainly a valid public policy goal to tax the tremendous profits of Prudhoe Bay. Policy makers should not forget that revenue from production in new fields is not going to make up for the loss of Prudhoe Bay revenues. The \$24 billion in profits that the companies took out of Alaska in the last four years is gone forever; it would be a mistake to continue encouraging them to take their money elsewhere.

D. Although much of Alaska's oil reserves lie off shore, development of these resources will not be a panacea for the decline of Prudhoe, either. These resources are owned by the federal government and therefore, most tax and other revenue benefits will flow back to the feds, not to the state. The only taxes that the state will get are property taxes from onshore facilities. It will not get any lease payments (except from 3-6 miles offshore if President Reagan approves a bill that may be taken up again by Congress in early 1986).

#### XI. Should any additional changes to the tax code be considered?

A. Ideally, the Alaskan tax code will provide revenue stability to the state even when market forces bring about lower oil prices and even when the quantity of oil in Alaska that can be taxed diminishes. Measuring price and quantity sensitivity is not easy, however.

B. Section VI discusses the fact that separate accounting is a better incentive for exploration and development than modified apportionment because it only requires the payment of taxes when a field is profitable. Many economists believe that a state can facilitate exploration and development of marginal oil fields if it increases the reliance on income taxes and decreases the reliance on severance taxes in the marginal fields. In other words, the state should consider emphasizing taxation of net income instead of gross income in marginal fields. For this reason, Professor Berman concludes that, for marginal fields, net income taxes and net profit shares in leases are superior to excise (such as severance) taxes and royalty shares in leases because a company shares profit with government, not income that just covers expenses. Although 1986 may not be the appropriate time to consider a complete overhaul of our tax and leasing policies, some comprehensive changes may eventually be desirable.

#### XII. What is the current status of ARCO v. State?

A. The Alaska Supreme Court ruled unanimously in the state's

favor on August 16, 1985. The decision fully supported the state's position that separate accounting is constitutional in every respect.

B. In fact, the Supreme Court went even farther than it had to in upholding the lower court's decision. Instead of stating that separate accounting was an acceptable method of tax accounting, it stated that, for Alaska, separate accounting is preferable to formula apportionment. (See section V for further details.)

C. The oil companies declined to petition the Alaska Supreme Court for a rehearing of the case. In November, 1985 they appealed the decision to the US Supreme Court. The justices declined to take the case on January 13, 1986, thus ending the lawsuit.

D. Though the industry challenged the use of separate accounting in Alaska, it has argued strenuously to be allowed to use it in other states. In at least two states, Wisconsin and South Carolina, the industry took their arguments to the top levels of the court system -- to the state supreme court in South Carolina and to the US Supreme Court in the Wisconsin case. Also, before Prudhoe Bay was in the production stage, the industry tried to file separate accounting returns in Alaska. This demonstrates that the industry is interested in separate accounting when it lowers its tax burden; in other words, when its operations in a state are less profitable than the industry average.

### XIII. Was there a conspiracy in 1981?

A. It has been suggested that the oil companies and the Department of Revenue conspired to convince the legislature to enact amendments in 1981 that substantially lowered our fair share of Alaskan oil wealth. Although this point of view is strengthened by the fact that the 1981 amendments now appear to have cost the state about \$850 million, an analysis prepared by OMB suggests that there probably was no conspiracy. The fiscal information provided by the companies to the department, which in turn was used to prepare the legislation's fiscal note, has turned out to be wrong. But it does not appear likely that wrong information was intentionally provided. According to Gregg Erickson, Senior Economist at OMB, "I know of no evidence which would positively rule out the possibility that this discrepancy resulted from an effort to mislead; ... a more plausible explanation is that the oil company experts simply goofed."

B. Although the above information is interesting, what did or did not happen in 1981 should not be the motivation for a

return to our pre-81 tax structure. Rather, the motivating forces should be such aspects of HB 353 as the superiority of separate accounting as evidenced by the recent court ruling, its incentives for exploration and development, and the goal of restoring Alaska's fair share of the wealth created by our abundant oil. In this context it is interesting to note that when the legislature enacted the 1981 changes, it did not repeal the findings section of the original 1978 statute which stated the superiority of separate accounting over an apportionment method.

#### XIV. Is the oil industry healthy?

A. It would certainly appear that Exxon is healthy. A recent Business Week article made the following observations: "The only surplus at Exxon Corp. is a surplus of cash. ... The bottom line is that Exxon can make a nice living even if the price of oil falls quite a bit more. ... Salomon Bros. estimates that Exxon will have as much as \$7 billion in spare cash to spend through 1988. ... In fact, Exxon's real limitation is not a lack of money but of enough places in which to invest it profitably." Because prices are down right now, Exxon is frugal with investments and cautious about the future. But it is hardly suffering and couldn't be accurately characterized as anything but very healthy.

B. The legislature commissioned a report by Tanzer Economic Associates, Inc. in 1977. Among other things, the report examined many historical examples of tax changes throughout the world. It concluded that "there is one effect almost invariably caused by such tax changes. Namely, an almost automatic reaction of the oil companies to claim that such increased taxation will force them to look elsewhere for increased future production. These claims are sometimes backed up by actions, aimed at getting the country to rescind the tax increase, such as temporarily cutting present production or reducing exploration and development efforts. ... Some of the actions and much of the rhetoric ... is 'theater', aimed at improving a bargaining position, and often needs to be taken with a very large grain of salt." One can infer from this observation that the industry will often exaggerate how it will be affected by a tax change in order to keep the change from occurring.

C. In 1985, the industry uses the current production surplus and price decline pattern as justification for laying off hundreds of Alaskans and cutting daily rates paid to the various oil industry support companies that operate on the Slope. Not surprisingly, it also comes to Juneau and complains bitterly about HB 353, implying that the bill is forcing it to cut back and to consider leaving Alaska. Industry testimony is difficult to accept since we know it is not leaving Alaska, with our Prudhoe bonanza and our

undeveloped reserves, and since we know that HB 353 provides the proper incentives to stay. It becomes even harder to accept when one considers the major factor that explains the majors' current restructuring efforts. Because of falling world oil prices, the fear of takeover is prevalent in industry thinking and the desire to cut costs to a minimum is really motivated by the need to have enough cash around to prohibit an unfriendly takeover (or in the case of some majors, to acquire less healthy companies). Furthermore, declining oil prices is a major factor in the majors' cut backs in exploration activity.

XV. How does taxation of the industry in Alaska compare to taxation in other states and at the federal level?

A. Of the top five oil producing states -- Alaska, California, Texas, Oklahoma and Louisiana, two currently require the use of separate accounting to determine income derived from oil production. These states are Louisiana and Oklahoma. California utilizes formula apportionment and Texas does not have a corporate income tax. (Actually California does require separate accounting in cases where formula apportionment under represents income generation within the state.) In addition, the United States government requires the use of separate accounting in certain instances. Moreover, President Reagan has recently taken an active stance against formula apportionment based on worldwide combination. Since apportionment taxes a portion of a company's worldwide income, some important US trading partners oppose it because they feel that American states take tax dollars away from them. Thus, Reagan has asked Congress to prohibit the use of this kind of formula apportionment at the state level.

B. Another way to compare taxation of the industry in Alaska to industry taxation elsewhere is to compare how much is collected by states from the whole tax code and leasing structure, not just the income tax. The ISER study compared tax and leasing policies in Alaska to such policies in Texas and concluded that "... Alaska and Texas collected approximately the same amount of revenue from oil and gas production." This is interesting because the tax and leasing structure in Texas and Alaska are very different yet, essentially, industry is treated the same. Alaska should not be judged by whether it has a separate accounting or a formula apportionment based income tax but rather by how its policies as a whole impact the oil industry.

XVI. Conclusion

A. HB 353 is well constructed tax reform legislation. It is an attempt to restore Alaska's fair share of the oil wealth to provide Alaskans with desired public services, provide an atmosphere that encourages the oil industry to remain in Alaska, and return Alaska's tax structure to the exhaustively

studied and carefully refined one that existed before it was challenged by the oil companies in the late 1970s.

III.

THE SEVERANCE TAX AND THE  
ECONOMIC LIMIT FACTOR

## I. Introduction

It is generally known that oil producers in Alaska are assessed severance tax rates of 12.25 or 15 percent. However, it may not be so well known that the actual tax rates they pay are much lower than this because of the economic limit factor or ELF. (A severance tax or production tax is a flat tax based solely on the amount produced; in contrast, an income tax is based on profits.)

The ELF is a statutory reduction to the severance tax. It was adopted in 1977<sup>1</sup> to promote production on oil and gas fields with low output and presumably little profit. As the cost of producing the oil gets closer to its value -- the economic limit -- the ELF reduces the tax that is owed. When a field reaches the economic limit the ELF reduces the severance tax to 0. The ELF is applied to both oil and gas, but this discussion deals only with oil.

In practical terms, the ELF dramatically reduces the state's base severance tax rates of 12.25% or 15% on all fields. Prudhoe Bay is a temporary exception to this

---

<sup>1</sup>In anticipation of North Slope production, the Department of Revenue recommended the ELF in its exhaustive 1977 study: "Alaska's Oil and Gas Tax Structure: A Study with Recommendations for Improvement." Previously a "stair-step" approach to severance taxes was used, keyed to Cook Inlet production, with graduated rates to 8 percent. The ELF improved upon the stair steps, retaining the idea that the tax should be reduced as production declined. The ELF also was able to adjust tax rates for both high-volume North Slope fields and the lower-volume Cook Inlet fields.

because of a provision that suspends the ELF for 10 years on high volume fields. However, in FY 88 the 10-year limit expires and Prudhoe will also enjoy tax concessions of the ELF -- and the state will lose \$156 million, according to OMB calculations (see Attachment A). Another example is Kuparuk. In FY 86 the ELF reduced Kuparuk's effective severance tax rate to 6%, and the state lost \$58 million.

An unforeseen consequence of the ELF is that it will greatly reduce the severance tax rates on most of the fields that have yet to begin producing. For example, in FY 90 the effective severance tax rate for Lisburne will be 3% and for Endicott it will be 4%. These cases show that the ELF is actually providing these marginal fields with a substantial incentive -- reducing costs at field start-up.

The ELF's original goal was to extend the life of fields, and thus extend revenues to the state. However, one study shows that the ELF only prolongs a field's life for one or two years, thus its direct benefit to the state is limited. Nonetheless, the ELF does appear to provide an incentive to developers of marginal fields because it reduces the severance tax rate. If the ELF were eliminated, for example, it is likely that some of the marginal fields would not be feasible to develop.<sup>2</sup>

---

<sup>2</sup>In a study entitled "Alaska North Slope Oil Production and Revenue Projections" published Feb. 1985 by the Institute of Social and Economic Research, author and UAA economist Matthew Berman concluded that the Endicott and Milne Point fields might not be feasible to develop without the ELF.

It's also apparent that fields with substantial output and correspondingly high profit rates, such as Prudhoe and Kuparuk, do not require the production incentive that the ELF provides.

## II. How the ELF Works

The ELF is a formula that is multiplied by the nominal rate of 12.25% or 15% to obtain the effective rate actually applied to a field. The ELF will never be more than 1. If the ELF is 1, then 100% of the severance tax is owed. An ELF of .8 means 80% of the tax is owed; 80% of 15% equals an effective tax rate of 12%.

Since 1981 the severance tax rate has been 15%, with an exception for new fields; fields that start producing after June 30, 1981 pay a reduced rate of 12.25% for the first five years. The law also requires that the ELF be calculated at 1 during the first 10 years of a field's production any time the ELF goes above .7. (Currently this provision only affects Prudhoe.) For fields with an ELF at or below .7, the actual ELF used. After 10 years the actual ELF is used in all cases.

For example, the ELF for Prudhoe Bay in FY 85 was .864. Since this is more than .7 and within the first 10 years of production, the 1 figure is used. Thus the full 15% severance tax was owed.

In FY 88, however, the 10-year limit will no longer be in effect for Prudhoe (production began in FY 78) and the actual ELF of .82 will be used. This means the amount of severance tax owed will be 82% of 15%, or an effective rate

of 12.5%. The amount to be paid to the state will be \$714 million, \$156 million less than if the full 15% severance tax were paid.

### III. Modifying the ELF

It is apparent that the ELF accomplishes its goals but not without some drawbacks. One drawback is providing and unnecessary tax reduction for Prudhoe and Kuparuk. Another issue is whether it goes far enough in reducing the severance tax rate on marginal fields. (A problem with a severance tax as opposed to an income tax is that it is not sensitive to profits or costs, thus a fair tax rate for a large field may be a burden for a small field.)

An additional problem with the current ELF formula is that it is based on daily output per well; total field production is not taken into account. This penalizes a marginal field like Milne Point (30,000 bbls/day) which has high output per well but few wells (about 22). Under the current ELF formula Milne is subject to a severance tax rate almost as high as the tax applied to Kuparuk (240,000 bbls/day), which is clearly not a marginal field. For example, in FY 88, Milne Point will be paying a 7.35% severance tax compared to Kuparuk's rate of 7.6%.

Instead of basing the ELF on individual wells, total field production could be included in the ELF formula to compensate for this inequity, keeping the severance tax low on the smaller fields that would benefit most from a tax break.

The ELF could be modified to accomplish these goals:

-- Dramatically reduce the effective severance tax rates for all marginal fields, including Cook Inlet.

-- Prevent a premature reduction to the severance tax rates for Prudhoe and Kuparuk. These highly profitable fields are years away from being marginal. When they do start approaching the economic limit, the ELF formula will provide them with a tax break.

-- More equitably set the tax rate for each field.

This formula modification would bring Prudhoe's ELF to .99 (now it is at .83); raise Kuparuk's to .8 and drop Milne Point's to .3. These ELFs translate into effective severance tax rates of about 14.85%, 12% and 4.5%.

Here are the current ELFs compared with ELFs under the revised formula.

	Current ELF	Modified ELF	% change
Prudhoe Bay	.80	.99	+23
Kuparuk	.50	.86	+72
Milne Point	.60	.31	-48
Endicott	.31	.0	-100
Lisburne	.11	.05	-54
West Sak	.0	.0	no change
Cook Inlet	.03	.0	-100

The formula change would result in the following positive state severance tax collections\*:

FY	millions	
87	\$ 32	* These numbers, based on June 1985 revenue projections, assume the actual ELF is used in all cases and assume a 15% severance tax rate across the board. (If the 12.25% for the first 5 years were retained, there would be little change in these amounts.)
88	179	
89	192	
90	184	
91	175	
92	173	
93	170	
94	158	

#### IV. What Legislation Would Require

1) Simplify the law so the actual ELF is always applied. Current law requires that an ELF of 1 be used if the actual ELF goes above .7 any time during the first 10 years of a field's production. (AS 43.55.013)

2) Change the ELF formula. (AS 43.55.013) This modification only alters the exponent part of the formula. It uses a different number as a constant and takes into account average daily production from the whole field.

#### Current ELF formula:

$$ELF = \left( 1 - \frac{PEL}{TP} \right) \exp \left( \frac{460 \times WD}{PEL} \right)$$

#### Revised ELF formula:

$$ELF = \left( 1 - \frac{PEL}{TP} \right) \exp \left( \frac{37,000,000 \times WD}{PEL \times TP / \text{Days}} \right)$$

PEL = monthly production rate at the economic limit  
(300 barrels x number of well days a month)  
TP = total production (number of barrels) during the month  
WD = well days in the month  
exp = the expression following this is an exponent  
Days = The number of days in the month for which the tax is to be paid

The numbers 460 and 37,000,000 are constants or scaling factors.

#### V. Conclusion

Enacting these changes to the severance tax would not only maintain our current level of severance tax revenue. More importantly, the revised ELF would provide a new

incentive for future oil exploration and production in Alaska by lowering the severance tax on marginal fields.

ALASKA NORTH SLOPE OIL AND GAS REVENUE

Alaska North Slope Oil Revenue

	Fiscal Years									
	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
June 1985 Net. Rev. Assumptions										
World Oil Price	26.37	24.81	22.41	22.206	22.731	23.464	24.362	25.465	26.934	28.379
Average Rate of Inflation	4.03	3.92	4.01	4.76	4.76	4.76	4.76	4.76	5.104	5.104
ANS/World Qual. & Marketing Adjust	3.253	2.532	2.663	2.639	2.386	2.447	2.475	2.528	2.507	2.612
TransAlaska Pipeline Tariff	6.007	6.007	6.007	6.007	6.007	6.007	6.007	6.007	6.007	6.007
ANS Netback Price 9801 (\$/bbl)	17.11	15.471	13.74	13.56	14.34	15.01	15.00	17.03	18.34	19.76
Prudhoe Bay Prod. (MMbbl/d)										
Prudhoe Bay Price (\$/bbl)	17.11	15.471	13.74	13.56	14.34	15.01	15.00	17.03	18.34	19.76
Wells	460.25	509.6	527.1	540.6	524.05	545.15	489.9	466.45	447.65	420.65
ELF	.0640307	.0496946	.0437062	.0205208	.0041141	.7034653	.7540433	.7491265	.7399201	.7145022
Nominal Tax Rate	.15	.15	.15	.15	.15	.15	.15	.15	.15	.15
Effective Tax Rate	.15	.15	.15	.1230793	.1206171	.1175190	.1131065	.1123690	.1109092	.1071753
Royalty Percentage	.125	.125	.125	.125	.125	.125	.125	.125	.125	.125
SEVERANCE TAX (ELF)	1252.465	1124.336	992.6137	714.2504	656.2593	500.2696	501.3609	490.1035	409.5263	433.5515
SEVERANCE TAX (NO ELF)	1252.465	1124.336	992.6137	714.2504	656.2593	748.6450	664.8966	664.9124	561.5043	606.7602
CONSERVATION TAX	.6100063	.6056140	.6020219	.5349531	.4742719	.4111953	.3489172	.3253633	.3006117	.2550992
Gathering & Cleaning Charge	.7	.72021	.7567550	.7071017	.8245670	.8630172	.9049349	.9400090	.9931351	1.044419
ROYALTIES	1146.023	1020.395	893.2797	700.9031	732.5702	664.7022	597.1494	597.9900	595.9624	547.3410
TOTAL OIL PROD REVENUES	2396.400	2144.731	1805.093	1495.153	1300.029	1245.052	1090.510	1096.102	1005.489	900.0945
Kuparuk River Prod. (MMbbl/d)										
Kuparuk River Price (\$/bbl)	16.29	14.651	12.92	12.74	13.52	14.19	15.06	16.21	17.52	18.94
Wells	154.5	240.5	204	205.25	205.25	205.25	276.5	276.5	254	254
ELF	.69	.4091136	.4697705	.5067938	.5067938	.5067938	.4627634	.4070192	.3771622	.3112742
Nominal Tax Rate	.1275	.1275	.1363	.15	.15	.15	.15	.15	.15	.15
Effective Tax Rate	.004525	.0599164	.0640297	.0760191	.0760191	.0760191	.0694145	.0610529	.0566043	.0466911
Royalty Percentage	.125	.125	.125	.125	.125	.125	.125	.125	.125	.125
SEVERANCE TAX (ELF)	73.43040	56.07173	57.06143	73.92490	70.45092	82.33065	70.11249	59.10602	51.30973	40.30790
SEVERANCE TAX (NO ELF)	106.4326	114.6395	123.1696	145.0670	154.7905	162.4697	151.5003	145.2160	135.9694	129.7502
CONSERVATION TAX	.0666695	.0790430	.0874209	.0954133	.0954133	.0954133	.0830359	.0746539	.0646734	.0570003
Gathering & Cleaning Charge	.4	.4005	.4010006	.4015019	.4020038	.4025063	.4030094	.4035132	.4040175	.4045226
ROYALTIES	121.0719	130.0350	125.0003	134.5436	143.0436	150.3440	140.4323	134.0590	126.5005	120.9324
TOTAL OIL PROD REVENUES	194.5103	186.1075	182.9497	200.4605	221.4945	232.6827	218.5448	193.9650	177.0102	161.3203
Milne Point Prod. (MMbbl/d)										
Milne Point Price (\$/bbl)	17.40	15.041	14.11	13.93	14.71	15.38	16.25	17.4	18.71	20.13
Wells	1	1	21.15	21.15	21.15	21.15	21.15	19.6	17.1	15.6
ELF	0	0	.0092003	.6096111	.6096111	.6096111	.6096111	.6159020	.5978649	.5802759
Nominal Tax Rate	.15	.15	.15	.15	.15	.15	.15	.15	.15	.15
Effective Tax Rate	0	0	.0133920	.0914417	.0914417	.0914417	.0914417	.0951053	.0896797	.0802414
Royalty Percentage	.1625	.1625	.1625	.1625	.1625	.1625	.1625	.1625	.1625	.1625
SEVERANCE TAX (ELF)	0	0	.4621040	0.955726	9.457195	9.087940	10.44720	11.46907	9.232479	8.607079
SEVERANCE TAX (NO ELF)	0	0	5.175901	14.69000	15.51349	16.22000	17.13761	18.35042	15.44242	12.76037



SEVERANCE TAX (11%)	0	0	0	0	0	0	0	0	0	0
SEVERANCE TAX (NO FLW)	0	0	0	0	0	0	0	0	0	0
CONSERVATION TAX	0	0	0	0	0	0	0	0	0	0
Gathering & Cleaning Charge	0	0	0	0	0	0	0	0	0	0
ROYALTIES	0	0	0	0	0	0	0	0	0	0
TOTAL OIL PROD REVENUES	0	0	0	0	0	0	0	0	0	0

MONTH SLOPE Prod. (MMbbl/D)	1.695	1.717	1.744	1.66	1.504	1.40	1.33	1.257	1.17	1.031
AVG. NORTH SLOPE PRICE (\$/bbl)	17.02921	15.37540	13.63733	13.40789	14.13640	14.74674	15.57237	16.70890	10.00509	19.39853
AVG. NOMINAL TAX RATE	.1472906	.1467967	.1401377	.1460136	.1420015	.1450169	.1469192	.1465652	.1462158	.1475727
AVG. EFFECTIVE TAX RATE	.1435491	.1395069	.1370037	.1115651	.1036090	.0986205	.0934909	.0912105	.0892272	.0830136
AVG. ROYALTY PERCENTAGE	.125	.125	.1251720	.1257340	.1262922	.1264004	.1265956	.1267101	.1267017	.1266031
SEVERANCE TAX	1325.903	1100.400	1050.937	797.1311	746.6525	693.3015	623.0119	617.2010	605.4633	540.1976
CONSERVATION TAX	.6766750	.6054506	.6961006	.6621466	.6314206	.5090927	.5299927	.5000326	.4661775	.4100404
ROYALTIES	1245.095	1150.430	1030.594	960.9079	902.9065	961.0279	916.9057	932.5029	936.9096	090.0760
TOTAL OIL PROD REVENUES	2591.675	2331.524	2002.220	1766.701	1730.190	1655.799	1541.240	1550.366	1542.839	1431.404
	14.39401	13.95069	13.70037	11.15651	10.36090	9.062054	9.149006	9.121049	0.922717	0.301360

FISCAL IMPACT OF ELP REPEAL ON SEVERANCE TAX INCOME  
ALL NORTH SLOPE FIELDS

	85	86	87	88	89	90	91	92	93	94
SEVERANCE TAX (MILLIONS OF \$)										
NO ELP	1350.097	1230.976	1129.702	1039.074	1023.750	1011.050	971.7900	903.3472	903.7061	941.9207
WITH ELP	1325.903	1100.400	1050.937	797.1311	746.6525	693.3015	623.0119	617.2010	605.4633	540.1976
REVENUES RESULTING FROM REPEAL OF ELP	32.99410	50.56776	74.76406	242.7423	277.0974	310.4690	347.9070	365.7653	370.2420	401.7331
CUMULATIVE TOTAL	32.99410	91.56106	166.3267	409.0693	606.1667	1004.636	1352.623	1710.300	2096.631	2490.362

PRUDHOE BAY ONLY

SEVERANCE TAX (MILLIONS OF \$)										
NO ELP	1252.465	1124.336	992.6137	870.4757	816.1270	740.6450	664.0966	664.9124	661.5063	606.7002
WITH ELP	1252.465	1124.336	992.6137	714.2504	656.2593	580.2696	501.3609	490.1035	409.5263	433.5515
REVENUES RESULTING FROM REPEAL OF ELP	0	0	0	156.2253	159.0670	160.3754	163.5337	166.0009	172.0600	173.2367
CUMULATIVE TOTAL	0	0	0	156.2253	316.0931	476.4605	640.0042	806.0131	970.0730	1152.110

Figures calculated  
by OMB

IV.

MAJOR LITIGATION

WITH THE OIL AND GAS INDUSTRY

**A. Introduction**

Alaska is currently involved in one of the largest litigation efforts in U.S. history. The amounts at issue in the state's oil and gas litigation total at least \$15 to \$20 billion. This section of the report focuses on two of the most important disputes with the oil and gas industry, both of which have to do with a single concern: the value of North Slope oil at the point it enters the pipeline. This is referred to as the wellhead value, and the state's tax revenue and royalty value are based on it. The State v. Amerada Hess case is a dispute over the value of the state's royalty oil; the Trans Alaska Pipeline Rate Case addresses proper pipeline tariffs. Both cases involve all the major oil producers and are characterized by their complexity and the enormous effort required to litigate them successfully.

**B. The Process of Valuing North Slope Oil**

Putting a price on North Slope oil is difficult because unlike oil produced in the Lower 48, most North Slope oil is not sold at the wellhead but rather far from its source, most often on the West Coast or Gulf Coast. Another complication is that much of the oil is refined by the producers themselves, so there are internal transfers within one company rather than third-party sales. In addition, many third-party sales are often done by

exchanges with other considerations rather than a simple price. Thus the value of the oil at those distant markets is not a clearcut issue, and the state contends the producers significantly understate the value of the oil when it reaches its ultimate destinations.

It is important to determine the wellhead value of North Slope oil, however, because it is at this point where the state determines the value of its royalty share and levies the severance tax. The federal government also sets the windfall profits tax at the wellhead.

Thus the value of the oil is determined by the process called netback. To arrive at netback, a destination price is set for the oil (by the oil companies) and then the costs of transportation -- primarily pipeline and tanker -- are subtracted. All three of these values, destination price, tanker costs, and pipeline tariffs, are not easy to determine and thus are the subject of litigation. It is usually to the benefit of the producers to keep transportation costs high in order to keep the wellhead price down and thus reduce the royalties and severance taxes they owe the state.

Compounding the difficulty of valuing North Slope oil is the fact that the producers, notably the three major North Slope producers, Arco, Exxon and Sohio, have different netback methods. They use different methods to set the destination price, different methods to determine tanker transportation costs and different methods of setting the pipeline tariff. Furthermore, a company's

valuation methods may change from month to month. Some months the state may agree with a particular company's figures; another month, it may disapprove of the same company's figures.

The destination price and tanker transportation costs are currently the subject of multi-million dollar litigation over the value of the state's royalty oil. The State v. Amerada Hess case is a dispute over the proper value to be attributed to crude oil when it reaches the Lower 48 and the proper deductions to be made for tanker transportation. (Similar issues are involved in the company's severance tax disputes with the state, but with this case the royalty contracts are at issue.) The TAPS tariff case addresses the third major area of dispute, proper pipeline charges.

C. State v. Amerada Hess

The amounts at issue in this case for both past and future royalties is probably upwards of \$2 billion in present day dollars.

In general, Alaska's position is that the value of the oil should be higher for West Coast destinations than for Gulf or East Coast destinations (because transportation costs to the West Coast are lower). Some companies agree with this premise but disagree with the actual prices, while other companies disagree with this approach altogether.

While it is not easy to get information on the record on the specifics of the valuation disputes, federal hearings<sup>1</sup> in early 1983 over the windfall profits tax reveal how the major producers value their North Slope oil. The hearings focused in particular on the method used by Arco.

Arco sets a single price for North Slope oil regardless of its destination. The price is based on West Texas sour, an oil comparable in quality to ANS crude and actively traded in the Gulf. Transportation costs to the Gulf Coast are then deducted to arrive at a wellhead value for all its North Slope oil. Thus Arco is valuing all of its oil as though it were sent to the Gulf Coast (it costs roughly \$4 more to transport oil to the Gulf). This pricing method has merit in theory, but was severely criticized during the hearings because in fact, Arco sells 70% of its oil on the West Coast. From Alaska's and the federal government's perspective, Arco is artificially setting its West Coast price too low and thus avoiding paying millions of dollars in taxes and royalties.

The oil companies again explained their valuation methods to the Alaska Senate Resources Committee in late

---

<sup>1</sup>The hearings on the windfall profits tax were held in February 1983 before the House of Representatives Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce.

1983.<sup>2</sup> One of the points made then was that Alaska prefers Sohio's valuation method. Sohio, which doesn't own refineries on the West Coast or in the Gulf, determines value for North Slope crude by finding out how much refiners would pay for comparable foreign crude. Sohio also adjusts its price for destination.

The disparity between the companies' valuation methods results in strikingly different wellhead values. For example, Arco's West Coast price averaged about \$2.50 per barrel less than Sohio's throughout 1984. For 1985, Arco's price averaged about \$1.50 less.

The transportation part of the dispute is complicated by the fact that some producers own their own tankers while others charter tankers. For example, Arco owns about 70 percent of its tankers; Sohio owns none and charters U.S. flagships; Exxon charters about 70 percent of its tankers.

Sohio deducts the actual costs it is charged, while Arco deducts costs based on a national shipping standard called U.S. Freight Rate Averages. Other producers that own their own tankers deduct actual costs of operation and capital investment. Yet another variable for those who charter tankers is whether to use long-term or short-term rates. According to company figures supplied to the federal government, 1982 shipping charges ranged from .78

---

<sup>2</sup>The committee held hearings in September 1983 on oil and gas issues.

to 2.35 a barrel for West Coast deliveries, and from 4.29 to 6.63 for Gulf/East Coast deliveries.

In late 1984 the U.S. General Accounting Office<sup>3</sup> drew the following profiles of the major North Slope producers based on information obtained from the windfall profits tax hearings. (While the figures are based on 1982 production, the methods and amounts are still fairly representative today.)

#### SOHIO

Sohio has no refineries on either the West or Gulf coasts. Thus the company either sells or exchanges all of its North Slope oil, about 597,000 barrels daily in 1982. About 40 percent of Sohio's North Slope oil went to the West Coast, about 60 percent went to the Gulf Coast and Caribbean.

For each of these market areas, Sohio negotiates a selling price for North Slope oil based on prices customers would pay for competing imported crude oils, with what the company considers appropriate adjustments for differences in oil quality.

Sohio transports its North Slope oil in chartered US-flag tankers operated by contract with outside parties. From the value received from those arm's-length, third-party transactions in each geographic area, Sohio deducts the pipeline tariff and waterborne and other transportation costs to establish wellhead price in Alaska.

#### ARCO

Arco uses most of its North Slope crude in its own refineries. In 1982, about 70 percent of Arco's 340,000 barrels per day went to the company's West Coast refinery at Los Angeles. Arco sold an additional 25,000 barrels on the West Coast. The remainder of Arco's North Slope oil, 50,000 to 75,000 barrels, went to the Gulf Coast.

Arco establishes a single wellhead price for its North Slope oil, regardless of its destination. Arco sets its price in the Gulf Coast, based on West Texas sour which is actively traded in the area. From this market price, Arco deducts pipeline tariffs and waterborne costs to the Gulf Coast. The resulting price is the wellhead value for both West Coast and Gulf Coast deliveries.

---

<sup>3</sup>The GAO report entitled "Response to Questions About the Windfall Profit Tax on Alaskan North Slope Crude Oil" was published in December 1984.

About 70 percent of Arco's North Slope production is transported in company-owned ships. For these ships Arco deducts U.S. Freight Rate Averages as costs. Actual charges are used for shipments on chartered vessels.

#### EXXON

In 1982 Exxon produced about 325,000 barrels a day and used about 94 percent of North Slope oil in its own refineries. About one third of its production went to the West Coast, about two-thirds went to its Gulf and East Coast refineries.

Exxon's general approach to pricing recognizes the West and Gulf/East Coasts as separate marketing areas. Exxon's assessment of market value is based on factors such as its own commercial transactions and posted prices of domestic crudes in the area as adjusted for quality. Then Exxon deducts transportation costs to arrive at netback value. These netback values are then averaged by volume shipped to each market area to arrive at wellhead value.

About 70 percent of Exxon's marine transportation is by U.S. chartered tankers.

The Amerada Hess case will require the state to make a detailed factual review of all West Coast and Gulf Coast oil marketing transactions for a seven-year period. The state will have to track the disposition of billions of barrels of North Slope oil. Fiscal years 1986 and 1987 will be peak years of activity for this case, which is currently in the stage of preliminary discovery.

#### D. The Trans Alaska Pipeline Rate Case

This is the case which has received the most intense litigation effort at this point. The amounts at issue between the best case and worst case outcomes, over the life of the field, are approximately \$7 to \$10 billion.

Ever since start-up of the Trans Alaska Pipeline System (TAPS) in 1977, the state and the pipeline owners have been in litigation over how much the tariff should be. The pipeline tariff -- the per barrel amount TAPS owners

charge for transporting oil through the pipeline -- affects the wellhead value of North Slope oil. The higher the tariff, the lower the wellhead price and the less the state collects in royalties and severance taxes. The state and others say the tariff is too high. (The prevailing tariff charges have ranged from about \$5.60 to \$6.40 per barrel.)

Last summer the state and six of the eight TAPS owners signed a settlement which affects tariffs through 2011; the Federal Energy Regulatory Commission subsequently approved the settlement which is now in effect. The remaining issue is whether to include the other pipeline owners, Sohio and Amerada Hess, in the settlement. After consulting with legislators and state officials in December, the governor decided to give the companies until February 12 to voluntarily join the settlement. If they don't, the state will continue litigation. However, FERC still has the option of imposing the settlement on the companies.

The settlement has had an immediate impact on state revenues, providing a welcome cushion against declining world oil prices. The increase in revenues is due to lower tariffs and therefore higher wellhead values. This TAPS money<sup>4</sup> has already been incorporated into current revenue forecasts and increased the forecasts by these amounts:

---

<sup>4</sup>These amounts are what could be termed net gain to the state's unrestricted revenues. The law requires that 25 percent of royalties be put into the Permanent Fund, so the net amount is what is left over after the Permanent Fund contributions.

FY 86	\$ 59.2 million
FY 87	156.9 million
FY 88	136.6 million

The Department of Revenue estimates the settlement will bring from \$120 to \$150 million each year to the state until 1992 and then the amounts will decline. In the late 1990s, the tariffs will start rising and revenues to the state will accordingly decrease.

In addition to the above amounts, the state expects to receive another \$120 million in refunds and legal expense reimbursements. This money has not yet been added to the current revenue projections. If Sohio signs the settlement, the state would receive an additional \$70-\$75 million in refunds. On the other hand, if litigation continues, the state may ultimately receive more money, although litigation always has its risks and resolution could be years away. It's hard to predict at this point if an eight-company settlement will ultimately occur.

FERC's decision approving the six-company settlement has been appealed by the Arctic Slope Regional Corporation and the Alaska Public Interest Research Group (AKPIRG). If an appeal is successful, FERC will hold more hearings.

This is the second attempt in more than eight years of litigation to settle the case. The 1982 effort failed, and the legislature decided to continue litigation to obtain two goals: to establish a rate-making methodology to last through the century, and to establish a methodology that would aid further oil development on the North Slope (meaning lower tariffs in the 1990s). Litigation has been

expensive. The Department of Law has spent over \$36 million on this case alone, not including in-house costs.

The settlement has been highly controversial, drawing fire from several quarters. Last summer the House Majority Leader hired independent economist Jamie Love to analyze the settlement. Love concluded the state gave away too much when it exchanged its litigation position for the settlement. According to Love's calculations, the settlement means the state will lose from \$5.2 to \$6.4 billion through the life of the settlement -- an amount that would be collected if the state's litigation position were to prevail. According to Department of Law figures, however, the settlement means an overall loss of \$2.5 billion (over the life of the settlement) when compared with the state's litigation position. The settlement is also a \$4.5 billion gain when compared with the TAPS owners' litigation position.

Bob Maynard, the assistant attorney general who's handling the TAPS case for the state, says Love made some big errors and used wrong assumptions in his report. Memos from attorneys working on the case to the Department of Law said Love's conclusions shouldn't be the basis of any policy. Maynard also pointed out that the settlement is a compromise which necessarily means the state gets less than if its litigation position were to prevail.

The Alaska Public Utilities Commission also did its own in-house analysis of the settlement late last year and concluded the settlement is not in the public's best

interest and may have an adverse effect on oil exploration and production on the North Slope. APUC thinks the settlement does not adequately balance the competing interests of past, present and future shippers, carriers, producers, royalty owners, the state of Alaska and the federal government. It also shares Arctic Slope Regional Corporation's concern that the rising tariffs at the end of the century will prevent future developers from producing North Slope oil.

There are many aspects of the settlement that contribute to higher tariffs in later years. One of APUC's biggest criticisms of the settlement is that the 35 cent barrel return is not cost-based and may lead to excessive rates of return and tariffs after 1989. APUC also criticized the settlement for eliminating all refund obligations prior to 1982. This means a potential loss of billions of dollars to early year shippers as well as the state of Alaska and the federal government.

A recent decision by FERC on pipeline ratemaking dubbed "Williams II" has been the subject of much speculation. The decision was handed down the same day last June that the state submitted its settlement proposal. The decision appeared to be more favorable to the state's litigation position, though a Department of Revenue analysis of the settlement shows that the settlement may actually be better than a "Williams II" outcome. In any case, it is difficult to say exactly how or if this case would apply to Alaska. In response to a letter written by

some House Majority members opposing the settlement late last year, FERC said the case was not applicable to TAPS.

Settling the dispute relies on how to compute the tariff, which is made up of operating expenses, depreciation, income taxes and after-tax return. Of these four, operating expenses is the least controversial, depreciation and after-tax return the most controversial. The Williams II decision adopted a hybrid ratemaking methodology involving part depreciated original cost and part trended original cost. A depreciated original cost scenario, as set out in the state's litigation position, is much better for the state than the trended for inflation rate base used in the settlement. The inflated base is somewhat of a compromise between the valuation methodology originally sought by TAPS owners and the state's position.

The six TAPS owners who have signed the settlement are: Arco, BP, Exxon, Mobile, Union and Phillips. They collectively own 65% of the pipeline. The other two owners are Amerada Hess and Sohio; Sohio has submitted its own settlement offer to FERC (which Love said would be "disastrous" to the state were it to be approved).

Comments opposing the settlement were filed by Arctic Slope Regional Corporation, Amerada Hess Pipeline Corp., Sohio Pipeline Co. and Sohio Petroleum Co., Tosco Corp., Alaska Oil Co. and AKPIRG.

#### E. Conclusion

These cases illustrate how various aspects of the

production and marketing process provide profit making opportunities for the industry and revenue opportunities for the state. They show the complexity of valuing our oil and how important that value is to maintaining the financial wellbeing of both parties.

AS 38.05.183 is amended to include the following new paragraph:

(g) The commissioner may enter into a contract for the sale of in-kind royalty gas to a non-profit electric utility or cooperative at less than market value, if the commissioner makes a written finding that the sale is fair and proper and in the best interests of the public, with due consideration given to the benefits of the sale.

Introduced: 4/26/85  
Referred: House Special Committee  
on Oil & Gas, Resources and Finance

1 IN THE HOUSE

BY PIGNALBERI

2 HOUSE BILL NO. 403

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 FOURTEENTH LEGISLATURE - FIRST SESSION

5 A BILL

6 For an Act entitled: "An Act relating to the royalty value of a natural  
7 gas lease on state land; and providing for an effective  
8 date."

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

10 \* Section 1. FINDING. The legislature find that to provide for the  
11 utilization, development and conservation of gas resources for the maximum  
12 benefit of the people of the state, the value of production of gas for  
13 purposes of computing the royalty reserved to the state must be based  
14 primarily on the contract price of gas rather than the current market value  
15 of the gas. This will encourage stable markets, promote investment, assure  
16 reasonable energy prices and provide the maximum benefit to the people of  
17 the state.

18 \* Sec. 2. AS 38.05.180 is amended by adding a new subsection to read:

19 (aa) Notwithstanding other provisions of this section, if the  
20 commissioner issues a gas lease under (f) of this section and the  
21 royalty value of the production of gas removed or sold from the lease  
22 is measured by a long-term contract price, the commissioner may not  
23 adjust the long-term contract price to reflect the current market  
24 value of gas if the commissioner determines the current market value  
25 price adjustment would result in an increase in the consumer price of  
26 the gas or unless the commissioner determines in a written finding  
27 supported by clear and convincing evidence that the long term contract  
28 price is unreasonably low.

29 \* Sec. 3. This Act applies to leases issued before or after the

1 effective date of this Act.

2 \* Sec. 4. This Act takes effect immediately in accordance with AS 01.-

3 10.070(c).

Introduced: 5/4/85  
Referred: House Special Committee  
on Oil & Gas and Resources

1 IN THE HOUSE

BY PEARCE

2

HOUSE BILL NO. 425

3

IN THE LEGISLATURE OF THE STATE OF ALASKA

4

FOURTEENTH LEGISLATURE - FIRST SESSION

5

A BILL

6

For an Act entitled: "An Act relating to the royalty value of a natural

7

gas lease on state land; and providing for an effective

8

date."

9

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

10

\* Section 1. AS 38.05.180 is amended by adding a new subsection to

11

read:

12

(aa) Notwithstanding other provisions of this section, the value

13

of the production of natural gas taken in value and sold under a lease

14

issued under (f) of this section may not exceed the long-term contract

15

price for the natural gas unless it is established by clear and con-

16

vincing evidence that the long-term contract price was unreasonably

17

low at the time of contract.

18

\* Sec. 2. This Act applies retroactively to leases issued before the

19

effective date of this Act.

20

\* Sec. 3. This Act takes effect immediately in accordance with AS 01.-

21

10.070(c).

ROYALTY GAS TESTIMONY

SENATE NATURAL RESOURCES COMMITTEE

February 10, 1986

Dr. Joyce M. Murphy  
President, Board of Directors

CHUGACH ELECTRIC ASSOCIATION, INC.

GOOD AFTERNOON MADAME CHAIR AND MEMBERS OF THE COMMITTEE. MY NAME IS DOCTOR JOYCE MURPHY AND I AM PRESIDENT OF THE BOARD OF DIRECTORS OF CHUGACH ELECTRIC ASSOCIATION. I HAVE BEEN PRESIDENT OF THE BOARD FOR THE LAST FOUR YEARS. I APPRECIATE THE OPPORTUNITY TO PARTICIPATE IN TODAY'S HEARING ON ISSUES RELATED TO COOK INLET ROYALTY GAS.

CHUGACH IS A NON-PROFIT, MEMBER-OWNED COOPERATIVE HEADQUARTERED IN ANCHORAGE. WE ARE THE STATE'S LARGEST ELECTRIC UTILITY AND WE PROVIDE POWER FOR CONSUMERS FROM FAIRBANKS TO HOMER.

SPECIFICALLY, WE HAVE ABOUT 60,000 RETAIL CONSUMERS IN THE ANCHORAGE AREA AND THE KENAI PENINSULA. IN ADDITION, WE ARE THE WHOLESALE POWER SUPPLIERS FOR TWO NEIGHBORING COOPERATIVES -- MATANUSKA ELECTRIC ASSOCIATION AND HOMER ELECTRIC ASSOCIATION -- PLUS THE CITY OF SEWARD, WHICH SUPPLY ANOTHER 48,000 CONSUMERS.

THROUGH THE NEW ANCHORAGE-FAIRBANKS INTERTIE, WE ARE SUPPLYING POWER TO BOTH GOLDEN VALLEY ELECTRIC AND THE FAIRBANKS MUNICIPAL UTILITY, WITH ANOTHER 25,000 CONSUMERS. THUS THE PRICE OF OUR FUEL IMPACTS THE PRICE OF ELECTRICITY TO NEARLY THREE-QUARTERS OF THE STATE'S POPULATION. THIS IS THE FIRST TIME THAT I CAN RECALL THAT AN ISSUE HAS UNITED ALL THE UTILITIES IN THE RAILBELT -- PLUS BUSH UTILITIES. THE REASON IS SIMPLE -- THIS IS A MAJOR CONSUMER ISSUE. THE EFFECTS ON OUR CONSUMER'S POCKETBOOKS ARE REAL -- NOT THEORETICAL. THE NUMBER AND GEOGRAPHIC DIVERSITY OF THOSE HERE TODAY TESTIFIES TO THAT.

ELECTRIC UTILITY CONSUMERS THROUGHOUT THE RAILBELT FACE AN INCREASE IN THEIR UTILITY BILLS AS A RESULT OF THE DEPARTMENT OF NATURAL RESOURCES' DECISION LAST MARCH TO DRASTICALLY RAISE THE PRICE OF ROYALTY GAS IN COOK INLET. FOR OUR CONSUMERS, THE IMPACT WILL TOTAL OVER \$6 MILLION PER YEAR, AND AT LEAST \$40 MILLION OVER THE REMAINING LIFE OF THE BELUGA GAS CONTRACTS. DNR'S ACTION WAS TAKEN WITH VIRTUALLY NO ADVANCE NOTICE TO THE PARTIES INVOLVED, TO THE PUBLIC OR TO YOU, THE STATE LEGISLATURE.

FOR CHUGACH, THERE ARE TWO MAJOR ASPECTS OF THIS ISSUE -- THE ADDITIONAL COST TO UTILITY CONSUMERS AS A RESULT OF DNR'S ACTION, AND MORE IMPORTANT, THE MEASURE OF UNCERTAINTY WHICH DNR'S ACTION HAS INJECTED INTO BOTH OUR LONG-TERM FINANCIAL PLANNING AND OUR ABILITY TO ENSURE RATE STABILITY.

I HAVE WITH ME TODAY AN IMPACT PAPER WHICH CHUGACH HAS DEVELOPED AND I WOULD LIKE TO MAKE A PART OF MY TESTIMONY HERE TODAY. COPIES ARE AVAILABLE FOR THE COMMITTEE MEMBERS. HOWEVER, I WOULD LIKE TO TAKE A FEW MINUTES TO HIGHLIGHT OUR AREAS OF CONCERN.

THE FIRST OF THESE IS THE DOLLAR IMPACT OF DNR'S DECISION. AS I MENTIONED EARLIER, WE ANTICIPATE THAT THE ANNUAL FINANCIAL IMPACT TO OUR CONSUMERS WILL BE OVER \$6 MILLION A YEAR. HOWEVER, THIS IS ONLY ONE PORTION OF THE PRICE INCREASES WE EXPECT TO HIT OUR CONSUMERS AS A RESULT OF ROYALTY GAS REVALUATIONS IN THE COOK INLET AREA. FIRST OF ALL, THE STATE ONLY OWNS 60 PERCENT OF THE ROYALTY SHARE AT BELUGA. THIS REVALUATION WILL COST ALMOST \$3

MILLION A YEAR. IF THE FEDERAL GOVERNMENT FOLLOWS SUIT AND REPRICES ITS 40 PERCENT OF THE ROYALTY GAS THE IMPACT WILL BE ANOTHER \$1.8 MILLION ANNUALLY. ADDITIONALLY, SEVERANCE TAXES, WHICH CHUGACH ALSO PAYS ON THE GAS IT PURCHASES, ARE CURRENTLY BASED ON A PERCENTAGE OF THE CONTRACT PRICE. IF DNR IS SUCCESSFUL IN REVALUING THE GAS TO A HIGHER PRICE IT IS LIKELY THAT THE DEPARTMENT OF REVENUE WILL FOLLOW SUIT, COSTING OUR CONSUMERS OVER ANOTHER \$150,000 A YEAR.

AS YOU ARE AWARE, THERE HAS BEEN A TREMENDOUS INCREASE IN THE COST OF ENSTAR'S GAS AS A RESULT OF ITS RECENT SETTLEMENT OF ROYALTY CLAIMS IN THE KENAI GAS FIELDS. BETWEEN THE GAS THAT WE PURCHASE DIRECTLY FOR USE IN OUR FACILITIES IN ANCHORAGE AND ON THE KENAI, AS WELL THE INCREASED COST IN THE ELECTRICITY THAT WE BUY FROM THE ANCHORAGE MUNICIPAL LIGHT & POWER, THE ENSTAR REVALUATIONS WILL COST OUR CONSUMERS \$1.5 MILLION MORE ANNUALLY.

THE TOTAL IMPACT OF THESE IS OVER \$6 MILLION A YEAR. MY POINT HERE IS THAT THE DOLLAR VALUES ARE SIGNIFICANT, AND ALSO THAT ROYALTY VALUATION HAS A RIPPLE EFFECT, WITH IMPLICATIONS FAR BEYOND THE DECISION MADE BY DNR LAST MARCH, AND FAR BEYOND CHUGACH.

CHUGACH IS A COOPERATIVE UTILITY ORGANIZED TO SERVE ITS MEMBER-OWNERS. THE ADDITIONAL COST FOR ROYALTY GAS WILL DIRECTLY TRANSLATE TO INCREASED UTILITY BILLS. THESE INCREASES WILL BE ON TOP OF ANY RAISE IN RATES DUE TO INCREASES IN OPERATING EXPENSES.

THE SECOND, AND EVEN MORE IMPORTANT -- I REPEAT, MORE IMPORTANT -- CONCERN WE HAVE WITH DNR'S ACTION IS THE MEASURE OF UNCERTAINTY THAT IS INJECTED INTO BOTH OUR POWER PLANNING AND OUR RATE PLANNING.

THE FOLLOWING EXCERPT FROM DNR'S OWN DECISION MEMO OF NOVEMBER 6, 1984, SAYS IT ALL:

"THE FLUCTUATION OF ROYALTY VALUE INDEPENDENTLY OF THE CONTRACT PRICE UNDER WHICH GAS IS SOLD INJECTS UNCERTAINTY INTO THE LONG-TERM PLANNING BY OIL COMPANIES AND UTILITIES. THIS UNCERTAINTY (AND HIGHER ROYALTY RATES) MAY REDUCE INCENTIVES TO INVEST CAPITAL IN OIL AND GAS UTILITY ENTERPRISES, OR AFFECT THE TIMING AND STRUCTURING OF SUCH ENTERPRISES."

DNR WAS RIGHT. FOR THE CONSUMERS OF CHUGACH AND OTHER UTILITIES THIS IS AN EXTREMELY SIGNIFICANT AREA, AND ONE WHICH HAS CAUSED A GREAT DEAL OF CONCERN. OUR COMMITMENT TO BUILD GENERATION FACILITIES AT THE BELUGA GAS FIELD BACK IN 1965 WAS ABLE TO OCCUR ONLY BECAUSE WE HAD SIGNED LONG-TERM CONTRACTS ENSURING THE STABILITY OF THE PRICE FOR THAT BELUGA RIVER GAS. IN FACT, HAD WE BEEN UNSUCCESSFUL IN OBTAINING LONG-TERM CONTRACTS ENSURING STABLE FUEL PRICES, WE WOULD HAVE BEEN UNABLE TO MAKE THAT PLANT INVESTMENT, AND THE BELUGA GAS FIELD MIGHT STILL BE UNDEVELOPED TODAY. HAD THAT BEEN THE CASE, THE STATE WOULD HAVE HAD NO ROYALTY OR SEVERANCE TAX REVENUE.

IT IS VERY IMPORTANT FOR CHUGACH TO ENSURE RATE STABILITY. WE MAY NOT ALWAYS BE ABLE TO AVOID RATE INCREASES, BUT WE TRY TO PLAN THOSE INCREASES CAREFULLY TO MINIMIZE MAJOR RATE FLUCTUATIONS.

FOR THESE REASONS, THEN, WE WOULD URGE THE COMMITTEE MEMBERS TO SUPPORT PASSAGE OF S.B. 309 OR BILLS CONTAINING SIMILAR LANGUAGE, WHICH WOULD REQUIRE DNR TO TIE ROYALTY VALUATION TO LONG-TERM CONTRACT PRICES.

BY TYING ROYALTY PRICE TO LONG-TERM CONTRACT PRICE, DNR WILL CONTINUE TO MANAGE THE STATE'S RESOURCES FOR MAXIMUM VALUE WHILE RECOGNIZING THAT, AS WE MENTIONED EARLIER, THESE RESOURCES OFTEN DO NOT HAVE A VALUE INDEPENDENT OF LONG-TERM CONTRACT PRICES. COURTS IN OKLAHOMA, LOUISIANA AND ARKANSAS HAVE RECOGNIZED THIS. ADDITIONALLY, WE WOULD NOTE THAT UNDER THE CURRENT LEASE FORMS, DNR WOULD STILL BE PERMITTED, ON ONLY SIX MONTH'S WRITTEN NOTICE, TO TAKE ITS ROYALTY SHARE IN KIND AND SELL IT DIRECTLY TO A WILLING PURCHASER. IN OTHER WORDS, IF DNR CAN FIND SOMEONE TO PAY WHAT IT BELIEVES IS PREVAILING MARKET VALUE -- FINE. LET DNR SELL IT TO THEM. WE WILL NOT STAND IN THEIR WAY.

I WOULD ALSO LIKE TO STRESS THAT ROYALTY OIL PRICES WILL NOT BE AFFECTED IN ANY WAY, SHAPE OR FORM BY S.B. 309 OR OTHER BILLS WE SUPPORT. THE LANGUAGE WE ENDORSE RELATES ONLY TO ROYALTY GAS. BECAUSE OF THIS, THE AMERADA-HESS CASE ON THE NORTH SLOPE, OVER WHICH SOME QUESTIONS HAVE BEEN RAISED, WILL NOT BE AFFECTED. IMPLICATIONS TO THE CONTRARY ARE SIMPLY NOT VALID.

SENATOR STURGULEWSKI, YOU AND OTHER MEMBERS OF THE LEGISLATURE ARE AWARE THAT CHUGACH HAS BEEN NEGOTIATING IN GOOD FAITH WITH THE ADMINISTRATION OVER ROYALTY GAS FOR THE PAST TEN MONTHS. I MET AS LATE AS THIS MORNING WITH COMMISSIONER WUNNICKE AND HER STAFF.

QUITE FRANKLY, WE BELIEVE OUR RECENT IMPROVED ACCESS TO THE ADMINISTRATION IS A DIRECT RESULT OF THE RECENT LEGISLATIVE AND PUBLIC ATTENTION THAT HAS BEEN FOCUSED ON THIS ISSUES.

WHAT IS MORE IMPORTANT, HOWEVER, IS THAT DNR HAS BEEN ABLE TO DO LITTLE MORE THAN DISCUSS A NEW ROYALTY PRICE FOR OUR EXISTING BELUGAS GAS, AND TO PROPOSE A SLIGHTLY DIFFERENT WAY TO CALCULATE ROYALTY PRICE ON A NEW OR RENEGOTIATED CONTRACT THERE. THIS IS ONLY AT BELUGA AND ONLY FOR CHUGACH.

WHAT DNR HAS PROPOSED DOES NOT RESOLVE THE UNDERLYING ROYALTY POLICY QUESTION. CHUGACH APPRECIATES DNR'S TIME AND EFFORT ON THIS, AND WE HAVE GREAT RESPECT FOR COMMISSIONER WUNNICKE AND HER STAFF. BUT THE LACK OF ACCOMMODATION JUST GOES TO PROVE WHAT WE AND MANY OTHERS HAVE BEEN SAYING ALL ALONG -- THE LEGISLATURE MUST GET INVOLVED, AND THE LEGISLATURE MUST PROVIDE A LASTING SOLUTION.

ROYALTY VALUATION IS TOO FUNDAMENTAL AND TOO IMPORTANT TO BE LEFT TO ANY ONE AGENCY. YOU ARE THE POLICY-MAKING BRANCH OF THE GOVERNMENT.

I PERSONALLY BELIEVE DNR WOULD GO FARTHER FOR CHUGACH IF IS COULD  
-- BUT IT CAN'T. YOU CAN AND YOU SHOULD -- NOT JUST FOR CHUGACH  
BUT FOR ALL ELECTRIC AND GAS CONSUMERS IN OUR STATE.

THANK YOU FOR YOUR TIME TODAY. I, AND OTHER CHUGACH  
REPRESENTATIVES, WILL BE HAPPY TO ANSWER ANY QUESTIONS THAT YOU  
MAY HAVE OR MEET WITH YOU AT YOUR CONVENIENCE. AGAIN, CHUGACH  
URGES YOUR SUPPORT FOR S.B. 309.

:test.2

## IMPACTS OF STATE ROYALTY GAS INCREASE ON RAILBELT CONSUMERS

Alaskans from Fairbanks to Homer face utility bill increases as a result of the Alaska Department of Natural Resources' decision to drastically raise the price of royalty gas in Cook Inlet. For Chugach Electric Association consumers in the Anchorage area, the impacts will be nearly \$3 million a year.

DNR's action was taken with virtually no advance notice to the parties involved, to the public or to the State Legislature. Litigation was initiated by the three producers against DNR on the revaluation in April 1985. Chugach is also involved in the litigation.

There are two major aspects of this issue: The additional costs to utility consumers of DNR's actions and, perhaps more important, the fundamental policy question of how royalty valuation is established.

On March 18, 1985, the Department of Natural Resources (DNR) issued a formal notice to the three Beluga River gas field producers -- ARCO, Shell and Chevron -- informing them that DNR would no longer accept royalty payments based on long-term contract price but would require payments based on the "prevailing market value."

This value was initially determined by DNR to be \$2.05 per thousand cubic feet (mcf), based on a Shell-ENSTAR (APL II) contract signed in December 1982. By contrast, Chugach currently pays \$.26/mcf for its Beluga gas, under long-term contracts on which the DNR had based its royalty price for the past 17 years.

Based on the \$2.05/mcf figure, the annual increase to Chugach retail and wholesale consumers would be approximately \$2.8 million. Even under a recent settlement offer by the state which would value the royalty gas at \$1.50/mcf, the impact would be approximately \$1.9 million annually.

Chugach negotiated its Beluga contracts in good faith and at arms length in 1965, and renegotiated with the producers in 1973. The contracts extend to 1998 or whenever 373 billion cubic feet (bcf) of gas is used, whichever comes first. That means the overall impact of the Beluga royalty revaluation alone could total more than \$30 million to consumers.

Additional financial impacts on Chugach consumers have resulted or could result from actions similar to or related to the Beluga royalty revaluation. Those actions are:

- a possible revaluation, identical to the state's, by the other Beluga royalty gas owners (the federal government and Cook Inlet Region, Inc.);
- the recent \$8.5 million settlement by ENSTAR relative to royalty gas from the Kenai field (raising ENSTAR's Kenai royalty price from \$.66 to \$1.95, and including retroactive payments);
- an increase in the cost of power purchased from Anchorage Municipal Light & Power, which was substantially impacted by the ENSTAR increase, and
- a possible increase in state gas severance taxes based on the Beluga royalty gas revaluation.

If all these actions occur, the impact on Chugach consumers would be approximately \$6 million annually -- the equivalent of about a 6 percent rate increase. Attachment A details the impacts.

Financial impacts also will be felt in the Fairbanks area, because Chugach has been selling wholesale power to Golden Valley Electric Association and Fairbanks Municipal Utility System over the Anchorage-Fairbanks intertie. ML&P also is selling power to Golden Valley. Golden Valley has estimated that its consumers will save more than \$600,000 this winter alone through purchases of power from Chugach and ML&P.

Copper Valley Electric Association also is concerned because the Glennallen-based cooperative wants its consumers from Glennallen to Valdez to be intertied with the Railbelt utilities and reap the benefits of less expensive power.

Approximately three quarters of the state's estimated 560,000 residents live in the Railbelt between Fairbanks and Homer. Chugach serves nearly half the state's population through sales to its own retail consumers and those of Matanuska Electric Association, Homer Electric Association and the City of Seward. Thus, residents of the Matanuska and Susitna Valleys and on the Kenai Peninsula are directly affected.

In addition to the cost increases associated with the existing gas contracts, there is another major -- and perhaps even more important -- impact of DNR's royalty revaluation decision.

This is what could be called the uncertainty factor. If DNR is ultimately successful in setting royalty prices on what it determines to be the prevailing market value of a resource, utilities, producers and other purchasing parties will have no assurance of what future royalty gas components will be. This injects a real measure of insecurity into long-term gas contracts and, for Chugach at least, into power supply planning and ratemaking.

The uncertainty factor is an important public policy question for the state and is one that may well eclipse the cost-increase aspect of any given royalty lease revaluation. It could be argued that settling the price dispute over a specific revaluation without first resolving the underlying policy question is getting the horse before the cart.

It is important to note that although DNR's gas and oil lease form has given rise to dispute and litigation in many instances over the years, DNR has failed to propose regulations defining important lease terms. Proposed regulations would at least allow for a public discussion of the policy questions.

To resolve the problem raised by the state's royalty gas revaluation, Chugach is supporting passage of S.B. 309, or similar bills H.B. 403 and H.B. 425. Each of these bills would require DNR to tie royalty valuation to long-term contract price, thereby resolving the underlying policy question. A copy of each of the bills is attached.

Uncertainty in long-term price for royalty gas raises problems for Chugach and other utilities both in terms of long-term financing for generation projects and in efforts to ensure electric rate stability. Tying royalty price to long-term contract price allows DNR to continue to manage the state's resources for maximum value, while recognizing that these resources do not have a value independent of long-term contracts. DNR would still be permitted, on only six months' written notice, to take its royalty share in kind and sell it directly to a willing purchaser.

## ATTACHMENT A

CHUGACH ELECTRIC ASSOCIATION, INC.  
Rate Impacts Due to Market Valuation of Royalty Gas

January 10, 1986

	<u>Retail:</u> <u>Dollars</u>	<u>Retail:</u> <u>Percent</u>	<u>Wholesale:</u> <u>Dollars</u>	<u>Wholesale:</u> <u>Percent</u>	<u>Total:</u> <u>Dollars</u>	<u>Total:</u> <u>Percent</u>
Current revenues	\$63,200,000		\$35,800,000		\$99,000,000	
Impacts:						
The state's Beluga royalty revaluation from \$.26/mcf to \$2.05/mcf	1,501,164	2.38	1,278,769	3.57	2,779,933	2.81
Possible federal/CIRI Beluga revaluation (based on state's \$2.05/mcf figure)	1,000,776	1.58	852,513	2.38	1,853,289	1.87
ENSTAR settlement	420,853	0.67	358,505	1.00	779,358	0.79
ML&P rate increase (resulting from ENSTAR settlement)	337,500	0.53	287,500	0.80	625,000	0.63
Possible state gas severance tax increase (based on state's Beluga royalty revaluation)	<u>87,100</u>	<u>0.14</u>	<u>74,196</u>	<u>0.21</u>	<u>161,296</u>	<u>0.16</u>
	\$3,347,393	5.30	\$2,851,483	7.97	\$6,198,876	6.26

Stephen M. Ellis  
William Rozell  
James D. Linxwiler

-3-

January 28, 1986

industry standard at the time; hence, the ontracts were not unreasonable. Finally, a majority of the Vela jurisdictions limit the royalty value to proceeds when there is a Natural Gas Policy Act ceiling on the price the producers may collect, as there is here.

A more recent and better reasoned line of cases is set forth in Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981). This line of cases adopts arm's-length contracts as determinative of value for royalty purposes. Tara, and the cases which follow, are based on the proposition that the lessee is obligated to develop the lease, and thus, must market the gas. Because large quantities of gas cannot be marketed absent long-term commitment of supply, proceeds from an arm's-length contract should be respected as determinative of value. The Tara line of cases is better law and is also the line of cases most often followed by courts deciding the issue in the recent past.

It is also important to note here that, should the State at any time believe its gas to have a higher value than current contract price, it may, on only six months' notice, elect to take its royalty share in-kind and sell it directly to a willing purchaser.

Additionally, as a matter of long-term policy, the State's injection of a measure of uncertainty into long-term contracts raises serious concerns. The State's action here opens the door for revaluations in the future. This uncertainty factor is unacceptable to Chugach, both in terms of access to long-term financing for generation projects and for our ability to ensure rate stability for our members.

Ironically, the desirability of long-term stability to ensure resource development was a recognized priority of the State when the DL-1 leases were developed. Additionally, Chugach's need for stable royalty prices was addressed by the State, Chugach and the Producers prior to making the commitment to construct the Beluga power facilities, without which the Beluga gas field might still lie undeveloped. At that time, you made a firm commitment to resist efforts to increase royalty prices above contract price.

Disregarding for the moment the legal reasons that the State's settlement position is unacceptable, the terms of the settlement themselves raise grave concerns. First, the price is out of line with market realities. A \$1.50/Mcf price for Beluga gas is a multiple of the price that consultants engaged by Chugach have placed on the value of the remaining reserves in the field. It is also just marginally below the price presently being offered

Statement - Shasta Stangulinski

The issue today is how the state should determine the value of its royalty share of natural gas on state lands. In the past this determination has been based on long-term contract prices. In November of 1984, the Administration switched to determining the fair market value of its royalty share by comparison with other recent gas sales in Cook Inlet.

DLI  
The lease language, unfortunately, is <sup>so</sup> sufficiently ambiguous that legal arguments can be made to support both methods. Our job is not to offer legal interpretation, but to consider what public policy makes the best sense for Alaska.

To make that determination <sup>of appropriate public policy</sup> we need to get answers to some questions today.

- 1 - What will be the impact on consumers of gas and gas generated electricity?
- 2 - What will be the impact on state revenue?
- 3 - What will be the effect of the relative future certainty or uncertainty of gas prices that different methods of valuation may result in?
- 4 - How will our decision effect other purchasers of natural gas for uses such as LNG or urea?
- 5 - What will be the effect on oil and gas companies and future exploration and production decisions?
- 6 - What effect will there be on other ongoing royalty suits?
- 7 - What will be the impact of our decisions on use of North Slope gas, both for instate energy use and for possible exportation as LNG?

We have all the parties assembled here today. I hope that they can answer these and a number of other questions on the issue. After the public testimony, I plan to bring these bills back to the committee on Wednesday, February 19th for action.

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

Outline of Presentation to Senate Resources Committee  
February 10, 1986

I. Introduction

II. History of Cook Inlet enforcement actions

- A. 1980 law requiring royalty audits
- B. Specific past actions and settlements
  - 1. Phillips
  - 2. Marathon
  - 3. Union
  - 4. Union, Marathon, and Enstar
- C. Pending disputes
  - 1. Beluga
  - 2. Kenai
  - 3. Other

III. Overview of Cook Inlet gas production

IV. Issues involved in Beluga dispute

- A. Legal issues
- B. Economic and social issues
  - 1. How is market value determined?
  - 2. Maximum benefit determination
  - 3. Impact on consumers
  - 4. Should energy subsidies be provided, and by what mechanism?
  - 5. Uncertainty. What long-term assurance this won't happen again?
  - 6. Effect on North Slope gas development.
  - 7. Effect on Power Cost Equalization program.
  - 8. Practical difficulties with in-kind gas sales.
- C. Procedural issues
  - 1. Why no notice and hearing?

V. Approaches for resolution

- A. Negotiation/settlement
- B. Litigation
- C. Statutory amendments
  - 1. SB 309
  - 2. Authorize in-kind, below market sales
  - 3. Put formula in statute

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:

<u>Date of Contract</u>	<u>Purchaser</u>	<u>Field</u>	<u>Starting Base Price</u>
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 dispositions to Enstar under Enstar's 1973 contract	\$ 4.1	\$1.95	6.90	✓
Total		<u>\$44.7</u>		<u>\$19.65</u>	

2/5/86

COOK INLET GAS ROYALTY CHRONOLOGY

<u>Month</u>	<u>Year</u>	<u>Description of Event</u>
March	1964	<u>Foster v. Atlantic Refining Company</u> , 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	<u>Piney Woods County Life School v. Shell Oil Company</u> , 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 <u>Foster</u> , 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.

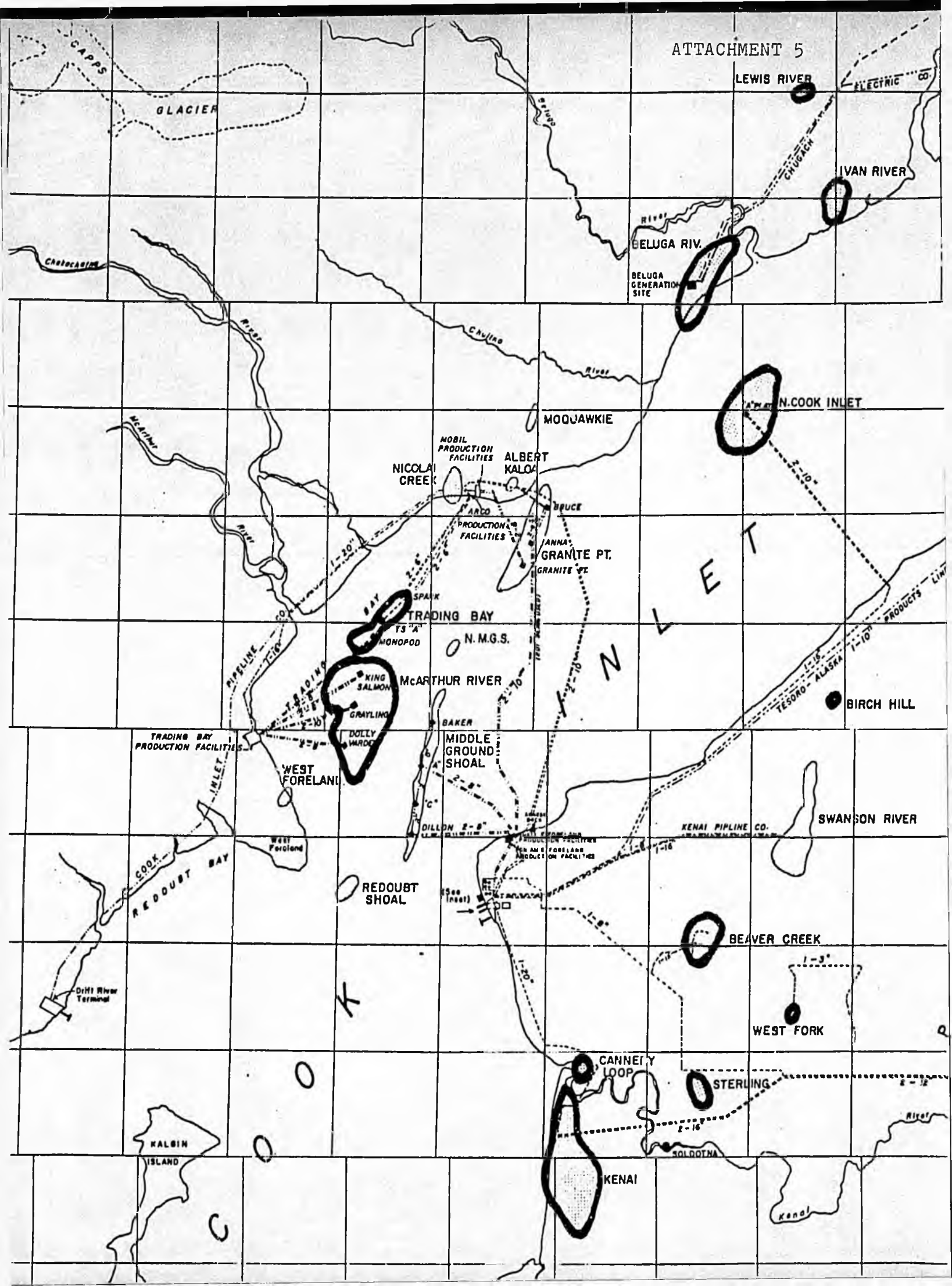
ALASKA DEPARTMENT OF NATURAL RESOURCES - DIVISION OF OIL AND GAS  
SUMMARY STATISTICS  
COOK INLET GAS PRICE DISPUTE  
AVERAGE MONTHLY SALES VOLUMES - JULY 1981 THROUGH JUNE 1983

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
<b>BELUGA RIVER FIELD</b>									
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%)	E:STAR	2.11%	37,790	0.07555	2,855	\$1.8000	\$2.0300 9/	12/20/82	10/1999
AGEA (100.00%)W-214-35	E:STAR	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	5/14/85	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		135,579				
<b>KEMAI FIELD</b>									
UNION (50%)	APL-ANCHORAGE	10.28%	845,622	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 KEMAI	0.25%	20,599	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%	1,185,535	0.020688	24,485	\$1.9500 8/	\$0.6220 6/	12/16/82	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 KEMAI	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 SH...		41.49%	3,414,390		70,637				
TOTAL KEMAI FIELD		100.00%	8,229,363		170,249				
<b>STERLING FIELD</b>									
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		22				
<b>MCARTHUR RIVER FIELD</b>									
UNION/MARATHON (50% each)		0.47%	1,671	0.125	209	0.000	0.000		
UNION/MARATHON (50% each)	RENTAL GAS	1.48%	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				
<b>TRADING BAY FIELD</b>									
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.



LEWIS RIVER

IVAN RIVER

BELUGA RIV.  
BELUGA GENERATION SITE

N. COOK INLET

MOQUAWKIE

MOBIL PRODUCTION FACILITIES  
ALBERT KALOC  
NICOLAI CREEK  
ARCO PRODUCTION FACILITIES  
BRUCE  
ANNA GRANITE PT.  
GRANITE PT.

TRADING BAY  
N.M.G.S.  
MCARTHUR RIVER  
SPARK MONOPOD

BIRCH HILL

TRADING BAY PRODUCTION FACILITIES  
WEST FORELAND

MIDDLE GROUND SHOAL

SWANSON RIVER

REDOUBT BAY  
COOK INLET

REDOUBT SHOAL

BEAVER CREEK

WEST FORK

CANNERY LOOP

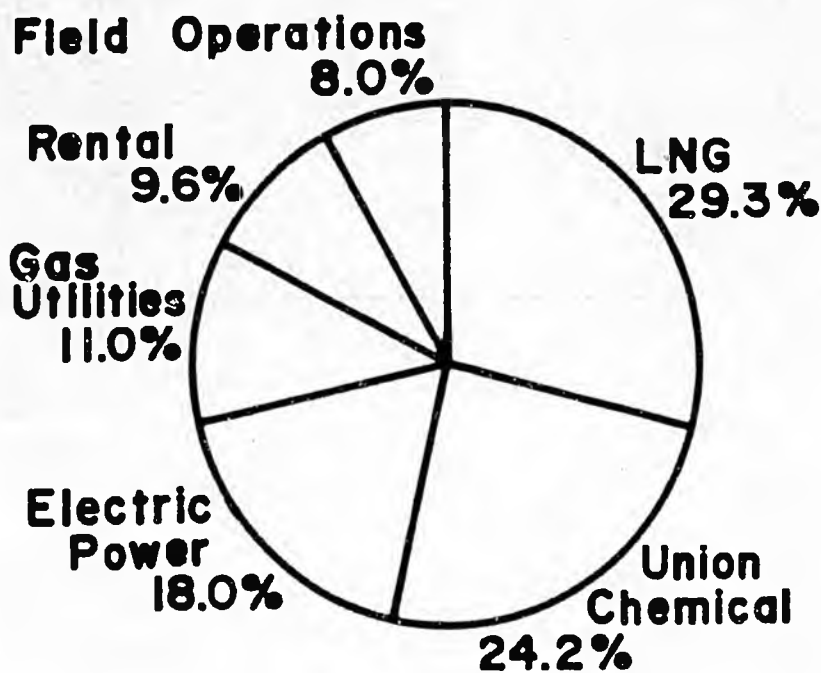
STERLING

KENAI

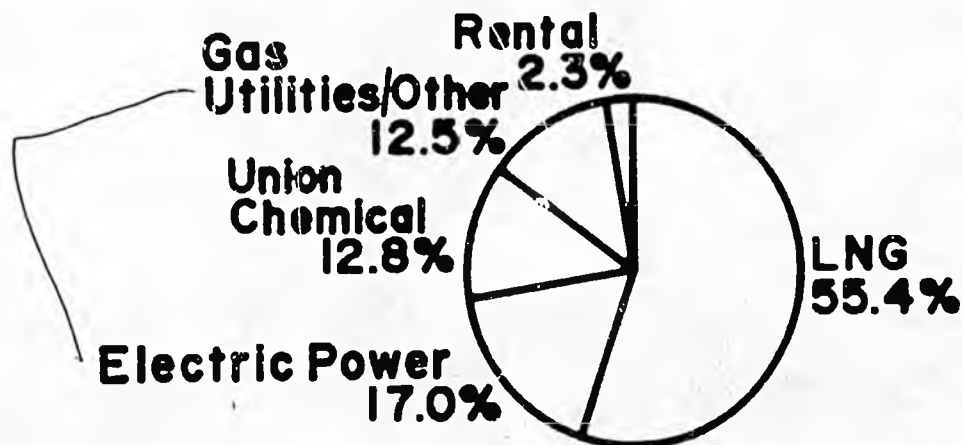
KALBIN ISLAND

# COOK INLET

## Total Sales

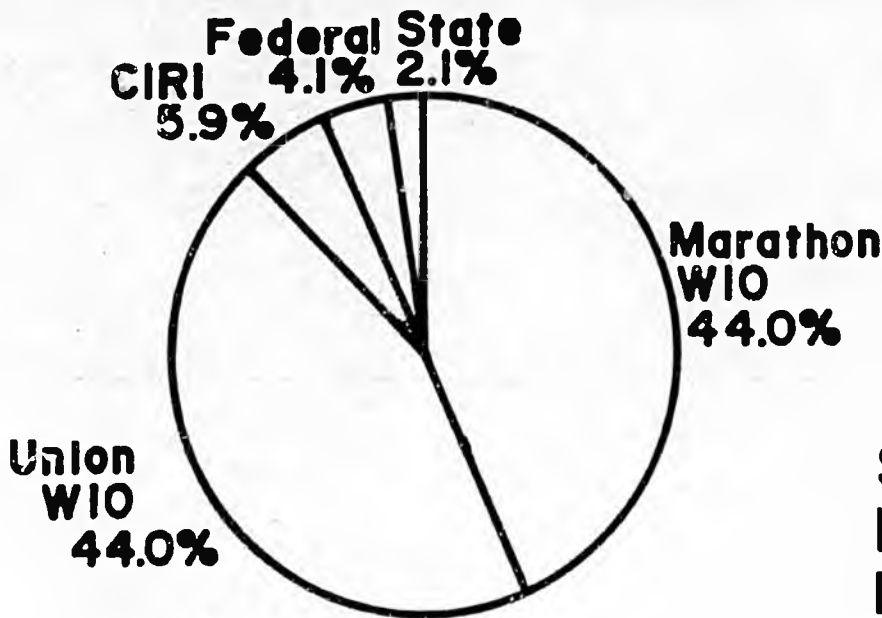


## State Royalty Disposition

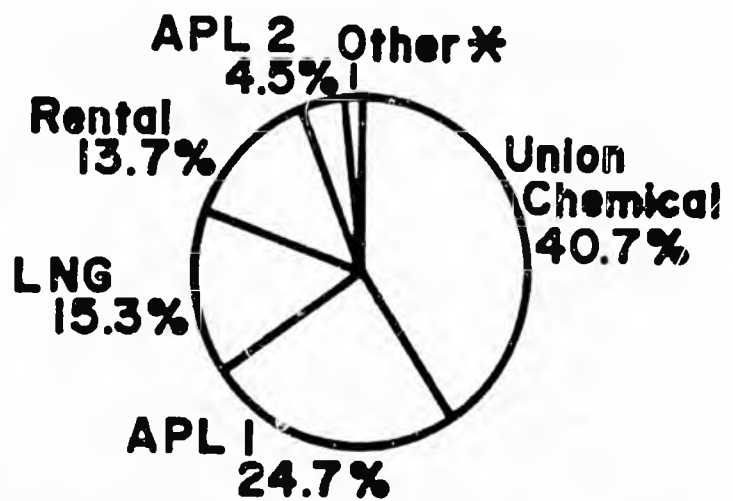


# KENAI FIELD

## Royalty And Working Interest Ownership



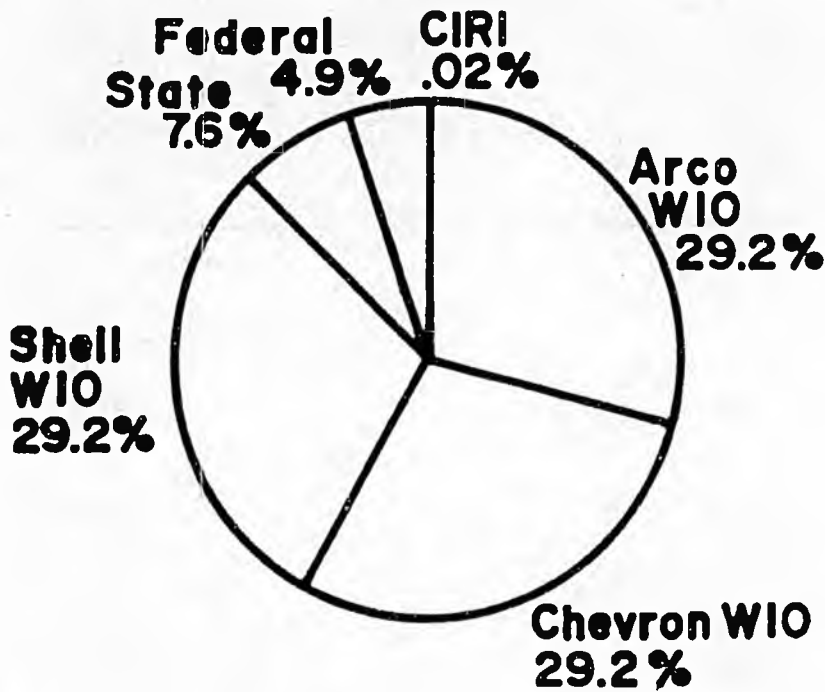
## State Royalty Disposition



\* APL-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	<u>121</u>	<u>9</u>
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	<u>1261</u>	<u>25</u>
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	<u>3932</u>	<u>491</u>
GRAND TOTAL	15,150	857

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.

264  
2.05-4

3 producers  
w/ separate

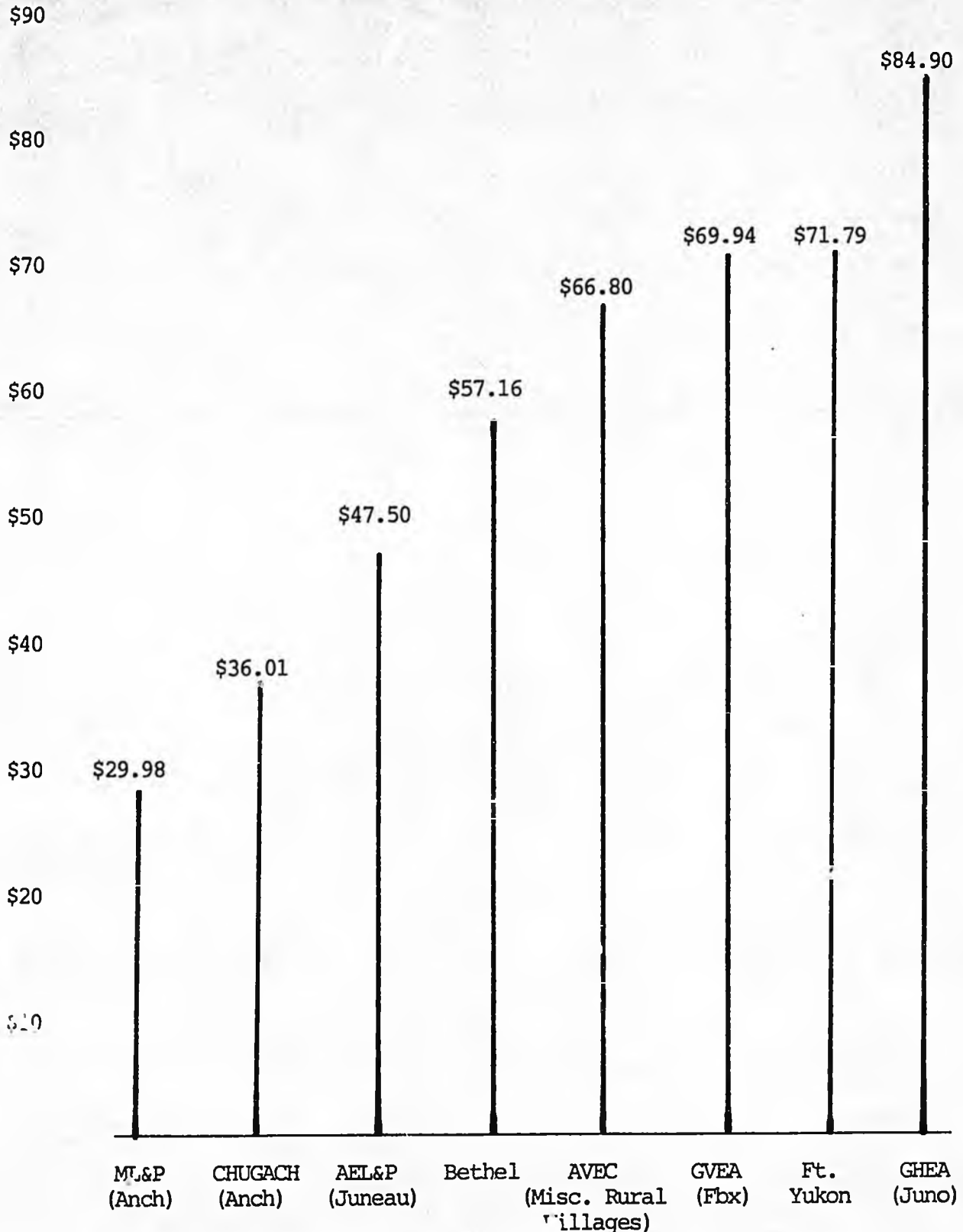
RECENT CONTRACTS AND PURCHASE AGREEMENTS

	<u>Purchaser</u>	<u>Field or Seller</u>	<u>Starting Base Price</u>
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	Beluga River	\$1.40-1.60
	(Peaking Gas)		
1983	Chugach	Cannery Loop	\$1.80
1984	Enstar	Lewis River	\$1.80
1985	Tesoro	Marathon	\$2.01
1985	AEG&T	Enstar	\$2.04
	(Homer Electric)		
1985	ML&P	Enstar	\$1.60
	(Anchorage)		

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.



# MATANUSKA ELECTRIC ASSOCIATION, INC.

P.O. BOX 1148

PALMER, ALASKA 99645

TELEPHONE  
(907) 745-3231

FEB 6 1986

February 4, 1986

The Honorable Arliss Sturgulewski  
Alaska State Legislature  
Pouch V  
Juneau, Alaska 99811

Dear Ms. Sturgulewski:

Subject: Senate Bill 309 (House Bills 403 and 425)

We strongly encourage your support of the above proposed legislation for the following reasons:

1. It will establish a law that the State of Alaska must follow in determining present and future royalty payments affecting utilities.
2. The proposal by the Department of Natural Resources and related actions that are likely to occur, could impact our power supplier (Chugach Electric Association, Inc.) by more than six million dollars annually. Since MEA represents approximately twenty percent of Chugach's revenues, this increased cost of providing electricity would amount to approximately \$1.2 million to our member/consumers.
3. Without SB 309, the price effect on pending negotiations between Chugach and the gas producers could result in additional costs to our member/consumers.
4. The State of Alaska needs a reasonable law which can be used by the utilities for long-term planning purposes and assist in rate stabilization, as well as provide our lenders with loan security.
5. The importance of this legislation has long-term impact on the consumers of electricity and natural gas from Homer to Fairbanks. As an electric cooperative, we are constantly making every attempt to keep rates as low as possible. Cost of purchasing power is the largest single expense for MEA, and I assure you that the member/consumers continually express their concerns about the cost of power. Senate Bill 309 is a consumer issue, as the outcome will affect their pocketbooks.

For these primary reasons, we urge you to support SB 309 (HB 403 and 425). Thank you for your cooperation.

Sincerely,

James F. Palin  
General Manager

cc: MEA Board of Directors  
Alaska Rural Electric Cooperative  
Association, Inc.



FEB 19 1986

**MATANUSKA ELECTRIC ASSOCIATION, INC.**

P.O. BOX 1148

PALMER, ALASKA 99645

TELEPHONE  
(907) 745-3231

February 11, 1986

The Honorable Arliss Sturgulewski  
Chairman, Senate Resources Committee  
Alaska State Legislature  
Room 508 Capitol Building  
Juneau, Alaska 99811

Dear Senator Sturgulewski:

Subject: Senate Bill 309

Due to apparent time constraints, I was not given the opportunity to offer my testimony via teleconference from Wasilla on February 10, 1986. In lieu of direct testimony, enclosed is a copy of the brief statement I planned to make in support of Senate Bill 309. I would appreciate it if you would provide the committee members a copy of this statement. If you would like additional information, please let me know and I will be happy to provide it.

Sincerely,

James F. Palin  
General Manager

rlh

Enclosure

cc: David P. Hutchens, ARECA  
Lawrence Markley, CEA

STATEMENT TO THE SENATE RESOURCES COMMITTEE

February 10, 1986

James F. Palin  
General Manager  
MATANUSKA ELECTRIC ASSOCIATION, INC.

GOOD AFTERNOON, MADAME CHAIRMAN, SENATORS...

ON BEHALF OF MATANUSKA ELECTRIC ASSOCIATION, I THANK YOU FOR THE OPPORTUNITY TO ADDRESS THIS COMMITTEE ON THE ISSUE OF ROYALTY NATURAL GAS PAYMENTS.

I AM JIM PALIN, GENERAL MANAGER OF MATANUSKA ELECTRIC ASSOCIATION, A POSITION I HAVE HELD SINCE 1981.

I'M HERE TODAY TO ADDRESS THE DECISION BY THE DEPARTMENT OF NATURAL RESOURCES TO INCREASE THE PRICE OF ROYALTY GAS IN THE COOK INLET BASIN FROM 26 CENTS PER MCF TO \$2.05 PER MCF -- NEARLY AN EIGHT-FOLD INCREASE, AND SENATE BILL 309.

AS YOU KNOW, WHEN THE PRICE OF RAW MATERIALS GOES UP, A BUSINESS HAS TWO CHOICES, IF IT WANTS TO STAY IN BUSINESS. IT CAN SELL ITS PRODUCT FOR THE SAME PRICE -- AND MAKE LESS OF A PROFIT, OR RAISE THE PRICE OF THE END PRODUCT.

OUR COOPERATIVE, MATANUSKA ELECTRIC, BUYS NEARLY ALL OF ITS POWER FROM CHUGACH ELECTRIC ASSOCIATION.

SINCE CHUGACH IS A NON-PROFIT COOPERATIVE, ITS ONLY CHOICE WHEN THE PRICE OF RAW MATERIALS GOES UP -- IN THIS CASE, NATURAL GAS -- IS TO RAISE THE PRICE OF ITS PRODUCT, ELECTRICITY.

ACCORDING TO CHUGACH ELECTRIC, DNR'S DECISION COULD COST CHUGACH MORE THAN \$6 MILLION PER YEAR.

AND SINCE MATANUSKA ELECTRIC'S PURCHASES MAKE UP APPROXIMATELY 20 PERCENT OF CHUGACH'S TOTAL REVENUES, OUR 26,000 CONSUMER-MEMBERS WOULD WIND UP PAYING ABOUT \$1.2 MILLION PER YEAR MORE THAN THEY NOW PAY FOR ELECTRICITY.

AND FOR MANY OF THEM, PARTICULARLY THOSE WHO LIVE IN THE MATANUSKA-SUSITNA VALLEY WHERE UNEMPLOYMENT IS OVER 17 PERCENT; THE COST OF ELECTRICITY IS ALREADY TOO HIGH.

BECAUSE OF THIS, BECAUSE DNR'S DECISION WOULD CAUSE A GENUINE HARDSHIP FOR MANY OF OUR MEMBER-CONSUMERS, MATANUSKA ELECTRIC ASSOCIATION SUPPORTS THE PASSAGE OF SENATE BILL 309, WHICH WOULD TIE THE PRICE OF ROYALTY GAS TO THE LONG-TERM CONTRACT PRICE.

IN ADDITION TO REDUCING THE IMPACT THAT THE COST OF ELECTRICITY HAS ON OUR MEMBERS, PASSAGE OF SB 309 WOULD PROVIDE A MEASURE OF CERTAINTY, OF SECURITY, FOR RAILBELT UTILITIES.

AS IT STANDS NOW, DNR COULD CHANGE THE PRICE OF ROYALTY GAS WHENEVER ANY ONE PURCHASER WAS WILLING TO PAY MORE FOR NATURAL GAS -- NO MATTER HOW MUCH OR HOW LITTLE OR FOR WHAT DURATION. THIS MAKES IT EXTREMELY DIFFICULT TO PLAN FOR THE FUTURE, TO SAY THE LEAST.

AS AN ELECTRIC COOPERATIVE, WE ARE CONSTANTLY MAKING EVERY EFFORT TO KEEP OUR MEMBERS' RATES AS LOW AS POSSIBLE. THE COST OF PURCHASING POWER IS MATANUSKA ELECTRIC'S LARGEST SINGLE EXPENSE, AND I ASSURE YOU THAT OUR MEMBERS CONTINUALLY EXPRESS THEIR CONCERNS ABOUT THE COST OF POWER. SENATE BILL 309 IS A CONSUMER ISSUE, A HUMAN ISSUE, AND WE URGE YOU TO VOTE FOR ITS PASSAGE.

THANK YOU VERY MUCH FOR GIVING ME THE OPPORTUNITY TO COMMENT ON THIS VITAL ISSUE, AND PLEASE FEEL FREE TO CALL ME IF I CAN BE OF ANY ASSISTANCE WHATSOEVER ON THIS ISSUE.

File  
SB 309

## ANCHORAGE CAUCUS

ALASKA STATE LEGISLATURE

### MINUTES

February 6, 1986

#### SENATE

Abood, M.  
DeVries, E.  
Faiks, J.  
Fischer, V.  
Halford, R.  
Josephson, J.  
Kelly, T.  
Kerttula, J.  
Rodey, P.  
Sturgulewski, A.

12:05 p.m., Senator Josephson called the meeting to order. The following members were not present: Representative Boucher; Senators DeVries, Kelly, Kerttula, and Rodey.

Dr. Joyce Murphy (President, Board of Directors, Chugach Electric Association) stated that the royalty gas increase impacts three-quarters of the State's population. The initial contract was a price of 26¢ per thousand cubic feet. DNR increased it to \$2.05. Most recently DNR offered a price of \$1.50 which we have turned down. We provide more than 85% of the power for half the residents of Alaska. We're looking at a 4.5 million dollar impact. On the consumer's electric bill it would be an increase of \$4.50 to \$5.00 per month. Our concern is that we have no long term assurance that this could not happen again. What Chugach is arguing now is that the market value is different than what the State is proposing. We feel it's because right now we're the only market. We understand the State's concern for wanting to get as much money as it can. In the last several days, we have been meeting with DNR and have had some good negotiations. We hope we can reach a settlement on the price. However, we're still concerned about the long term implications.

Rep. Cotten did you say you were about ready to reach a settlement?

Murphy we have been negotiating for about two years with the companies, we are delivering hard numbers back and forth. Hopefully, very soon we will reach an agreement.

Rep. Cotten that's with the producers, not with the Department.

#### HOUSE

Boucher, R.  
Clocksin, D.  
Collins, V.  
Cotten, S.  
Furnace, W.  
Gruenberg, M.  
Hanley, A.  
Jenkins, R.  
Martin, T.  
Pearce, D.  
Pettyjohn, F.  
Phillips, R.  
Pignalberi, M.  
Pourchot, P.  
Rieger, S.  
Szymanski, M.  
Uehling, R.

## ANCHORAGE CAUCUS

### ALASKA STATE LEGISLATURE

Minutes 2/6/85

Page Two

#### SENATE

Abood, M.  
DeVries, E.  
Faiks, J.  
Fischer, V.  
Halford, R.  
Josephson, J.  
Kelly, T.  
Kerttula, J.  
Rodey, P.  
Sturgulewski, A.

Murphy that's with the producers, however we are also negotiating with DNR in some productive meetings. Our major concern is the long term issue. We're not clear right now whether DNR can give us the assurance of a long term settlement that would not be needing some sort of legislative approval.

Sen. Sturgulewski what's your involvement with Susitna?

Murphy we support hydroelectric power. "No, we have not ever put our eggs in the Susitna basket." We have been concerned about the financial feasibility of it. We have not opposed it nor favored it. We have been looking at alternatives - small hydroelectric projects and coal.

#### HOUSE

Boucher, R.  
Clocksin, D.  
Collins, V.  
Cotten, S.  
Furnace, W.  
Gruenberg, M.  
Hanley, A.  
Jenkins, R.  
Martin, T.  
Pearce, D.  
Pettyjohn, F.  
Phillips, R.  
Pignalberi, M.  
Pourchot, P.  
Rieger, S.  
Szymanski, M.  
Uehling, R.

Sen. Halford what are your thoughts on putting an amendment on power cost assistance to make up the difference?

Murphy as a taxpayer, I don't like subsidies. I believe that we're looking at the fact that we went out and negotiated at arms length a real favorable contract and it is now being disrupted. And we're about to go out and negotiate real favorable new contracts because we did have prior favorable contracts, and that's about to be disrupted. I don't consider that a subsidy, I consider that foolish.

Sen. Halford do you think we should treat the oil industry the same way?

Murphy I personally think the oil industry is a totally different ballgame.

Sen. Faiks expressed her disapproval with DNR's decision to increase royalty gas prices. She noted that to her, this is the consumer issue of the session.

## ANCHORAGE CAUCUS

### ALASKA STATE LEGISLATURE

Minutes 2/6/86

Page Three

#### SENATE

Abood, M.  
DeVries, E.  
Falks, J.  
Fischer, V.  
Halford, R.  
Josephson, J.  
Kelly, T.  
Kerttula, J.  
Rodey, P.  
Sturgulewski, A.

Jim Palin (General Manager, Matanuska Electric Association) we have about 27,000 consumers we are now serving. If this proposal goes through, we're talking about an impact of \$1.2 million annually. Our existing rates are about one-third higher than Chugach's. We support the legislation that was introduced this year (SB 309, HB 403 and HB 425). We are concerned about the long term impact about the gas price.

Sen. Halford why does MEA support the Bradley Lake intertie?

Palin by existing law, we're entitled to a portion of that energy. In the long run, obviously it should be one of the cheaper sources of power available in the State.

#### HOUSE

Boucher, R.  
Clocksin, D.  
Collins, V.  
Cotten, S.  
Furnace, W.  
Gruenberg, M.  
Hanley, A.  
Jenkins, R.  
Martin, T.  
Pearce, D.  
Pettyjohn, F.  
Phillips, R.  
Pignalberi, M.  
Pourchot, P.  
Rieger, S.  
Szymanski, M.  
Uehling, R.

Esther Wunnicke (Commissioner, Department of Natural Resources) DNR is not the cause of any increase of price. The lease terms are such that the representation of value is indicated by contracts that are entered into at arms length by other parties. The State of Alaska was not a party to the contract entered into between the producers and Chugach Electric or any other takers of gas from the producers. We were a party to the contract entered into with the producers when they took oil and gas leases from the State of Alaska. It was that contract that we sought to enforce. This particular enforcement should not be seen in isolation from all the other enforcement actions taken by DNR to do what is our responsibility on behalf of all of the people of Alaska in order to get full value for the State's royalty resources. We recognize that the Beluga field, because of the volumes taken by Chugach Electric, is a somewhat unique situation compared to some of the other fields in Cook Inlet. It was in recognition of that fact and also because there would be pass through effects on the utilities that DNR determined we would not ask for retroactive payment. Instead, the payment would be prospective.

# ANCHORAGE CAUCUS

## ALASKA STATE LEGISLATURE

Minutes 2/6/86

Page Four

### SENATE

Abood, M.  
DeVries, E.  
Falks, J.  
Fischer, V.  
Halford, R.  
Josephson, J.  
Kelly, T.  
Kerttula, J.  
Rodey, P.  
Sturgulewski, A.

Discussion ensued about comparing gas contracts to oil contracts and the effect, if any, it would have on oil royalty prices.

Rep. Szymanski are you currently a party to the Chugach litigation with producers?

Wunnicke the producers have sued the State of Alaska. The last offer of \$1.50 was rejected, so we are still in Superior Court.

Murphy noted that in relationship to subsidy, if this Legislature passes a subsidy, it won't necessarily mean that your successors next year would approve it. We're not talking about something just this year, we're talking about thirty years down the road. The point we have tried to reiterate to DNR is that they have the right that with six months notice can take it out and sell it to whomever they want to if they think they can get a better price for it. Chugach would in no way ever block them from doing that. In fact, if DNR thinks they can do it, we'd like to see them do it today and then maybe this whole mess would go away.

Sen. Josephson adjourned the meeting at 1:05 pm.

### HOUSE

Boucher, R.  
Clocksin, D.  
Collins, V.  
Cotten, S.  
Furnace, W.  
Gruenberg, M.  
Hanley, A.  
Jenkins, R.  
Martin, T.  
Pearce, D.  
Pettyjohn, F.  
Phillips, R.  
Pignalberi, M.  
Pourchot, P.  
Rieger, S.  
Szymanski, M.  
Uehling, R.

Original sponsors: Faiks, Kelly  
and V.Fischer

1 IN THE SENATE

BY THE RESOURCES COMMITTEE

2 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. (a) The legislature finds that the best inter-  
10 est of the state will be served if the commissioner of natural resources is  
11 authorized to establish the value for royalty gas taken in value by the  
12 state and sold to a nonprofit electric utility by using the contract price  
13 between the lessee of the state and the nonprofit electric utility, whether  
14 or not the royalty gas lease with the state establishes a different stan-  
15 dard for the valuation and if the lessee and the nonprofit electric utility  
16 are not related to each other. The legislature finds that this authoriza-  
17 tion should apply prospectively and does not intend the authorization to  
18 apply to the valuation of royalty gas that is sold by a lessee of the state  
19 under a contract entered into before the effective date of this Act with a  
20 nonprofit electric utility.

21 (b) The legislature finds that it is also in the best interest of the  
22 state to give the commissioner explicit discretionary authority to sell  
23 royalty gas received in kind by the state to nonprofit electric utilities  
24 at a price that is below market value.

25 (c) The proper exercise of the discretion conferred by this Act on  
26 the commissioner would support and complement the other programs that  
27 assist the citizens of the state with their long-term electrical needs,  
28 including the power cost equalization program under AS 44.83.162 - 44.83.-  
29 165 and hydroelectric and other programs for the generation of electricity.

1 (d) The state should adopt a policy for the sale of royalty gas to  
2 nonprofit electric utilities for in-state generation of electricity that is  
3 fundamentally different from the policies of the state for the sale of  
4 royalty oil and for the sale of royalty gas for export from the state or  
5 for uses other than in-state generation of electricity.

6 \* Sec. 2. AS 38.05.180 is amended by adding a new subsection to read:

7 (aa) Within 90 days after the written request of a lessee of a  
8 lease issued under this section, unless the commissioner makes a  
9 written finding based on clear and convincing evidence that the con-  
10 tract price is unreasonably low and that a prospective reduction in  
11 royalty receipts would not be balanced by increased benefits to elec-  
12 tric consumers, the commissioner shall enter into an agreement with  
13 the lessee to use the price for the gas established in the contract  
14 between the lessee and a nonprofit electric utility, if the lessee and  
15 the utility are not related in management, ownership, or other aspect,  
16 as the value of the state's royalty share of gas production sold by a  
17 lessee of the state to a nonprofit electric utility. In this  
18 subsection

19 (1) "nonprofit electric utility" includes an electric  
20 cooperative organized under AS 10.25 and a municipal utility; and

21 (2) "price for the gas established in the contract" in-  
22 cludes tax reimbursement amounts, deliverability and other charges,  
23 and other forms of consideration paid by the nonprofit electric utili-  
24 ty under the contract.

25 \* Sec. 3. AS 38.05.183(h) is amended by adding a new subsection to  
26 read:

27 (h) [~~Within 90 days after the written request of a lessee of a~~  
28 ~~lease issued under AS 38.05.180;~~] the commissioner may enter into a  
29 contract to sell royalty gas taken in kind by the state to a nonprofit

1 electric utility at less than the market value of the royalty gas if  
2 the commissioner, after considering the consumer benefits, other  
3 benefits, and detriments of the sale, makes a written finding that the  
4 sale is in the best interest of the state. In this subsection, "non-  
5 profit electric utility" includes an electric cooperative organized  
6 under AS 10.25 and a municipal utility.

7 \* Sec. 4. AS 38.05.810(a) is amended to read:

8 (a) Except as otherwise provided in AS 38.05.183(h), the [THE]  
9 lease, sale, or other disposal of state land or resources may be made  
10 to a state or federal agency or political subdivision, or the lease,  
11 sale, or disposal of coal deposits suitable for mining may be made to  
12 a utility owned and operated by a government agency or nonprofit  
13 cooperative association organized to participate under the Federal  
14 Rural Electrification Act for the purpose of generating electric power  
15 and energy or the production of process steam, or both, for less than  
16 the appraised value as determined by the director and approved by the  
17 commissioner to be fair and proper and in the best interests of the  
18 public, with due consideration given to the nature of the public  
19 services or function rendered by the agency, subdivision, or utility  
20 making application, and of the terms of the grant under which the land  
21 was acquired by the state.

22 \* Sec. 5. Section 2 of this Act applies to contracts entered into on or  
23 after the effective date of this Act to sell to nonprofit electric  
24 utilities gas produced under a lease issued under AS 38.05.180.

25 \* Sec. 6. Section 3 of this Act applies to contracts entered into by  
26 the state on or after the effective date of this Act to sell new quantities  
27 of royalty gas to nonprofit electric utilities.

28 \* Sec. 7. This Act takes effect immediately in accordance with AS 01.-  
29 10.070(c).

ENSTAR

Bannister  
2/26/86

Original sponsors: Faiks, Kelly  
and V.Fischer

1 IN THE SENATE

2 CS FOR SENATE BILL NO. 309 ( )

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. (a) The legislature finds that the best inter-  
10 est of the state will be served if the commissioner of natural resources is  
11 authorized to establish the in-value royalty for gas sold to a gas or  
12 electric utility by using the contract price between the lessee of the  
13 state and the utility, whether or not the gas lease establishes a different  
14 standard for the valuation and if the lessee and the utility are not re-  
15 lated to each other. The legislature finds that this authorization should  
16 apply prospectively and does not intend the authorization to apply to the  
17 valuation for royalty purposes of gas sold by a lessee under a gas sales  
18 contract entered into before the effective date of this Act.

19 (b) The legislature finds that it is also in the best interest of the  
20 state to give the commissioner explicit discretionary authority to sell  
21 royalty gas received in kind by the state to gas or electric utilities at a  
22 price that is below market value.

23 (c) The legislature finds that the proper exercise of the discretion  
24 conferred on the commissioner by this Act would support and complement the  
25 other programs that assist the citizens of the state with their long-term  
26 gas and electrical needs, including the power cost equalization program  
27 under AS 44.83.162 - 44.83.165 and hydroelectric and other programs for the  
28 generation of electricity.

29 (d) The legislature finds that the state should adopt a policy for

1 the sale of royalty gas to gas or electric utilities for in-state consumer  
2 use and in-state generation of electricity that is fundamentally different  
3 from the policies of the state for the sale of royalty oil and for the sale  
4 of royalty gas for export from the state or for uses other than in-state  
5 consumer use and in-state generation of electricity.

6 \* Sec. 2. AS 38.05.180 is amended by adding a new subsection to read:

7 (aa) Within 90 days after the written request of a lessee of a  
8 lease issued under this section, unless the commissioner makes a  
9 written finding based on clear and convincing evidence that the con-  
10 tract price is unreasonably low and that a prospective reduction in  
11 royalty receipts would not be balanced by increased benefits to in-  
12 state gas and electric consumers, the commissioner shall enter into an  
13 agreement with the lessee to use the price for the gas established in  
14 the contract between the lessee and a gas or electric utility, if the  
15 lessee and the utility are not related in management, ownership, or  
16 other aspect, as the value of the state's royalty share of gas produc-  
17 tion sold by the lessee under the contract to the utility. In this  
18 subsection

19 (1) "gas or electric utility" includes an electric coopera-  
20 tive organized under AS 10.25, a municipal utility, and a gas or  
21 electric utility regulated under AS 42.05; and

22 (2) "price for the gas established in the contract" in-  
23 cludes tax reimbursement amounts, deliverability and other charges,  
24 and other forms of consideration paid by the gas or electric utility  
25 under the contract.

26 \* Sec. 3. AS 38.05.183 is amended by adding a new subsection to read:

27 (h) The commissioner may enter into a contract to sell royalty  
28 gas taken in kind by the state to a gas or electric utility at less  
29 than the market value of the royalty gas if the commissioner, after

1 considering the consumer benefits, other benefits, and detriments of  
2 the sale, makes a written finding that the sale is in the best inter-  
3 est of the state. In this subsection, "gas or electric utility"  
4 includes an electric cooperative organized under AS 10.25, a municipal  
5 utility, and a gas or electric utility regulated under AS 42.05.

6 \* Sec. 4. AS 38.05.810(a) is amended to read:

7 (a) Except as otherwise provided in AS 38.05.183(h), the [THE]  
8 lease, sale, or other disposal of state land or resources may be made  
9 to a state or federal agency or political subdivision, or the lease,  
10 sale, or disposal of coal deposits suitable for mining may be made to  
11 a utility owned and operated by a government agency or nonprofit  
12 cooperative association organized to participate under the Federal  
13 Rural Electrification Act for the purpose of generating electric power  
14 and energy or the production of process steam, or both, for less than  
15 the appraised value as determined by the director and approved by the  
16 commissioner to be fair and proper and in the best interests of the  
17 public, with due consideration given to the nature of the public  
18 services or function rendered by the agency, subdivision, or utility  
19 making application, and of the terms of the grant under which the land  
20 was acquired by the state.

21 \* Sec. 5. Section 2 of this Act applies to agreements to establish for  
22 a lease issued under AS 38.05.180 the in-value royalties on gas production  
23 that is sold under a contract entered into on or after the effective date  
24 of this Act between the state's lessee and a gas or electric utility.

25 \* Sec. 6. This Act takes effect immediately in accordance with AS 01.-  
26 10.070(c).

Original sponsors: Faiks, Kelly  
and V.Fischer

1 IN THE SENATE

BY THE RULES COMMITTEE

2 CS FOR SENATE BILL NO. 309 (Rules)

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 FOURTEENTH LEGISLATURE - SECOND SESSION

5 A BILL

6 For an Act entitled: "An Act relating to 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. (a) The legislature finds that the best inter-  
10 est of the state will be served if the commissioner of natural resources is  
11 authorized to establish the in-value royalty for gas sold to a gas or  
12 electric utility by using the contract price between the lessee of the  
13 state and the utility, whether or not the gas lease establishes a different  
14 standard for the valuation and if the lessee and the utility are not re-  
15 lated to each other. The legislature finds that this authorization should  
16 apply prospectively and does not intend the authorization to apply to the  
17 valuation for royalty purposes of gas sold by a lessee under a gas sales  
18 contract entered into before the effective date of this Act.

19 (b) The legislature finds that it is also in the best interest of the  
20 state to give the commissioner explicit discretionary authority to sell  
21 royalty gas received in kind by the state to gas or electric utilities at a  
22 price that is below market value.

23 (c) The legislature finds that the proper exercise of the discretion  
24 conferred on the commissioner by this Act would support and complement the  
25 other programs that assist the citizens of the state with their long-term  
26 gas and electrical needs, including the power cost equalization program  
27 under AS 44.83.162 - 44.83.165 and hydroelectric and other programs for the  
28 generation of electricity.

29 (d) The legislature finds that the state should adopt a policy for

1 the sale of royalty gas to gas or electric utilities for in-state consumer  
2 use and in-state generation of electricity that is fundamentally different  
3 from the policies of the state for the sale of royalty oil and for the sale  
4 of royalty gas for export from the state or for uses other than in-state  
5 consumer use and in-state generation of electricity.

6 (e) The legislature finds it is in the state's best interest to  
7 facilitate the financing and construction of a pipeline and increased gas  
8 production from the Prudhoe Bay reservoir by establishing a procedure by  
9 which the state could commit itself to a royalty valuation methodology for  
10 as long as the state takes its royalty share of gas production in value.

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

12 (aa) Within 90 days after the written request of a lessee of a  
13 lease issued under this section, unless the commissioner makes a  
14 written finding based on clear and convincing evidence that the con-  
15 tract price is unreasonably low and that a prospective reduction in  
16 royalty receipts would not be balanced by increased benefits to in-  
17 state gas and electric consumers, the commissioner shall enter into an  
18 agreement with the lessee to use the price for the gas established in  
19 the contract between the lessee and a gas or electric utility, if the  
20 lessee and the utility are not related in management, ownership, or  
21 other aspect, as the value of the state's royalty share of gas produc-  
22 tion sold by the lessee under the contract to the utility. In this  
23 subsection

24 (1) "gas or electric utility" includes an electric coopera-  
25 tive organized under AS 10.25, a municipal utility, and a gas or  
26 electric utility regulated under AS 42.05; and

27 (2) "price for the gas established in the contract" in-  
28 cludes tax reimbursement amounts, deliverability and other charges,  
29 and other forms of consideration paid by the gas or electric utility

1 under the contract.

2 (bb) In the event of a contract between parties that are unrelat-  
3 ed in management, ownership, or other aspect for the sale of gas from  
4 Prudhoe Bay reservoir gas leases by means of delivery of the gas  
5 through a pipeline for export out of the state, and within 90 days  
6 after the written request of a lessee of a lease issued under this  
7 section, unless the commissioner makes a written finding that the  
8 contract price does not assure the maximum benefits to the people of  
9 the state in return for the state's gas resources, the commissioner  
10 shall enter into an agreement with the lessee to use the price for the  
11 gas established in the gas sales contract as the value of the state's  
12 royalty share of gas production sold by the lessee under the gas sales  
13 contract. The lessee shall have the burden of providing all informa-  
14 tion necessary for the commissioner to make an informed decision, and  
15 shall provide clear and convincing evidence that the value of the gas  
16 is reflected by the gas sales contract price rather than being attri-  
17 buted to transportation, marketing, or other profit or cost centers.  
18 In this subsection, "price for the gas established in the gas sales  
19 contract" includes tax reimbursement amounts, deliverability and other  
20 charges, and other forms of consideration received by the lessee under  
21 the gas sales contract.

22 \* Sec. 3. AS 38.05.183 is amended by adding a new subsection to read:

23 (h) The commissioner may enter into a contract to sell royalty  
24 gas taken in kind by the state to a gas or electric utility at less  
25 than the market value of the royalty gas if the commissioner, after  
26 considering the consumer benefits, other benefits, and detriments of  
27 the sale, makes a written finding that the sale is in the best inter-  
28 est of the state. In this subsection, "gas or electric utility"  
29 includes an electric cooperative organized under AS 10.25, a municipal

1 utility, and a gas or electric utility regulated under AS 42.05.

2 \* Sec. 4. AS 38.05.810(a) is amended to read:

3 (a) Except as otherwise provided in AS 38.05.183(h), the [THE]  
4 lease, sale, or other disposal of state land or resources may be made  
5 to a state or federal agency or political subdivision, or the lease,  
6 sale, or disposal of coal deposits suitable for mining may be made to  
7 a utility owned and operated by a government agency or nonprofit  
8 cooperative association organized to participate under the Federal  
9 Rural Electrification Act for the purpose of generating electric power  
10 and energy or the production of process steam, or both, for less than  
11 the appraised value as determined by the director and approved by the  
12 commissioner to be fair and proper and in the best interests of the  
13 public, with due consideration given to the nature of the public  
14 services or function rendered by the agency, subdivision, or utility  
15 making application, and of the terms of the grant under which the land  
16 was acquired by the state.

17 \* Sec. 5. AS 38.05.180(aa), enacted by sec. 2 of this Act, applies to  
18 agreements to establish for a lease issued under AS 38.05.180 the in-value  
19 royalties on gas production that is sold under a contract entered into on  
20 or after the effective date of this Act between the state's lessee and a  
21 gas or electric utility.

22 \* Sec. 6. This Act takes effect immediately in accordance with AS 01.-  
23 10.070(c).  
24  
25  
26  
27  
28  
29

Original sponsors: Faiks, Kelly  
and V.Fischer

1 IN THE SENATE

2 CS FOR SENATE BILL NO. 309 ( )

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. (a) The legislature finds that the best inter-  
10 est of the state will be served if the commissioner of natural resources is  
11 authorized to establish the in-value royalty for gas sold to a gas or  
12 electric utility by using the contract price between the lessee of the  
13 state and the utility, whether or not the gas lease establishes a different  
14 standard for the valuation and if the lessee and the utility are not re-  
15 lated to each other. The legislature finds that this authorization should  
16 apply prospectively and does not intend the authorization to apply to the  
17 valuation for royalty purposes of gas sold by a lessee under a gas sales  
18 contract entered into before the effective date of this Act.

19 (b) The legislature finds that it is also in the best interest of the  
20 state to give the commissioner explicit discretionary authority to sell  
21 royalty gas received in kind by the state to gas or electric utilities at a  
22 price that is below market value.

23 (c) The legislature finds that the proper exercise of the discretion  
24 conferred on the commissioner by this Act would support and complement the  
25 other programs that assist the citizens of the state with their long-term  
26 gas and electrical needs, including the power cost equalization program  
27 under AS 44.83.162 - 44.83.165 and hydroelectric and other programs for the  
28 generation of electricity.

29 (d) The legislature finds that the state should adopt a policy for

1 the sale of royalty gas to gas or electric utilities for in-state consumer  
2 use and in-state generation of electricity that is fundamentally different  
3 from the policies of the state for the sale of royalty oil and for the sale  
4 of royalty gas for export from the state or for uses other than in-state  
5 consumer use and in-state generation of electricity.

6 \* Sec. 2. AS 38.05.180 is amended by adding a new subsection to read:

7 (aa) Within 90 days after the written request of a lessee of a  
8 lease issued under this section, unless the commissioner makes a  
9 written finding based on clear and convincing evidence that the con-  
10 tract price is unreasonably low and that a prospective reduction in  
11 royalty receipts would not be balanced by increased benefits to in-  
12 state gas and electric consumers, the commissioner shall enter into an  
13 agreement with the lessee to use the price for the gas established in  
14 the contract between the lessee and a gas or electric utility, if the  
15 lessee and the utility are not related in management, ownership, or  
16 other aspect, as the value of the state's royalty share of gas produc-  
17 tion sold by the lessee under the contract to the utility. In this  
18 subsection

19 (1) "gas or electric utility" includes an electric coopera-  
20 tive organized under AS 10.25, a municipal utility, and a gas or  
21 electric utility regulated under AS 42.05; and

22 (2) "price for the gas established in the contract" in-  
23 cludes tax reimbursement amounts, deliverability and other charges,  
24 and other forms of consideration paid by the gas or electric utility  
25 under the contract.

26 \* Sec. 3. AS 38.05.183 is amended by adding a new subsection to read:

27 (h) The commissioner may enter into a contract to sell royalty  
28 gas taken in kind by the state to a gas or electric utility at less  
29 than the market value of the royalty gas if the commissioner, after

1 considering the consumer benefits, other benefits, and detriments of  
2 the sale, makes a written finding that the sale is in the best inter-  
3 est of the state. In this subsection, "gas or electric utility"  
4 includes an electric cooperative organized under AS 10.25, a municipal  
5 utility, and a gas or electric utility regulated under AS 42.05.

6 \* Sec. 4. AS 38.05.810(a) is amended to read:

7 (a) Except as otherwise provided in AS 38.05.183(h), the [THE]  
8 lease, sale, or other disposal of state land or resources may be made  
9 to a state or federal agency or political subdivision, or the lease,  
10 sale, or disposal of coal deposits suitable for mining may be made to  
11 a utility owned and operated by a government agency or nonprofit  
12 cooperative association organized to participate under the Federal  
13 Rural Electrification Act for the purpose of generating electric power  
14 and energy or the production of process steam, or both, for less than  
15 the appraised value as determined by the director and approved by the  
16 commissioner to be fair and proper and in the best interests of the  
17 public, with due consideration given to the nature of the public  
18 services or function rendered by the agency, subdivision, or utility  
19 making application, and of the terms of the grant under which the land  
20 was acquired by the state.

21 \* Sec. 5. Section 2 of this Act applies to agreements to establish for  
22 a lease issued under AS 38.05.180 the in-value royalties on gas production  
23 that is sold under a contract entered into on or after the effective date  
24 of this Act between the state's lessee and a gas or electric utility.

25 \* Sec. 6. This Act takes effect immediately in accordance with AS 01.-  
26 10.070(c).

Add to section (1)(b) the following language at the end of the paragraph:

The legislature finds it is in the state's best interest to facilitate the financing and construction of a pipeline and increased gas production from the Alaska North Slope gas fields by establishing a procedure by which the state could commit itself to a royalty valuation methodology for so long as the state <sup>takes</sup> ~~look~~ its royalty share of gas production in value.

Add to section 2 a new subsection (bb):

In the event of a contract between parties which are unrelated in management, ownership, or other aspect for the sale of gas from Alaska's North Slope gas leases by means of delivery through a pipeline for export out of Alaska, within ninety days after the written request of a lessee of a lease issued under this section, unless the Commissioner makes a written finding that the contract price does not assure the maximum benefits to the people of Alaska in return for the state's gas resources, the Commissioner shall 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 contract. The lessee shall have the burden of providing all information necessary for the Commissioner to make an informed finding, and must

provide clear and convincing evidence that the value of the gas is reflected in the contract price rather than being attributed to transportation, marketing, or other profit or cost centers. For the purpose of this subsection, the term "price for 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 contract.

Offered: 5/11/86  
For Today's Calendar

Original sponsors: Faiks, Kelly  
and V. Fischer

1 IN THE SENATE BY THE RULES COMMITTEE

2 HOUSE CS FOR CS FOR SENATE BILL NO. 309 (Rules)

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 FOURTEENTH LEGISLATURE - SECOND SESSION

5 A BILL

6 For an Act entitled: "An Act relating to 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 the best interest of  
10 the state will be served if the commissioner of natural resources is au-  
11 thorized to establish the in-value royalty for gas sold to a gas or elec-  
12 tric utility by using the contract price between the lessee of the state  
13 and the utility, whether or not the gas lease establishes a different stan-  
14 dard for the valuation and if the lessee and the utility are not related to  
15 each other. The legislature finds that this authorization should apply  
16 prospectively and does not intend the authorization to apply to the val-  
17 uation for royalty purposes of gas sold by a lessee under a gas sales  
18 contract entered into before the effective date of this Act. The legisla-  
19 ture does not intend this Act to apply to the policies of the state regard-  
20 ing the value of the state's royalty share of oil production.

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

22 (aa) Within 90 days after the written request of a lessee of a  
23 lease issued under this section, the commissioner shall enter into an  
24 agreement with the lessee to use the price for the gas established in  
25 the contract between the lessee and a gas or electric utility as the  
26 value of the state's royalty share of gas production sold by the  
27 lessee under the contract unless the commissioner makes a written  
28 finding, based on clear and convincing evidence, that

(1) the contract price is unreasonably low;

*SENTENCE  
FROM ORIG*

*Restructured*

1 (2) the prospective reduction in royalty receipts would not  
2 be balanced by increased benefits to in-state gas and electric con-  
3 sumers;

4 (3) the lessee and the utility are related in management,  
5 ownership, or other aspect; and

6 (4) the contract price is not in the best interest of the  
7 state.

8 (bb) In (aa) of this section

9 (1) "gas or electric utility" includes an electric coopera-  
10 tive organized under AS 10.25, a municipal utility, and a gas or  
11 electric utility regulated under AS 42.05; provided that if the con-  
12 tract gas is transmitted to consumers through a pipeline and the gas  
13 utility either owns the pipeline or is related in ownership to the  
14 owner of the pipeline, then the gas utility qualifies as a "gas or  
15 electric utility" within the meaning of this paragraph only if it is  
16 bound or agrees to be bound by the covenants set out in AS 38.35.120;

17 (2) "price for the gas established in the contract" in-  
18 cludes tax reimbursement amounts, deliverability and other charges,  
19 and other forms of consideration paid by the gas or electric utility  
20 under the contract;

21 (3) "state's royalty share of gas production" does not  
22 include the state's royalty share of gas production from land patented  
23 to the state under

24 (A) P.L. 84-830, 70 Stat. 709 (Alaska Mental Health  
25 Enabling Act);

26 (B) 38 Stat. 1214 (Act of March 4, 1915); or

27 (C) 43 U.S.C. 1635 in settlement of the claims of the  
28 state under 38 Stat. 1214.

29 \* Sec. 3. AS 38.05.183 is amended by adding a new subsection to read:

*Removed  
Senate Rules  
CS  
(b)(1)  
North Slope  
Gas  
Pipeline*

*Common  
Costen  
amendment*

*same*

*added at  
DNR's request  
of an advisor  
of Law*

*File under  
38.06.055 already  
Provides for  
legislative approval*

1 (h) Upon legislative approval, the commissioner may enter into a  
2 contract to sell royalty gas taken in kind by the state to a gas or  
3 electric utility <sup>at less than market value</sup> at a negotiated price for the gas if the  
4 commissioner, after considering the consumer benefits, other benefits,  
5 and detriments of the sale, makes a written finding that the sale is  
6 in the best interest of the state. In this subsection,

7 (1) "gas or electric utility" has the meaning given in  
8 AS 38.05.180(bb);

9 (2) "royalty gas taken in kind by the state" does not  
10 include royalty gas taken in kind by the state from gas production on  
11 land patented to the state under

12 (A) P.L. 84-830, 70 Stat. 709 (Alaska Mental Health  
13 Enabling Act);

14 (B) 38 Stat. 1214 (Act of March 4, 1915); or

15 (C) 43 U.S.C. 1635 in settlement of the claims of the  
16 state under 38 Stat. 1214.

17 \* Sec. 4. AS 38.05.810(a) is amended to read:

18 (a) Except as otherwise provided in AS 38.05.183(h), the [THE]  
19 lease, sale, or other disposal of state land or resources may be made  
20 to a state or federal agency or political subdivision, or the lease,  
21 sale, or disposal of coal deposits suitable for mining may be made to  
22 a utility owned and operated by a government agency or nonprofit  
23 cooperative association organized to participate under the Federal  
24 Rural Electrification Act for the purpose of generating electric power  
25 and energy or the production of process steam, or both, for less than  
26 the appraised value as determined by the director and approved by the  
27 commissioner to be fair and proper and in the best interests of the  
28 public, with due consideration given to the nature of the public  
29 services or function rendered by the agency, subdivision, or utility

*SOME*

1 making application, and of the terms of the grant under which the land  
2 was acquired by the state.

3 \* Sec. 5. AS 38.05.180(aa), enacted by sec. 2 of this Act, applies to  
4 agreements to establish for a lease issued under AS 38.05.180 the in-value  
5 royalties on gas production that is sold under a contract entered into on  
6 or after the effective date of this Act between the state's lessee and a  
7 gas or electric utility.

} SAME

8 \* Sec. 6. This Act takes effect immediately in accordance with AS 01.-  
9 10.070(c).