SB
430

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 March 17, 1985

FROM: Senate Resource Committee Staff

RE: Sponsor Substitute for Senate Bill No. 430
"An Act authorizing the commissioner of the Department of Natural Resources under certain circumstances to reduce or revoke royalty oil or gas obligation increases made in connection with the institution or operation of a cooperative or unit plan; and providing for an effective date."

In this packet is a analysis of this bill by the sponsor, a letter and fiscal note from DNR, a letter from CONOCO and a relevant article from the Daily News.

SPONSOR ANALYSIS OF SB 430

Relating to the reduction or revocation of royalty oil and gas obligation increases under certain circumstances.

PURPOSE

The purpose of SB 430 is to remove a perceived ambiguity in Alaska's oil and gas laws that is impairing the Commissioner of the Department of Natural Resources' ("DNR") ability to encourage oil production from marginal oil and gas units.

BACKGROUND

In 1979, DNR adopted a short-lived policy of requiring a royalty surcharge as a condition of approval of certain oil or gas units. For example, when the working interest owners of the Milne Point Unit sought unit approval in September, 1979, they were required to accept an increase in their royalty from 12½% to 20%.

This 7½% royalty surcharge was imposed at a time when DNR believed that, in 1985, the wellhead price of Milne Poin oil would be approximately $34/barrel. In fact, the current wellhead price has plummeted to the point where continued development of the Milne Point Unit has been suspended.

THE PROBLEM

DNR recognizes the dramatic difference between the predictions of 1979, and the facts of 1986. From the industry's perspective, DNR should reconsider the desirability of its royalty surcharge because of these changes. That agency is concerned, however, that

the legislature may have unintentionally limited DNR's authority to adjust the terms of unit agreements as circumstances change.

The 1979 royalty surcharge was imposed under AS 38.05.180 (p), which broadly authorizes the commissioner to "change or revoke . . royalty requirements of the leases . . . .in connection with the institution and operation of a . . . unit plan. Under the plain words of that section, the commissioner may increase royalties at the time of unit "institution," and she may also reduce them at the time of unit "operation." As a result, that subsection empowers the commissioner to change the royalty stipulations of a unit agreement whenever the public interest demands it.

DNR, however, has also pointed to AS 38.05.180(j), which requires two years of production from the field before a royalty may be reduced on "leases." Since DNR believes that two year's production has not occurred from the Milne Point "field," the agency is concerned that the two year limitation of subsection (j) may imply a limit to the commissioner's very different authority to change royalty requirements in conjunction with unitization under subsection (p).

LEGISLATIVE HISTORY

A review of the legislative history of subsection (j) shows that this was never the legislature's intent. In 1978, "when subsection (j) was created," the legislature authorized royalty and net profit share bidding. With the royalty as a bid variable, the legislature was concerned that a company might bid an artificially

high royalty to obtain the lease, and then immediately seek a royalty reduction. As a result, the legislature enacted subsection (j) in order to limit the circumstances under which a lessee could reduce its royalty <u>below that bid upon or agreed to at the competitive sale.</u>

On the other hand, it was never the legislature's intention to prevent the commissioner from reassessing her own, unilateral royalty increases made in connection with unitization. In fact, an amendment which would have made the commissioner's unitization authority under subsection (p) subject to the limitations of subsection (j) was rejected by the legislature.

<u>What the Bill Does</u>

Despite the clear legislative intent behind these statutes, this perceived uncertainty has nonetheless detered DNR from reconsidering its royalty surcharge. Accordingly, SB 430 would remove any question about the commissioner's authority to change the special royalty stipulations of a unit agreement whenever the public interest warrants. The bill is very narrowly drawn. For example, it would not authorize royalty reductions below the amount agreed to at the competitive sale; rather, it would only authorize reconsideration of special royalty stipulations in the unit agreement itself.

STATE OF ALASKA

DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

BILL SHEFFIELD, GOVERNOR

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

March 17, 1986

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

Dear Senator Sturgulewski:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

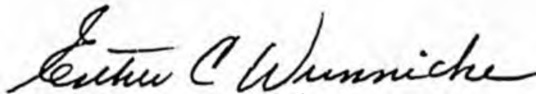
The bill that created AS 38.05.180(j) went through several committee substitutes. One committee, the House Resources Committee, voted to place an express limit on the commissioner's powers under AS 38.05.180(p) by adding the language: "however, the commissioner may not reduce the state's royalty within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

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

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

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

Sincerely,



Esther C. Wunnicke
Commissioner

Attachment

cc: Senator Bettye Fahrenkamp

STATE OF ALASKA 1986 LEGISLATIVE SESSION
FISCAL NOTE

Revision Date: ________

REQUEST

Bill/Resolution No.: SSSB 430
Title: Revoke/Reduce Royalty Increase

Sponsor: Fahrenkamp
Requestor: Senate Resources
Date of Request:

FISCAL DETAIL

Agency Affected: Natural Resources
BRU: Petroleum Management

Components:

EXPENDITURES/REVENUES: (Thousands of Dollars)

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

CAPITAL						

REVENUE	(4500.0)*	(4500.0)*	(4500.0)*	(4500.0)*	(4500.0)*	(4500.0)*

FUNDING: (Thousands of Dollars)

GENERAL FUND						
FEDERAL FUNDS						
OTHER						
TOTAL						

POSITIONS:

FULL-TIME						
PART-TIME						
TEMPORARY						

ANALYSIS: Attach a separate page if necessary

* - This revenue loss would occur if production continues at current levels. The department has proposed an administrative resolution with similar fiscal impact in the short-term. If the bill is not enacted and production stops because the unit is not economic, revenue losses would be higher. See attached page for assumptions.

Prepared by: Kay Brown Phone: 762-4241
Division: Oil and Gas Date: 3/13/86

Approved by Commissioner: Norman D Arnold, Deputy Date: 3/16/86
Agency: Natural Resources

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

10/25/85

Attachment to fiscal note for SSSB 430

The fiscal impact (revenue) is estimated on the basis of several assumptions:

The bill would affect only Milne Point unit production;

Milne Point Unit production at 30,000 bpd;

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

Gulf price of $15/barrel.

CONOCO

DEC 31 1985

Conoco Inc.
3201 C Street
Suite 200
Anchorage, AK 99503
(907) 564-7600

Received Juneau Office 1/8/86 MEA

FILE SB430

December 23, 1985

The Honorable Arliss Sturgulewski
Senator, Alaska
1024 West Sixth Avenue
Anchorage, Alaska 99501

Re: Enclosed Request for Unit
Agreement Amendment

Dear Senator Sturgulewski:

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

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

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

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

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

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

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

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

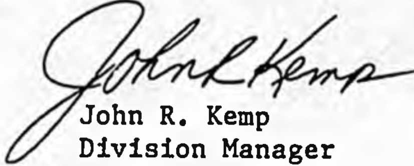
The other option is legislation that would even more clearly direct the commissioner to act in the very limited and compelling circumstances present here. We had hoped that DNR would process our request in a way that would allow the legislature to consider this matter, if it needs to consider it at all,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

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

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

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

Sincerely,



John R. Kemp
Division Manager
Anchorage Division

vv

TESTIMONY OF JON K. TILLINGHAST

BEFORE THE SENATE RESOURCES COMMITTEE

REGARDING SB 430 (MARCH 17, 1986)

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

DESPITE ITS MARGINAL NATURE, MILNE POINT, AND MILNE POINT ALONE, IS REQUIRED TO PAY A SPECIAL ROYALTY SURCHARGE. AT THE STATE'S 1969 COMPETITIVE SALE, THE SUCCESSFUL BIDDERS STRUCK A BARGAIN UNDER WHICH THEY AGREED TO PAY A 12.5% ROYALTY. IN 1979, HOWEVER, WHEN THE MILNE POINT COMPANIES SOUGHT APPROVAL OF THEIR UNIT, THE STATE REFUSED UNLESS THE COMPANIES AGREED TO PAY A 20%, RATHER THAN A 12.5% ROYALTY. SINCE REJECTION OF THE UNIT WOULD

CAUSE THE COMPANIES TO LOSE THEIR LEASES, THEY HAD LITTLE CHOICE BUT TO ACCEPT.

IN 1979, THE STATE BELIEVED THAT THIS ROYALTY SURCHARGE WAS IN THE PUBLIC INTEREST, BECAUSE IT ALSO BELIEVED THAT WELLHEAD OIL PRICES IN 1985 WOULD BE NEARLY $35 PER BARREL. AS EVENTS HAVE TRANSPIRED, A BARREL OF MILNE POINT OIL IS NOW WORTH ABOUT $3.50 AT THE WELLHEAD. AS A RESULT, INSTEAD OF INCREASING STATE REVENUES, THE ROYALTY SURCHARGE THREATENS TO FORCE PREMATURE ABANDONMENT OF THE UNIT.

CONOCO RECOGNIZED THE NEED FOR ROYALTY RELIEF THREE YEARS AGO, WHEN WELLHEAD PRICES WERE $21 BARREL. AT THAT TIME, WE FIRST ASKED DNR TO RECONSIDER THIS ROYALTY SURCHARGE IN LIGHT OF THE FACT THAT THE ASSUMPTIONS BEHIND IT HAVE TURNED OUT NOT TO BE TRUE. DNR, IN TURN, LET US KNOW THAT IT TOO WAS CONCERNED THAT THE SURCHARGE MAY NO LONGER SERVE ITS INTENDED PURPOSE. NEVERTHELESS, DNR FEELS THAT ITS HANDS MAY BE TIED BY 1978 CHANGES TO AS 38.05.180 THAT IT BELIEVES PREVENTS IT FROM RECONSIDERING ITS OWN UNITIZATION DECISIONS.

CONOCO'S POSITION IS THAT § 180(p) BROADLY AUTHORIZES THE COMMISSIONER TO CHANGE OR REVOKE ROYALTY REQUIREMENTS IN CONNECTION WITH UNIT OPERATION. DNR, ON THE OTHER HAND, HAS POINTED TO § 180(j), AND SUGGESTED THAT ITS RESTRICTIONS ON THE REDUCTION OF LEASE ROYALTIES MAY IMPLICITLY LIMIT ITS AUTHORITY UNDER § 180(p) TO CHANGE UNIT TERMS.

LAST NOVEMBER, CONOCO SUBMITTED A FORMAL REQUEST TO RECONSIDER THE ROYALTY SURCHARGE IN THE MILNE POINT UNIT AGREEMENT. ON FEBRUARY 5th OF THIS YEAR, WE RECEIVED A LETTER FROM COMMISSIONER WUNNICKE, WHICH I HAVE PROVIDED TO EACH OF YOUR OFFICES, WHICH INDICATED THAT EXISTING LAW COULD PRECLUDE HER FROM REDUCING OR REVOKING THE ROYALTY SURCHARGE; THEREFORE, SHE INDICATED A WILLINGNESS TO EXPLORE (AND HERE I AM QUOTING) "CHANGING ROYALTY REQUIREMENTS IN A MANNER WHICH WOULD NOT CONSTITUTE AN ACTUAL OVERALL REDUCTION OF CONOCO'S ROYALTY OBLIGATION."

AT THAT POINT, AND IN LIGHT OF DNR'S CONCERNS OVER THE STATUTE, IT BECAME OBVIOUS THAT LEGISLATION WAS NECESSARY IF DNR

WAS TO FEEL ITSELF ABLE TO CONSIDER REVOKING OR REDUCING THE SURCHARGE, AS OPPOSED TO SIMPLY CHANGING ITS FORM. SB 430 WOULD ACCOMPLISH PRECISELY THAT.

THERE ARE A FEW POINTS THAT I WOULD LIKE TO BRIEFLY MAKE WITH RESPECT TO THE BILL, THE URGENCY BEHIND IT, AND THE ONGOING EFFORTS TO NEGOTIATE A SOLUTION TO THIS CONTROVERSY WITH DNR. FIRST, THE BILL IS VERY NARROWLY DRAFTED. ON PAGE 2, LINES 3 - 7, IT WOULD AUTHORIZE, AND ONLY AUTHORIZE, THE COMMISSIONER TO REDUCE OR REVOKE HER ROYALTY SURCHARGES. ONCE THE SURCHARGE DISAPPEARS, SO DOES THE COMMISSIONER'S AUTHORITY UNDER THIS BILL. THIS BILL GIVES THE COMMISSIONER NO AUTHORITY WHATSOEVER TO REDUCE ROYALTIES BID UPON OR AGREED TO AT A COMPETITIVE SALE.

NEXT, THE BILL DOES NOT GRANT CONOCO, OR ANYONE ELSE, ROYALTY RELIEF. IT MERELY AUTHORIZES THE COMMISSIONER TO RECONSIDER ROYALTY SURCHARGES IN UNIT AGREEMENTS WHEN THE PUBLIC INTEREST WARRANTS. CONOCO WILL STILL HAVE TO PROVE ITS CASE BEFORE THE DEPARTMENT. THE ISSUE BEFORE THE RESOURCES COMMITTEE THEN IS NOT WHAT CONOCO'S ROYALTY SHOULD BE; THAT ISSUE WILL HAVE

TO BE RESOLVED BY DNR, BASED ON THE CONSIDERATION OF FINANCIAL DATA, SOME OF IT CONFIDENTIAL. THE ONLY RELIEF CONOCO IS ASKING HERE IS TO REMOVE A PERCEIVED AND VERY UNINTENTIONAL IMPEDIMENT TO DNR'S ABILITY TO RECONSIDER THE SURCHARGE.

THERE IS URGENCY TO THIS LEGISLATION. AS YOU KNOW, THE UNIT HAS ALREADY HAD TO SUSPEND NEW DRILLING AT MILNE POINT, AND IN LIGHT OF THE RECENT DRAMATIC DECLINE IN OIL PRICES THE SURCHARGE IS JEOPARDIZING NOT ONLY FUTURE DEVELOPMENT, BUT EXISTING PRODUCTION AS WELL.

DESPITE THE TIME PRESSURES PRESENT HERE, CONOCO HAS SPENT THE PAST WEEKS IN ONE LAST ATTEMPT TO RESOLVE THIS MATTER THROUGH NEGOTIATION WITH DNR. IN THOSE NEGOTIATIONS, DNR HAS USED ITS BEST EFFORTS TO WORK WITHIN ITS PERCEIVED CONSTRAINTS. SPECIFICALLY, DNR HAS DONE AS WELL AS ANYONE COULD TO CHANGE THE NATURE OF THE SURCHARGE WITHOUT REDUCING IT, AND AT THE SAME TIME AFFORD SOME MEANINGFUL RELIEF TO CONOCO. WE COMMEND DNR FOR THE EFFORTS THEY HAVE MADE IN THIS REGARD; HOWEVER, THEIR JOB MAY BE AN IMPOSSIBLE ONE UNDER THEIR VIEW OF THE STATUTE, FOR IT IS VERY

HARD TO REDUCE A ROYALTY WITHOUT IN FACT REDUCING IT. INDEED, THE FAILURE, TO THIS POINT, OF OUR DISCUSSIONS WITH DNR VIVIDLY ILLUSTRATES THE NEED FOR THIS LEGISLATION; FOR, IF A REVOCATION OR REDUCTION OF THE SURCHARGE IS NECESSARY TO PERMIT ECONOMIC FIELD DEVELOPMENT, AND DNR BELIEVES THAT THE SURCHARGE CANNOT BE REDUCED AT ALL, THERE IS LITTLE REASON FOR OPTIMISM.

CONOCO, OF COURSE, WILL CONTINUE TO TALK WITH THE AGENCY AS THIS BILL--HOPEFULLY--PROGRESSES THROUGH THE LEGISLATURE. AT THIS POINT, HOWEVER, FURTHER DELAYS IN LEGISLATIVE CONSIDERATION OF THIS BILL WILL TEND TO HINDER, RATHER THAN AID CONTINUED NEGOTIATIONS, SINCE IT WILL PERPETUATE PRECISELY THAT STATUTORY UNCERTAINTY WHICH DNR BELIEVES PRECLUDES IT FROM CONSIDERING THE COMPANY'S POSITION ON ITS MERITS.

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

Anchorage Daily News Sunday, March 16, 1986

Low prices could force state's newest well to shut down

By JEFF BERLINER
United Press International

If oil prices drop much lower, it will cost more to produce a barrel of oil at Alaska's newest oil field than it can fetch on the open market.

Oil from Conoco's new Milne Point field costs $6 per barrel — including state fees and royalties — to produce at Pump Station No. 1, the start of the $9 billion, 800-mile trans-Alaska pipeline, said Chuck Logsdon, state petroleum economist.

By the time the pipeline tariff — about $5 a barrel — and the cost of shipping the oil to a West Coast refinery are added, Logsdon said, the oil has cost the producer $12 a barrel.

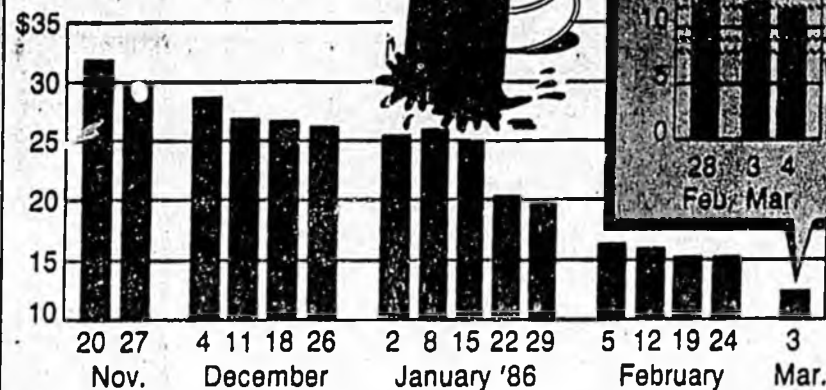
Oil prices on the world spot market were hovering near $13 last week, although contract prices average above $15 a barrel.

"Milne Point would shut down before going below the break-even point, and it's close to that margin right now," Logsdon said. A Conoco spokeswoman, however, said the company would continue operation.

"Should oil prices force Milne point economics to a break-even point, we would not overreact by shutting the project down immediately," said spokeswoman Sondra Fowler. "There are several things that would rapidly improve the project's economics — a rebound in the price of oil, a reduction in the state's royalty rights, or an elimination of the ban on North Slope oil exports."

Milne Point is a major oil

See Page D-3, MILNE POINT



Nearby settlement prices for NYMEX crude oil futures contracts
Source: New York Mercantile Exchange

United Press International Color by Roger Everhart

MILNE POINT: Selling price could soon match production costs at Alaska's newest oil well

Continued from Page D-1

eld by Lower 48 standards it is dwarfed by the size of the other two North Slope fields. Milne Point produces about 20,000 barrels a day. That compares with about 1.5 million barrels a day pumped from the Prudhoe Bay field and about 250,000 barrels a day from the Kuparuk River field.

These two other oil fields on the North Slope are not as close to break-even, Logsdon said.

Prudhoe oil costs $8 per barrel to deliver to West Coast refineries. Kuparuk oil comes to $9 a barrel at the refineries, Logsdon said.

About half Alaska's oil journeys to Gulf Coast refineries. This longer trip adds $3 to the per-barrel cost, Logsdon said.

In comparison to the North Slope, Saudi Arabian oil is brought out of the ground for "from 25 cents to 50 cents a barrel, and who knows, they may be able to produce it cheaper than that," Logsdon said.

Shipping costs in a depressed market for oceangoing tankers add only about $1.50 a barrel to get Saudi oil to the U.S. Gulf coast refineries. Alaskan producers are bound by law to use more expensive American-flag shippers.

Alaskan and Saudi Arabian crude are of comparable quality.

Conoco Inc. brought Milne Point into production with much fanfare in November, well ahead of schedule, and announced it was going ahead with plans to expand the field.

Less than three months later Conoco has halted further development of Milne Point, cut its budget and slapped a hiring freeze on the project, while continuing to pump oil from the already developed portion of the field.

The relative high cost of North Slope oil leaves little margin for profit and reinvestment in new development.

However, oil company officials would not discuss their break-even figures.

"That's competitive information and we ain't going to tell," said D.J. Moon, Standard Alaska Production Co. spokesman.

"It's different for each company and it's different for each oil field," said Susan Andrews, ARCO Alaska Inc.'s spokeswoman.

Economist Arlon Tussing believes prices could drop so low that the state will collect no oil royalty, sending the state's economy into a depression.

However, Tussing said he did not expect Standard and ARCO, operators at Prudhoe Bay and Kuparuk, to shut down the fields unless prices dropped so low that the companies were losing money before the oil left Pump Station No. 1.

Logsdon said he believed Prudhoe Bay and Kuparuk would continue to operate, but he said if prices drop below a profitable level, companies may cut back production, stop shipment to Gulf Coast refineries, and sell it all on the West Coast.

Every day, the three North Slope fields send a total of 1.8 million barrels of oil down the 800-mile trans-Alaska pipeline to the oil port of Valdez, said John Ratterman, Alyeska Pipeline Service Co. spokesman. That figure represents 20 percent of U.S. production.

Because of the high cost of producing oil in the arctic, Milne Point is considered a marginal field. One year ago, when Milne Point was being developed during a time of less drastic oil price declines, Conoco regional manager Rob McKee said:

"If the decision to develop Milne Point were to be made on today's price projection, the unit owners could conceivably reach a different decision than the one reached a year ago because the much-reduced profitability might not justify the risk."

Development of Milne Point has stopped. ARCO plans to idle five of its nine drill rigs this spring, Andrews said, adding that ARCO still plans a huge summer construction season to boost production at Kuparuk and bring the new Lisburne field into production.

Sohio has not announced any major cutbacks and Moon said the firm plans to begin development of its Endicott field in April and have it pumping oil by late next year.

Said ARCO President Harold Heinze, "We know of huge accumulations of oil on the North Slope, including the West Sak field, which may be larger than the Prudhoe Bay field. But the West Sak field is a marginal field, and with the price of oil in decline and an uncertain tax picture in Alaska, we cannot go beyond the research and planning stage."