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5-2162A
Chenoweth
4/14/88

1 IN THE HOUSE

BY THE RESOURCES COMMITTEE

2 HOUSE BILL NO.

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 FIFTEENTH LEGISLATURE - SECOND SESSION

5 A BILL

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

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

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

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

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

18 (1) concern the hiring of state residents; and

19 (2) are in effect or take effect during the term of the

20 lease.

21 * Sec. 2. This Act takes effect immediately under AS 01.10.070(c).
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5-2016A
Bannister
3/1/88

1 IN THE HOUSE

2 HOUSE BILL NO.

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 FIFTEENTH LEGISLATURE - SECOND SESSION

5 A BILL

6 For an Act entitled: "An Act relating to state oil and gas royalty reduc-
7 tions."

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

9 * Section 1. AS 38.05.180(j) is repealed and reenacted to read:

10 (j) To prolong the economic life of an oil and gas field or to
11 encourage commercial production of oil or gas that would not otherwise
12 be economically feasible, the commissioner shall adopt regulations to
13 allow for the reduction of royalty on leases. Except as otherwise
14 provided in this subsection, the commissioner may not grant a reduc-
15 tion of royalty until the lessee requesting the reduction makes a
16 clear showing that the revenue from the lessee's share of all hydro-
17 carbons produced from the unit is or will be insufficient to produce a
18 reasonable rate of return with respect to the lessee's total invest-
19 ment in the unit. To encourage commercial development and production
20 of low-gravity oil, the commissioner may grant a lessee a reduction of
21 royalty if the lessee requesting the reduction makes a clear showing
22 that the reduction is necessary to obtain commercial production of
23 low-gravity oil and agrees to begin development within one year of the
24 reduction and production within ~~three~~ ^{four} years of the reduction. A
25 royalty reduction to encourage commercial development and production
26 of low-gravity oil may not begin later than 10 years after the
27 effective date of this Act. The commissioner may condition a reduc-
28 tion granted under this subsection on an increase in the price of oil
29 or gas and may restore the royalty in the event of an oil or gas

1 ^{ORIGIN} increase. When considering a royalty reduction, the commissioner
2 shall attempt to obtain the maximum economic return for the state that
3 is compatible with allowing a reasonable rate of economic return for
4 the lessee. In this subsection, "low-gravity oil" means oil whose
5 specific gravity measured in degrees on the American Petroleum Insti-
6 tute scale is less than 20 degrees.
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8 EFFECTIVE DATE
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STATE OF ALASKA
DEPARTMENT OF NATURAL RESOURCES

BILL SHEFFIELD, GOVERNOR

OFFICE OF THE COMMISSIONER

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

April 24, 1986

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

Dear Representative Adams:

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

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

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

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

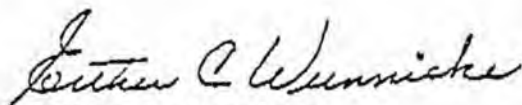
The Honorable Al Adams
Page 2
April 23, 1986

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

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

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

Sincerely,



Esther C. Wunnicke
Commissioner

cc: Representative Pourchot
Representative Cotten
Representative Sund
Senator Fahrenkamp

2001K

April 23, 1986

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

Introduction

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

Commissioner's Authority and Duties

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

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

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

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

Abbreviated Unit History

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

The Companies' Application

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

Basis for the Decision

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

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

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

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

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

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

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

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

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

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

Decision

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

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

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

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

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

Esther C. Wunnicke, Commissioner
Department of Natural Resources

Date

4551Z

Offered: 4/21/86
Referred: Finance

Original sponsor: Fahrenkamp

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

5 A BILL
6 For an Act entitled: "An Act relating to the reduction or revocation by
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25 operation of a cooperative or unit plan as the commissioner determines
26 necessary or proper to secure the proper protection of the public
27 interest. The commissioner may require oil and gas leases issued
28 under this section to contain a provision requiring the lessee to
29 operate under a reasonable cooperative or unit plan, and may prescribe

1 a plan under which the lessee must operate. The plan must adequately
2 protect all parties in interest, including the state. Notwithstanding
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4 obligation increase that was made by the commissioner in connection
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8 royalty obligation increase, the commissioner shall include a mecha-
9 nism to raise the royalty to a level not exceeding its former level in
10 the event that the lessee's market conditions improve or if the
11 profitability of a lessee's operation increases to a specified level.
12 As a condition of the reduction or revocation of a royalty obligation,
13 the commissioner shall require the lessee to comply with all valid and
14 applicable laws and regulations of the state

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

16 (2) that are in effect or take effect during the term of
17 the lease.

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

STATE TAX INCENTIVES: ALASKA

Recent events in Alaska suggest the general issue of tax incentives may receive considerable attention over the next year. Alaskan State Senator Falks has asked some oil companies to comment on possible exploration and production incentives. Key state officials have expressed an interest in resource industry incentives. And on the industry side, Conoco and Hess have proposed incentives specific to their interests. Thus, legislation may be introduced in the next legislative session.

Exxon's position on any proposed incentives in Alaska should be governed by four broad principles:

- Tax stability is the single most important incentive Alaska can provide. This applies not just to oil industry taxation but to general business taxes, for example the corporate income tax.
- In reviewing policies that might stimulate industrial activity, consideration should first be given to removing any current impediments and avoiding unjustified new cost burdens.
- If the state believes additional incentives should be pursued, a strategy which stimulates exploration and development of new reserves is most likely to increase oil industry activity and benefit the state over the long term.
- Government should not have to shoulder the traditional risks and costs associated with resource exploration and development. These are properly the responsibility of private industry.

Beyond these overarching principles, there are several considerations that come into play. Any proposed incentives should be:

- available to all industry participants without discrimination.
- directly tied to increased business activity.
- general, that is should avoid targeting specific conditions, geographic areas, or depths.
- aimed at rewarding successful efforts, avoiding policies that encourage companies to assume risks for purely tax reasons.
- non-refundable.
- simple to administer.

Exxon can support incentives consistent with these considerations. In addition, Exxon representatives will encourage the Alaska Oil and Gas Association to develop a position consistent with the above comments. When endorsing specific incentives, industry should avoid unrealistic statements of the likely impact of those incentives on oil activity in the state.

4/4/88

IN THE HOUSE

HOUSE BILL NO.

IN THE LEGISLATURE OF THE STATE OF ALASKA
FIFTEENTH LEGISLATURE - SECOND SESSION

A BILL

FOR AN ACT ENTITLED: "AN ACT RELATING TO OIL AND GAS
ROYALTY REDUCTIONS"

AS ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA

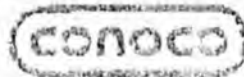
SECTION 1. AS AMENDED (j) is repealed and enacted to read:

(j) To promote the economic development of the oil and gas field and to encourage conservation of production of oil and gas that would not otherwise be economically feasible, the commissioner shall adopt regulations to allow for the reduction of royalty on leases. Leases entered into with either lease royalty or net profits above royalty as a bid variable shall have two years of production before the lease is eligible for a royalty reduction under this subsection. Except as otherwise provided in this subsection, the commissioner may not grant a reduction of royalty under this subsection if the regulation makes a determination that the lease is in the leaseholder's state of oil production process for the unit or lease if the lease is not an eligible lease as defined in the regulation to produce a reasonable rate of return with respect to the leaseholder's investment in the unit.

The commissioner may grant a reduction of royalty on low-gravity oil from non-producing leases. The commissioner may grant a two-year reduction of royalty if the leaseholder provides the commissioner with a plan showing that the reduction is necessary to obtain commercial production of low-gravity oil and agrees to begin development within one year of the start of production within five years of the start of production. A royalty reduction to encourage leases for development of production of low-gravity oil may not begin later than 10 years after the effective date of this Act. The commissioner may conflict a reduction granted under this subsection on

4/4/88

an increase in the price of oil or gas will reduce the royalty in accordance with any lease and any other agreement entered with the royalty receiver. The purpose of this clause is to protect the oil or gas price increase. When a contract for a royalty is in force then, the commission shall attempt to determine the maximum economic return for the state of the oil or gas property and a reasonable rate of return. The commission shall, in this connection, "regulate" the royalty of the oil or gas property owned in the state of the state. The commission shall also regulate the lease of the oil or gas property owned in the state of the state. The commission shall also regulate the lease of the oil or gas property owned in the state of the state. The commission shall also regulate the lease of the oil or gas property owned in the state of the state.



Tom Painter
Division Manager

Conoco
Oil, Lubes,
Auto Parts
P.O. Box 10000
Denver, CO 80201

March 29, 1988

Mr. Matt Fry
APL-C10
2501 Commercial Bldg
Anchorage, Alaska 99501

Dear Matt:

Subsequent to our March 24 meeting, we have prepared a list of suggestions for establishing a new Alaska Wage Survey. The survey will be conducted by the Alaska Department of Labor, and we are requesting that you provide the following information:

1. The amount of the survey fee (currently \$10,000) and the following general information:

2. Gross Overtime - Would include time worked in excess of about 40 hours per week.

3. Specialized Equipment Operators - Operators of heavy equipment primarily used in the oil industry.

4. Specialized Technical Personnel - Personnel who are directly related to the oil industry.

An appropriate work order or list of work orders should be provided for the conduct of the survey.

The above information is intended to provide a comprehensive survey of the Alaska Wage Survey. The survey will be conducted by the Alaska Department of Labor, and we are requesting that you provide the following information:

The following data are requested regarding the Alaska Wage Survey: 1. Alaska Industry - The survey will be conducted by the Alaska Department of Labor, and we are requesting that you provide the following information: 2. Gross Overtime - Would include time worked in excess of about 40 hours per week. 3. Specialized Equipment Operators - Operators of heavy equipment primarily used in the oil industry. 4. Specialized Technical Personnel - Personnel who are directly related to the oil industry. An appropriate work order or list of work orders should be provided for the conduct of the survey.

Mr. Mann Frey
March 25, 1988
Page 2

The two year period was selected as a reasonable time period to review the results of this type of contract. The results of the study are shown in the following table for the period 1984-1985 at the end of the study.

Yours very truly,



F. H. Painter
Division Manager

AHJ:s

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Table 2.1
Average Wage Rates of Job Orders
Alaska Job Vacancies
July 1980-June 1980
Statewide

Job Title	Number of Job Orders	Number of Job Vacancies	Average Hourly Wage
Accountant	12	12	6.72
Administrative Assistant	10	10	5.65
Assistant Manager	10	10	6.31
Business Development Representative	10	10	5.09
Customer Service Representative	10	10	6.51
Executive Assistant	10	10	7.21
General Office Worker	10	10	5.37
Human Resources Specialist	10	10	6.11
Information Systems Specialist	10	10	10.41
Inventory Control Clerk	10	10	7.44
Marketing Representative	10	10	7.40
Office Clerk	10	10	5.97
Office Manager	10	10	7.77
Office Worker	10	10	6.08
Operator	10	10	6.27
Production Worker	10	10	6.19
Receptionist	10	10	5.13
Secretary	10	10	6.14
Shipping and Receiving Clerk	10	10	6.70
Systems Administrator	10	10	8.19
Telephone Operator	10	10	5.84
Training Specialist	10	10	6.11
Warehouse Worker	10	10	5.88
Word Processing Clerk	10	10	6.28
Accounting Clerk	10	10	6.50
Administrative Support	10	10	6.11
Business Office Worker	10	10	6.11
Customer Service	10	10	6.11
Executive Office Worker	10	10	6.11
General Office	10	10	6.11
Human Resources	10	10	6.11
Information Systems	10	10	6.11
Inventory Control	10	10	6.11
Marketing	10	10	6.11
Office Management	10	10	6.11
Office Support	10	10	6.11
Production	10	10	6.11
Shipping and Receiving	10	10	6.11
Systems Administration	10	10	6.11
Telephone	10	10	6.11
Training	10	10	6.11
Warehouse	10	10	6.11
Word Processing	10	10	6.11

STATE OF ALASKA

BILL SHEFFIELD, GOVERNOR

DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

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

April 24, 1986

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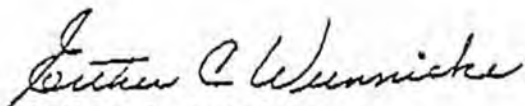
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The threshold prices that would trigger the higher royalty rates are based on a preliminary staff analysis of the information previously submitted by Conoco. Before issuing a final decision, the staff and I will further evaluate available information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

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

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

Sincerely,



Esther C. Wunnicke
Commissioner

cc: Representative Pourchot
Representative Cotten
Representative Sund
Senator Fahrenkamp

2001K

April 23, 1986

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

Introduction

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

Commissioner's Authority and Duties

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

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

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

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

Abbreviated Unit History

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

The Companies' Application

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

Sbasis for the Decision

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

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

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

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

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

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

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

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

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

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

Decision

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

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

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

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

2. The Companies and the State will proceed to amend the Milne Point Unit Agreement to incorporate the provisions necessary to implement this decision.
3. This decision is effective _____ 1986. Royalty payments for the leases due the State in the month of _____, 1986 and thereafter shall be calculated using the royalty rate schedule specified above.
4. Article 30 of the Milne Point Unit Agreement will be amended as follows: The Unit Operator and lessees shall comply with all valid and applicable laws and regulations that concern the Nizing of Alaska residents and that are in effect or take effect during the term of the leases.
5. It is acknowledged that this decision does not preclude the Companies from making future applications for royalty alterations or reductions under applicable Alaska statutes and regulations.
6. The Companies' simultaneous application for reconsideration/reopening of Commissioner LeResche's 1979 Decision is hereby denied. The Companies' simultaneous application for a royalty reduction pursuant to AS 38.05.120(j) also is denied.

Esther C. Wunnicke, Commissioner
Department of Natural Resources

Date

45512

3:15 - Peter.

CONOCO
Exxon

reasonable rate of return -

- 1) - Exxon believes full recovery of full interest + capital cost + 6% - shd say commrs det'n of rr of r.
- 2) → how many \$ are given up? time-value of \$,
- 3) open to other arguments about inc'vs?
- 4) best interest to allow prod'n now or wait?
- 5) Conoco only co. that ever did this. - were lazy basically
+ got caught + made a deal w/ Lebesche -

most which would have been in the...
United States...
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Resource Development Council

for Alaska, Inc.

807 "G" Street, Suite 200, Anchorage, Alaska 99501-3440
Box 100516, Anchorage, Alaska 99510-0516 - 907/276-0700

January 18, 1988

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To: RDC's Oil and Gas Division
From: Becky L. Gay
Executive Director *Becky L. Gay*

Re: Oil and gas incentives

The Resource Development Council's Executive Committee endorsed the following position on December 30, 1987. On behalf of RDC, I want to thank all of you that participated in the Division's activities that led to our support for this policy.

Incentives to be added:

- * Discovery royalty incentives: Draft legislation was prepared by RDC last year, but has not been introduced legislatively.
- * Exploration incentive credits: Exploration incentives should be added to all future state lease sales, especially to encourage drilling.
- * Non-competitive leasing: Certain tracts should be allowed to be filed for and awarded through this over-the-counter or lottery process as was done until 1978. This measure would encourage "grass-roots" interest in oil and gas issues, give opportunities to risk-takers and potentially create a positive, pervasive attitude change in the public favorable to development.
- * Increase DNR's flexibility to add acreage to scheduled lease sales: Conciguous or adjacent acreage, for which there has been a best interest finding made within the last three years, should be available for addition to programmed lease sales.

Disincentives to be removed:

- * Abolish DGC coordination of permitting: Instead, institute lead agency permitting as introduced as SB280 and HB212 last year.
- * Change the SEEA process: Develop a legislative resolution and/or gain administrative consent to support lead resource agency supervision of the Social, Economic and Environmental Analysis (SEEA).
- * Worker Compensation insurance premiums: Support reform which can demonstrably reduce premiums in order to make Alaskans more competitive in labor markets.

ARCO Alaska, Inc.
Post Office Box 100360
Anchorage, Alaska 99510-0360
Telephone 907 265 6335

David A. Heatwole
Vice President

RECEIVED



OCT 19

ATLANTIC RICHFIELD COMPANY
PRODUCING TAXES - ANCHORAGE

October 16, 1987

Senator Jan Faiks
3111 C Street, Suite 525
Anchorage, AK 99503

Dear Jan:

We appreciate your focusing on two important issues to the Alaska oil industry: incentives for exploration development and prompt settlement of disputed taxes. I share your feeling that there are legislative opportunities to act on these issues and provide mechanisms to stimulate oil exploration and simplify tax collection.

We still firmly believe that tax stability, in itself, is the most important long-term incentive state government can offer any business taxpayer. Oil production is a capital intensive industry that requires long lead times for engineering, planning and implementation. Inconsistent tax policies impair our ability to work project economics, and tax changes can cause us to forego development opportunities. If an oil development project is uneconomic, the people of Alaska lose both job opportunities and state revenue.

As you are aware, existing state law contains a number of incentives which could be used to expand exploration and development activities. A number of state leases currently contain exploration credit incentives. Expanding this provision to include additional qualifying leases should stimulate drilling activity. The current gas plant income tax credit could be expanded to a broader based investment credit tax system that could enhance the attractiveness of large projects such as enhanced oil recovery, gas handling, and gas liquids recovery.

The State's "uncollected" taxes are largely the result of administrative policies and practices of the Department of Revenue. For example, the DOR's current practice of multiple audits and assessments of the same tax for the same tax year is the most significant deterrent to efficiently resolving tax disputes. Any challenge by a taxpayer prolongs the audit process because the Department invariably begins a re-audit, makes additional findings, and pushes the assessment upward. This process results in a soaring level of "uncollected" taxes.

Page Two
State Taxes
Senator Jan Faiks

The Legislature could impose both timeliness and equity in the process by establishing a system that would provide for hearings of taxpayer appeals before independent administrative law judges or by a state tax court. Under the present system, a taxpayer is not likely to have its case fully reviewed by anyone other than employees of the Department of Revenue. It is difficult for these employees to make fair and objective decisions when the Commissioner is the final court of review.

To minimize collection delays, the Legislature may want to require the Department of Revenue to render decisions to taxpayers in reasonable periods of time such as 90 to 180 days. Currently taxpayer proceedings often take several years for the Department to render a decision. Over time, these delays raise the amount of "uncollected" taxes.

As always, we appreciate the opportunity to share our views with you on these issues. If you would like additional information on these or other issues, please let us know.

Sincerely,



Dave Heatwole

c: William E. Wade, Jr., ARCO

bc: C. H. Rosenthal, ARCO
✓H. R. Motley, ARCO
J. Palmer, Standard
D. Cornett, Exxon