Royalty Oil

HOUSE SPECIAL COMMITTEE ON OIL AND GAS

AUGUST 11, 1986
Anchorage Legislative Information Office
10.00 A.M.

Members Present:

Rep. Mike Davis, Chairman
Rep. Sam Cotten, Vice-Chairman
Rep. Marco Pignalberi
Rep. Mike Szymanski
Rep. Andre Marrou, by teleconference from Homer

CALENDAR

Briefing on royalty oil at or near zero wellhead value.

WITNESS REGISTER

Esther Wunnicke
Commissioner
Department of Natural Resources
PO Box M
Juneau, AK 99811
telephone: 4652400

Jim Eason
Acting Director
Division of Oil and Gas
Dept. of Natural Resources
PO Box 7034
Anchorge, AK 99510
telephone: 561-2020

Chat Chatterton
Chairman
Oil and Gas Conservation Commission
3001 Porcupine Dr.
Anchorage, AK
telephone: 279-1433

Steven Porter
Assistant Attorney General
Dept. of Law
1031 W 4th Ave., Suite 200
Anchorage, AK 99501
telephone: 276-3550

Richard Monkman
Deputy Commissioner, Taxation
Dept. of Revenue
PO Box S
Juneau, AK 99811
telephone: 465-2301

Robert Maynard
Assistant Attorney General
Dept. of Law
PO Box K
Juneau, AK 99811
telephone: 465-3600

Chuck Logsdon
Petroleum Economist
Dept. of Revenue
PO Box S
Juneau, AK 99811
telephone: 465-2300

Roger Marks
Petroleum Economist
Dept. of Revenue
PO Box S
Juneau, AK 99811
telephone: 465-2300

ACTION NARRATIVE

TAPE ONE SIDE ONE
Number 000

The House Special Committee on Oil and Gas was called to order at 10:05 a.m. Members present were Representatives Davis, Cotten, and Pignalberi. Rep. Szymanski arrived at 11:15 a.m. Rep. Marrou joined the meeting by teleconference at 10:20. Rep. Navarre was present at the Soldotna L.I.O.

Number 015

Rep. Davis introduced the issues to be discussed.

Number 050

The Commissioner of the Department of Natural Resources, Esther Wunnicke, made an opening statement. First, she outlined recent department activities which might be of interest to committee members. Issues included the Cook Inlet royalty solicitation, Chevron's application for a price reduction under the price reopener provisions of its royalty

oil contract, and Jim Eason's participation in the federal government's Royalty Management Advisory Committee.

Commissioner Wunnicke then addressed the topic of royalty oil near zero wellhead value. DNR had been assessing and ranking the state's options. The best alternative was mutual agreement with the oil producers, rather than unilateral state action. Preliminary discussions had begun involving DNR, Attorney General Hal Brown, and individual producers. The possibility of an underlift agreement was discussed at those meetings.

The oil and gas leases reserve a royalty for the state, typically 12.5% In an underlift agreement the state would obtain the producers' consent to take a lower royalty percentage now, and a larger percentage later. AS 38.05 180 1 authorizes underlifting, provided the state receives back its deferred royalty share during the first half of field life, or no later than fifteen years after the start of production. AS 31.05 110 p further restricts underlifting. This statute limits recovery from fields unitized after June 30, 1978 to a daily rate not to exceed 10% of the state's royalty interest share of daily production at the time of underlift production.

These limitations allow underlift at Prudhoe Bay and Kuparuk, but would preclude it at the Milne Point field. The Prudhoe Bay underlifts could be recovered at some mutually agreeable rate. However, the Kuparuk underlifts could be recovered only at a rate less than 10% of daily royalty production rates.

Underlifts would not reduce production. Therefore, underlifting would not reduce deliveries to Alaska's in kind royalty purchasers. The state's royalty oil contracts expressly provide that the purchasers receive a percentage of field production calculated without regard to underlift. The Mapco contract is an exception.

In kind contracts obligate approximately 130,000 barrels per day from Prudhoe Bay, and approximately 4,500 barrels per day from Kuparuk. Currently only 75,400 barrels/day would be available for underlift. In addition, some of the oil must be left in-value to obtain royalty reports necessary to bill the state's purchasers.

A second option is for the state to take its royalty oil in kind and store it for future disposal. For the first time in history the state would be taking actual custody of the oil. Normally, royalty oil sales take place at the location where the state takes custody, and purchasers take responsibility for the costs and risks of loss of the oil. If Alaska chose to store the oil, it would have to pay field costs, pipeline tariffs, insurance costs, and storage fees, as well as bare the risk in case of accident. If oil prices did not rise, the state would lose money in the transaction.

Commissioner Wunnicke also discussed the state's liability for field costs. The Prudhoe Bay field cost settlement agreement provides that the state is liable for field costs for any oil it takes in kind. However, the in kind contracts pass this liability on to purchasers. The settlement agreement also allows producers to deduct the field cost allowance from their royalty payments for in value oil. The state's position is that the producers' deductions can reduce the oil's value to zero, but the state would not be required to pay the producers for the in value field costs. Allowing a deduction from a payment is not the same as assuming a liability to pay.

Ms. Wunnicke explained why the state could not order a reduction in production at fields in Alaska. Alaska's Oil and Gas Conservation Commission does not have the power to do so. Some other states, such as Texas, give their Conservation Commissions the statutory power to control economic waste. Alaska's statutes refer only to physical waste, which is inefficient production that depletes the reservoir.

Number 240

Rep. Cotten asked whether the the state's liability for field costs could accumulate during times when wellhead value was too low for the complete deduction, to be applied against future royalty payments.

Number 250

Steve Porter cited the text of the settlement agreement as the basis for the Commissioner's claim that there was a zero floor on deduction of field costs. The interpretation agreed with a general principle of oil and gas leasing, in which the land owner was entitled to payment by the producer for the extraction of the resource. The owner would never have to pay the producer to take the resource from the land.

Number 280

Rep. Cotten asked if the producers agreed with DNR's view.

Number 287

Commissioner Wunnicke replied that conservations between DNR and producers had not reached that level of detail. Producers might have a different legal interpretation of the liability for field costs.

Number 300

Rep. Marrou was present at the teleconference site in Homer. He requested a committee packet.

Number 310

Rep. Davis asked for the details of Chevron's request for a royalty price reduction.

Number 315

Commissioner Wunnicke replied that Chevron had simply approached DNR to find out if the department would negotiate a price reduction under the price reopener clause of the royalty contract. It was agreed that renegotiation would require legislative approval. Chevron had then requested that the time for the price reopener be amended to occur immediately before the legislative session.

Number 330

Rep. Davis inquired about discussions with Japan, Korea, and Taiwan regarding the purchase of Cook Inlet oil.

Number 332

Commissioner Wunnicke responded that the discussions were not negotiations, but rather an opportunity for Jim Eason to explain the solicitation package.

Number 340

Rep. Davis asked if DNR was drafting recommendations for changes in statute to lessen restrictions on underlifting.

Number 355

Commissioner Wunnicke said DNR would be alert to language restricting underlifting in future unitary agreements. The department felt bound by the existing statutes and unit agreements. Therefore, voluntary agreement by the producers would be necessary to underlift.

Number 370

Rep. Davis asked about the percentage of the state's royalty oil available for underlifting.

Number 400

Commissioner Wunnicke listed the state's royalty commitments.

Number 425

Rep. Davis asked that participants stand by while the teleconference system was cleared up.

Number 645

The meeting resumed.

Number 650

Commissioner Wunnicke reviewed the field costs for the various fields.

TAPE ONE SIDE TWO
Number 000

Rep. Cotten asked if any zero wellhead values had been reported.

Number 005

Commissioner Wunnicke replied there had been one report of a zero wellhead value from the Milne Point field in June.

Number 010

Rep. Cotten asked if Sohio had announced a new official price.

Number 017

Jim Palmer of Sohio shook his head "no". He said the current official prices were $9.00 and $10.00.

Number 020

Rep. Cotten asked what market prices would yield zero wellhead values.

Number 025

Commissioner Wunnicke said DNR and DOR calculated the figures slightly differently. The figures provided by the Dept. of Revenue showed zero wellhead values for Prudhoe Bay oil at $8.10 - Gulf ($8.80 including field costs). Kuparuk oil would have zero wellhead value at $8.70 - Gulf ($9.10 including field costs).

Number 040

Rep. Pignalberi expressed concern about Mr. Eason's position of the federal Royalty Management Advisory Committee. He did not want the State of Alaska to become involved in a valuation methodology which would increase the price of Cook Inlet gas. Low priced gas was in the best interest of in-state consumers.

Number 058

Commissioner Wunnicke explained that Mr. Eason was one of many advisors to the Secretary of the Interior. He was not serving as an official representative of the state.

Number 070

Rep. Pignalberi wanted to ensure that all parties went on record as soon as possible with their interpretation of the state's liability for field costs. He asked DNR to give a list of questions to royalty producers, so any differences would be pinned down.

Number 080

Commissioner Wunnicke replied that she felt the state's position was clear already.

Number 100

Rep. Pignalberi asked why DNR and DOR zero wellhead prices were different.

Number 105

Commissioner Wunnicke explained the differences in computation.

Number 140

Chat Chatterton, Chairman of the Oil and Gas Conservation Commission, gave his view of the situation. He pointed out that the state could take unilateral action to underlift. Article 6 Section 4 of the Prudhoe Bay unit agreement gave the Commissioner of DNR the right, on 90 day notice, to underlift that portion of royalty oil that is being taken in kind by 10%.

Mr. Chatterton gave a brief overview of the history of the world oil market. Prior to the 1930's there were great excursions in price. From the early 1930s until 1972, the United States controlled the world market price for crude oil by serving as the swing producer to meet demand. Several states had statutes that spoke to "market pro-ration". Texas, for example, had laws prohibiting the production of more oil than the market could use. Today, Saudi Arabia is the swing producer. The only countries which seem able to control production are those with nationalized petroleum industries.

Number 220

Rep. Davis asked whether sale of royalty oil at zero wellhead value could be considered economic waste, and banned as such.

Number 235

Mr. Chatterton said Title 31, which governs the Oil and Gas Conservation Commission, speaks only of physical waste. From the beginning he had been strongly opposed to the inclusion any language referring to economic waste in the regulatory powers of the Commission.

Number 250

Rep. Cotten asked if the legislature could change Title 31 to give the Commission such power if it choose.

Number 255

Chat Chatterton did not know of anything in the state constitution or statute that would prevent such action. Alaska is a member of the Interstate Oil Compact Commission which deals with physical waste. Texas, Louisiana, and Oklahoma are pro-ration states belonging to the Compact Commission. They restrict economic waste by regulating physical waste by evaporation from above ground storage.

Number 280

Rep. Szymanski joined the meeting.

Number 290

Chat Chatterton reminded the committee that the formula for field costs was arrived at through negotiation of the Amerada-Hess settlement. Perhaps a reduction in the charge could be negotiated. A reserves tax had been imposed in the past. The legislature could consider reinstituting such a tax.

Number 330

Rep. Davis asked for further explanation of the origins of the field cost formula.

Number 350

Bob Maynard replied that the field cost was a result of the Amerada-Hess case. Originally the case had two parts. The first was whether the state was liable for field costs if the royalty oil was taken in value or in kind. The second was the determination of the value of oil at pump station one to which the field cost was chargeable. The case was argued and briefed before the Juneau superior court in the late 1970's. In early 1980, the court rendered a judgement that the state was liable for field costs only when its royalty oil was taken in kind. At that time it was state policy to take all its oil in kind. The field costs at stake were upwards of $1.10/barrel.

After the decision of the superior court and before an appeal to the supreme court, the state settled for a $0.42 charge in 1980? dollars, whether the oil was taken in value or in kind. Field costs were a negotiated item, however the state had agreed to a court approved settlement. The field cost for in kind oil had always been considered a deduction from a

downstream value, similar to the situation when the tanker or TAPS charge might be high. It would surely not be the state's or the companies' position that there would be a charge for the TAPS tariff if the price of oil dropped below cost.

Number 410

Rep. Cotten asked if Mr. Maynard thought there should be an inquiry made into the producers' positions on those deductions.

Number 415

Bob Maynard said he was not sure if the people currently in charge of the production decisions were the same people involved in the original Prudhoe Bay settlement. If they were asked now, producers would probably concede nothing in their responses. However, Mr. Maynard did recall specific discussions of the liability vs. deduction issue.

Number 430

Rep. Pignalberi asked about Title 38.180q which referred to production rates. Unfortunately, the state had waived its authority to modify the quantity and rate of production at Prudhoe Bay and Kuparuk. Was there anything in the Prudhoe Bay unit plan which would allow the state to modify the production rate?

Number 455

Chat Chatterton responded that Article 11 Section 3 permits DNR to modify the rate of production for conservation purposes. He was not sure of the definition of conservation in that context.

Number 475

Rep. Pignalberi asked for an example of physical waste.

Number 485

Chat Chatterton referred him to the definitions in AS 31.05 170 (14).

Number 505

Rep. Pignalberi asked whether the definition in statute allowed for an interpretation to include fiscal and economic waste.

Number 510

Chat Chatterton said in his opinion it did not. While the evaporation technique worked for Texas prior to 1972, he doubted it would hold up today.

Number 540

Rep. Pignalberi asked a question submitted by Rep. Rieger. Did the state have any protection against the lag between the rise in market prices for crude and the time that increase in price was reported to the state?

Number 550

Commissioner Wunnicke replied that the price on which the royalty and severance tax were based was determined at the time of sale. The companies report back the actual amount the oil is sold for. Daily spot prices are used only for planning. The Department of Revenue is responsible for audits to ensure the producers are reporting truthfully.

Number 610

Rep. Davis rephrased the question by asking how closely the contract price could be expected to follow the spot price.

Number 635

Dick Monkman said the actual price producers received for their oil had been the subject of many disputes. Many oil companies do not simply sell their oil for cash. Instead, they exchange their ANS oil for other oil in other parts of the world. Therefore, there were arguments over the value of the oil received in trade.

Number 700

Chuck Logsdon described DOR's auditing procedure. He agreed with Mr. Monkman that determining the correct price of ANS crude was very difficult.

TAPE TWO SIDE ONE

Number 000

Rep. Pignalberi asked about the source of disputes over tax assessments.

Number 005

Chuck Logsdon replied that whenever you dealt with a very valuable resource in an area with a great deal of subjectivity billion dollar assessments could result. Essentially it was a question of value and costs.

Number 010

Rep. Pignalberi disagreed that these were areas of subjectivity. There were written records of all oil transactions. On a different subject, Rep. Pignalberi recalled reading that the composition of crude in the pipeline changed over time. By now a higher percentage of NGL (natural gas liquids) was in the stream, so the wellhead value should be higher.

Number 040

Chuck Logsdon replied that in a free market the price that a buyer and seller agree on should reflect the value of the product. There would be additional NGLs put into the line in the future. The average AGI gravity would probably not change very much because of the volume of oil in the pipeline.

Number 055

Rep. Pignalberi expressed concern that the state would not realize a benefit from the presence of the NGL. Perhaps the state ought to consider the fact that the pipeline was carrying to distinct products with two prices.

Number 065

Chuck Logsdon said that pricing structure would be difficult to achieve.

Number 080

Rep. Davis asked about the status of ongoing discussions with Conoco, and about the economic limit factor (ELF).

Number 085

Commissioner Wunnicke said the Dept. of Revenue could better address the ELF. She had not met with representatives of Conoco since the last legislative session. DNR had offered to spread the royalty due over time, but Conoco had not accepted. That offer was still good, but Ms. Wunnicke could not respond to the request for a royalty reduction without legislative approval.

Number 100

Rep. Davis asked whether DNR had been approached by any other producers seeking royalty reductions.

Number 105

Commissioner Wunnicke answered that she had not been approached by any other royalty oil contract purchasers with

respect to price reopeners. Perhaps their contracts had not come due yet.

Number 125

Rep. Davis asked if the Dept. of Revenue would like to comment on the ELF factor.

Number 130

Chuck Logsdon said there would be a lowering of Prudhoe Bay's effective tax rate due to the expiration of the 10 year production horizon specified "in whether or not the ELF is applied when the calculated value is greater than 0.7". There is a chance that low wellhead prices would encourage North Slope producers to file for a hearing and redetermination of the ELF based on actual production and price data. The evidence would probably be in their favor.

Number 160

Dick Monkman added that any recalculation of the ELF could not occur until this upcoming December or January. The problem with the economic limit factor is that near zero wellhead value, the ELF would also be extremely close to zero. When the ELF is multiplied by the severance tax, there could be a zero severance liability. For a recalculation, the companies would have to request a hearing, then present clear and convincing evidence of a new value.

Number 180

Rep. Szymanski asked what Conoco's current proposal is.

Number 190

Commissioner Wunnicke said there was a general request to reduce the royalty to 12.5%, but nothing more specific.

Number 195

Rep. Davis asked if DNR had evaluated the state's net profit share leases in light of the drop in oil prices.

Number 200

Commissioner Wunnicke responded that the only net profit share leases currently being produced were three in the Kuparuk unit. It was too early to evaluate those leases. In any case, they were binding agreements.

Number 215

Rep. Davis asked about the predicted return on the 1987 sale. What type of lease did DNR anticipate using in the future?

Number 225

Commissioner Wunnicke replied that net profit share agreements were always an option under consideration. At times when producers have cash flow problems, net profit share leases may be even more viable because the state shares the risk.

Number 235

Rep. Davis commented that when companies' profits came from transportation of oil rather than production, net profit share leases would not be to the state's advantage.

Number 240

Commissioner Wunnicke responded that those were important factors to consider.

Number 265

Rep. Pignalberi asked Mr. Monkman whether the revenue forecast the administration was currently working from took into account the possibility of a zero severance tax liability.

Number 270

Dick Monkman replied that "We're all crossing our fingers and knocking on wood and hoping that the February OPEC price agreement holds and that we won't be faced with that situation."

Number 287

Rep. Davis recessed the meeting for lunch at 12 noon.

Number 300

Rep. Davis reconvened the meeting at 1:30 p.m. Representatives Davis, Marrou, Pignalberi, Cotten, and Szymanski were present after lunch.

Number 310

Roger Marks reviewed royalty oil storage alternatives. The state's total royalty oil is about 220,000 barrels/day. By September, the total in kind royalty will be about 120,000 barrels/day. The wellhead value for Gulf coast sales is slightly over one dollar.

Mr. Marks commented that producers are not prone to store oil or curtail production since they earn profits on the pipeline,

shipping, and refining. They earn these profits off the state's royalty oil as well as their own. Subsequently, we can expect to see production even at negative wellhead values.

If we are in a world of vacillating prices, the state could optimize its ultimate revenue by storing its in value oil until the price recovers. Storage would not be riskless. Its ultimate feasibility depends on the timing of the eventual price recovery.

From an economic perspective, the best place to store the oil is in the ground. With underlifting, the only cost to the state would be the opportunity cost of foregone revenue. At the 10% discount rate currently earned by the permanent fund, that cost would be $0.09/barrel for a six month period of underlifting, $0.19 over a year, and $0.39 over two years. That is also the necessary price recovery needed to break even. There would be a cash flow loss of $220,000/day in royalty income, which would be made up when production occurred

If underlifting is not possible, the state could take its in value oil in kind, and store it. Eventually there would be an in kind sale similar to the one held last year. In general, the state would need to give producers 6 months notice for denomination. The state would take possession of the oil at pump station 1, which represents a radical departure from customary state policy. Traditionally, the state has unburdened its self at pump station one, exchanging any downstream benefits for administrative simplicity.

DOR has come up with three alternatives for storing royalty oil in addition to the preferable underlift option. The first option is storing oil in tankers near Valdez. The state would have to pay storage costs up front, possibly causing cash flow problems. There are many excess tankers in the world today, so they could be obtained fairly cheaply. The largest tanker that can enter the port of Valdez can hold about 1.9 million barrels, one half month of in kind royalty oil. A foreign bottom tanker could be charged for about $10,000/day ($0.16/barrel/month) including crew, pumpers and heating. If American bottom tankers were necessary, the cost would be $15,000/day. The fee to transfer the oil from the pipeline to the tanker would be $0.15. The mooring buoy would cost about $2 million. Insurance would be about $0.01/barrel/month.

The second option would be to build storage in Valdez. Land is available and could be leased for $5,000/acre. A 510,000 barrel (25 day) storage tank would cover 2 acres, cost $4.20/barrel, and require a year to build. The advantage of a tank farm over the tanker option is that it is a one time cost with cheaper long term per barrel rates. The state could always have access to the facility, there was less environmental risk, and it would assist Valdez in its economic

development. The disadvantages of this option are that it is slower to implement, and it is more expensive in the short term.

The third and best option economically, is storage in Lower 48 tanks. The independent storage industry is small and fragmented. Most major producers and refiners have their own tanks. 25% of the 40 million barrel independent storage capacity is currently idle. Storage costs would be approximately $0.15/barrel/month, including pumping and insurance. The advantage of this option is that it is quicker to implement. The disadvantage is that the state would have to arrange transportation.

Mr. Marks presented a table comparing costs and necessary appropriations for the options over different time periods.

Number 515

Rep. Davis commented that the federal government was increasing its stored reserves and asked how that would affect Lower 48 storage.

Number 525

Roger Marks said DOR had contacted the federal Dept. of Energy to see if Alaska could store oil with the strategic petroleum reserve. The answer was no.

Number 550

Rep. Pignalberi suggested that the legislature ask the congressional delegation to petition D.O.E.

Number 560

Rep. Marrou asked about the feasibility of a refinery in Valdez with the owner shipping refined products to Asia.

Number 585

Rep. Pignalberi asked what Mr. Marks thought the state should do.

Number 590

Roger Marks said the state should compare costs and benefits.

Number 610

Rep. Szymanski asked if statutory changes would be necessary to implement any of the options.

Number 625

Rogers Marks replied that denomination of in value oil for a period longer than one year would require legislative approval. Underlift would have to be negotiated with producers.

Number 680

Chuck Logsdon discussed recent OPEC developments.

TAPE TWO SIDE TWO

Number 000

Chuck Logsdon continued his OPEC update. DOR will be putting together new revenue estimates in September. He was "cautiously optimistic" that the state's FY 88 revenues would be near the figures used in preparing the budget in March. Regardless of OPEC's action, there would be a large shortfall in FY 87.

Number 040

Rep. Pignalberi asked how aware OPEC was of Alaska oil production.

Number 050

Chuck Logsdon said the people he came in contact with were well aware of Alaskan oil and gas. They tended to lump the state with other high cost producing areas like the North Sea. They were also aware of the prohibition on export which prevented Alaska from being a player in the world market.

Number 065

Rep. Davis asked about the volume of world wide production, and OPEC's ability to drive up the price of oil.

Number 070

Chuck Logsdon said the result depended on the cooperation of major non-OPEC countries with discretionary production. Great Britain had declared its intention to continue producing at the same volume. On the other hand Egypt, Mexico, and Norway would probably voluntarily hold down production. In the most recent OPEC agreement, Iran had pledged to hold to 2.3 million barrels/day and ensure that Iraq does not increase production above 1.8 million. Iraq had not signed anything.

Number 115

Rep. Davis recessed the meeting until 3:00 p.m.

The final portion of the meeting was cancelled because Tom Hawkins was unable to make his presentation. The meeting therefore adjourned at 2:00 p.m.