

SB

112

HFIN

FILE

(11)

HOUSE COMMITTEE REPORT

Date Referred to Committee: April 29, 1996

FURTHER REFERRALS:

Date of Committee Action: 5/1/96

The FINANCE Committee considered:

CSSB 112(RES)

CS FOR SENATE BILL NO. 112(RES)

DISCOVERY ROYALTY CREDIT

"An Act establishing a discovery royalty credit for the lessees of state land drilling exploratory wells and making the first discovery of oil or gas in an oil or gas pool in the Cook Inlet sedimentary basin."

recommends it be replaced with the following committee substitute HCS CS SB 112 (FIN) [X] the same title [] a new title

[] additional referral to _____ Committee [] attached amendment(s)

ADOPTS: _____ Letter of Intent

ATTACHES NEW FISCAL NOTE(S): (Dep)

APPROVES PREVIOUS: (Dep/Date)

[] fiscal note(s) _____

[X] fiscal note(s) Rev 3/29/96

DNR 3/25/96

[] zero fiscal note(s) _____

[] zero fiscal note(s) _____

SIGNING WITH RECOMMENDATIONS		DP	DNP	NR	AM
<i>Richard Foster</i>	Foster	X			
<i>Alden Mulder</i>	Mulder	X			
<i>Tom Martin</i>	Martin	X			
<i>Sean Farrell</i>	Farrell	X			
<i>Tam Brown</i>	Brown				X
<i>John Kelly</i>	Kelly	X			
<i>John Grussendorf</i>	Grussendorf				X
<i>Mike Navarre</i>	Navarre				X

CHAIR'S SIGNATURE

Richard Foster

FISCAL NOTE

No. 3

STATE OF ALASKA
1996 LEGISLATIVE SESSION

Bill Version: CS SB 112 (RES)
 (S) Publish Date: 3-25-96

Revision Date: Original Dept Affected: Natural Resources
 Title: An Act establishing a discovery royalty credit BRU: Resource Development
 for the lessees of state land drilling exploratory wells and... Component: Oil & Gas Development
 Sponsor: Senate Resources
 Requestor: Senate Finance Component Serial No. 439

Expenditures/Revenues (Thousands of Dollars)

OPERATING EXPENDITURES	FY97	FY98	FY99	FY00	FY01	FY02
PERSONAL SERVICES	91.0	91.0	91.0	91.0	91.0	91.0
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	91.0	91.0	91.0	91.0	91.0	91.0

CAPITAL EXPENDITURES	0.0	0.0	0.0	0.0	0.0	0.0
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CHANGE IN REVENUES (I)						
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FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF	91.0	91.0	91.0	91.0	91.0	91.0
1005 GF/Program Receipts						
1006 GF/MHTIA						
Other						
TOTAL	91.0	91.0	91.0	91.0	91.0	91.0

Estimate of any current year (FY96) cost: \$ none

POSITIONS

FULL-TIME	1	1	1	1	1	1
PART-TIME	0	0	0	0	0	0
TEMPORARY	0	0	0	0	0	0

ANALYSIS: (Attach a separate page if necessary)

This bill reinstates Discovery Royalty (which was repealed in 1969) as a means to reduce royalty payments under certain conditions for leases in Cook Inlet Sedimentary Basin.

It is apparent that the discovery royalty incentive has previously been geared toward frontier exploration. In frontier areas, the geologic risk of drilling an unsuccessful well is high, since little geological information is available to the operator prior to drilling. The element of risk was used by the state as an important yard stick for determining eligibility in some previous discovery royalty decisions in Cook Inlet. Cook Inlet was a frontier basin in the 1950's and 1960's. However, today, due to a long history of exploration and production, geologists consider Cook Inlet a mature petroleum province. Almost all wells drilled on state land in Cook Inlet are drilled in close proximity to other wells containing known oil or gas and should be considered step-out wells and not wildcat exploration wells. Step-out wells have relatively low exploration risk when compared to wildcat exploration wells.

Prepared by: Ken Boyd, Director Phone: 269-8800
 Division: Oil & Gas Date: 22-Mar-96
 Approved by Commissioner: [Signature] Date: 22-Mar-96
 Agency: Natural Resources

Based on past experience, SB 112 will be very difficult to administer. Due to the issuance of pre-1970 conditional leases and the holding of other pre-1970 leases by unitization, the state has many current leases that still have a contractual right to a discovery royalty under the repealed program. As of January 1995, the state has 340 active leases that currently retain the discovery royalty provision, and the Division of Oil and Gas still actively manages the program. Under the previous discovery royalty program, thirteen applications were made for wells in Cook Inlet Basin, eight of which were granted and five were denied. Many of these applications were granted or denied only after years of litigation.

Although SB 112 attempts to eliminate many of the administrative problems with the old discovery royalty program, certain significant problems are inherent with both the repealed program and SB 112. These problems were recognized as far back as 1962 and remain today. It is doubtful that new regulations could eliminate the problems faced in the earlier program.

It is unlikely that the Division can draft regulations under the time constraints imposed by the bill.

Analysis of discovery royalty applications is a very time consuming process and will require the addition of one Petroleum Geologist.

Revision Date: _____ Dept. Affected: Revenue
 Title: Discovery Royalty Credit BRU: Revenue Operations
 Component: Oil and Gas Audit
 Sponsor: (S) Resources
 Requestor: (S) Rules COMPONENT SERIAL NO.: 115

Expenditures/Revenues:

(Thousands of Dollars)

OPERATING EXPENDITURES	FY 97	FY 98	FY 99	FY 00	FY 01	FY 02
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES () See Analysis
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FUND SOURCE

(Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other						
TOTAL

Estimate of any current year (FY96) cost \$ _____

POSITIONS:

FULL-TIME						
PART-TIME						
TEMPORARY						

ANALYSIS: (Attach a separate page if necessary)

This bill would grant a royalty rate of 5 percent to all oil and gas produced from the lease from which a discovery was made for a period of ten years following the date of discovery.

The revenue impact would depend on the size of the discovery and the timing of the development of the discovered oil and gas accumulation.

See attached analysis for potential revenue loss.

Prepared by: Chuck Logsdon Phone: 277-5627
 Division: Oil and Gas Audit Date: March 28, 1996
 Approved by Commissioner: Walter Longfellow Date: March 28, 1996
 Agency: Department of Revenue

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Fiscal Note Analysis
CSSB 112 (RES)

This bill would grant a discovery royalty rate of 5% for production from a previously undiscovered oil or gas pool attributed to and under a lease in the Cook Inlet sedimentary basin for 10 years following the date of discovery of that pool. This would apply to oil discovered in the Cook Inlet 180 days following the enactment of the bill.

The revenue impact would depend on the size of the discovery and the timing of development of the discovered oil and gas accumulation. The following hypothetical Cook Inlet example would be indicative of the cost of the lower discovery royalty rate.

Oil = 2 wells * 250 bbl/day/well * 365 * \$15/bbl * (.125 - .05) = \$205,000 per year

Gas = 1 well * 10,000 mcf/well * 365 * \$2.25/mcf * (.125 - .05) = \$616,000 per year

adopted
amended #1
pt 2
pg 4

HOUSE CS FOR CS FOR SENATE BILL NO. 112(RES)

IN THE LEGISLATURE OF THE STATE OF ALASKA

NINETEENTH LEGISLATURE - SECOND SESSION

BY THE HOUSE RESOURCES COMMITTEE

Offered: 4/29/96

Referred: Finance

Sponsor(s): SENATE RESOURCES COMMITTEE

A BILL

FOR AN ACT ENTITLED

1 "An Act establishing a discovery royalty credit for the lessees of state land
2 drilling exploratory wells and making the first discovery of oil or gas in an
3 oil or gas pool in the Cook Inlet sedimentary basin."

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

5 * Section 1. AS 38.05.134 is amended to read:

6 Sec. 38.05.134. CONVERSION TO LEASE. If the licensee requests and the
7 commissioner determines that the work commitment obligation set out in an oil and
8 gas exploration license issued under AS 38.05.132 has been met, the commissioner
9 shall convert to one or more oil and gas leases all or part, as the licensee may indicate,
10 of the area described in the exploration license that remains after the relinquishments,
11 removals, or deletions required by AS 38.05.132(d)(2). A lease issued under this
12 section

13 (1) is subject to the acreage limitations imposed by AS 38.05.140(c);

14 (2) is subject to AS 38.05.180(j) - (m), (o) - (u), and (x) - (z);

also

Pg 4
LW 8:29

7
passed

→

(3) must be conditioned upon a royalty in amount or value of not less than 12.5 percent of production, except that the lessee who, proceeding under AS 38.05.131 - 38.05.134, under a lease issued in the Cook Inlet sedimentary basin who is the first to file with the commissioner a nonconfidential sworn statement claiming to be the first to have drilled a well discovering oil or gas in a previously undiscovered oil or gas pool and who is certified by the commissioner within one year of completion of that discovery well to have drilled a well in that pool that is capable of producing in paying quantities, [as that term is defined in AS 38.05.180(f)(4)] shall pay a royalty of five percent on all production of oil or gas from that pool attributable to that lease for a period of 10 years following the date of [completion of the] discovery [well in] ^{of} that pool, and thereafter the royalty payable on all production of oil or gas from the pool attributable to that lease shall be determined and payable as specified in the lease; the payment of the five percent royalty under this paragraph is authorized only to a holder of a lease who meets the requirements of AS 38.05.180(f)(4):

(4) must include an annual rent of \$3 per acre or fraction of an acre initially paid to the state at inception of the lease and payable annually after that until the income to the state from royalty under that lease exceeds the rental income to the state under that lease for that year; and

(5) is subject to other conditions and obligations that are specified in the lease.

• Sec. 2. AS 38.05.180(f) is amended to read:

(f) Except as provided by AS 38.05.131 - 38.05.134, the commissioner may issue oil and gas leases on state land to the highest responsible qualified bidder as follows:

(1) the commissioner shall issue an oil and gas lease to the successful bidder determined by competitive bidding under regulations adopted by the commissioner; bidding [BIDDING] may be by sealed bid or according to any other bidding procedure the commissioner determines is in the best interests of the state;

(2) whenever [WHENEVER], under any of the leasing methods listed in this subsection, a royalty share is reserved to the state, it shall be delivered

1 in pipeline quality and free of all lease or unit expenses, including but not limited to
2 separation, cleaning, dehydration, gathering, salt water disposal, and preparation for
3 transportation off the lease or unit area;

4 ~~(3) following~~ [FOLLOWING] a pre-sale analysis, the commissioner
5 may choose at least one of the following leasing methods:

6 ~~(A) [(1)]~~ a cash bonus bid with a fixed royalty share reserved
7 to the state of not less than 12.5 percent in amount or value of the production
8 removed or sold from the lease;

9 ~~(B) [(2)]~~ a cash bonus bid with a fixed royalty share reserved
10 to the state of not less than 12.5 percent in amount or value of the production
11 removed or sold from the lease and a fixed share of the net profit derived from
12 the lease of not less than 30 percent reserved to the state;

13 ~~(C) [(3)]~~ a fixed cash bonus with a royalty share reserved to the
14 state as the bid variable but no less than 12.5 percent in amount or value of the
15 production removed or sold from the lease;

16 ~~(D) [(4)]~~ a fixed cash bonus with the share of the net profit
17 derived from the lease reserved to the state as the bid variable;

18 ~~(E) [(5)]~~ a fixed cash bonus with a fixed royalty share reserved
19 to the state of not less than 12.5 percent in amount or value of the production
20 removed or sold from the lease with the share of the net profit derived from
21 the lease reserved to the state as the bid variable;

22 ~~(F) [(6)]~~ a cash bonus bid with a fixed royalty share reserved
23 to the state based on a sliding scale according to the volume of production or
24 other factor but in no event less than 12.5 percent in amount or value of the
25 production removed or sold from the lease;

26 ~~(G) [(7)]~~ a fixed cash bonus with a royalty share reserved to the
27 state based on a sliding scale according to the volume of production or other
28 factor as the bid variable but not less than 12.5 percent in amount or value of
29 the production removed or sold from the lease;

30 (4) notwithstanding a requirement in the leasing method chosen of
31 a minimum fixed royalty share, on and after a date that is 180 days following the

1 effective date of this Act, the lessee under a lease issued in the Cook Inlet
2 sedimentary basin who is the first to file with the commissioner a nonconfidential
3 sworn statement claiming to be the first to have drilled a well discovering oil or
4 gas in a previously undiscovered oil or gas pool and who is certified by the
5 commissioner within one year of completion of that discovery well to have drilled
6 a well in that pool that is capable of producing in paying quantities shall pay a
7 royalty of five percent on all production of oil or gas from that pool attributable
8 to that lease for a period of 10 years following the date of completion of the
9 discovery well in that pool, and thereafter the royalty payable on all production
10 of oil or gas from the pool attributable to that lease shall be determined and
11 payable as specified in the lease; for purposes of this paragraph,

12 (A) the reduced royalty authorized by this paragraph is
13 subject to the following:

14 (i) only one reduction of royalty authorized by this
15 paragraph may be allowed on each lease that qualifies for reduction
16 of royalty under this paragraph;

17 (ii) if, under this paragraph, application is made for
18 a royalty reduction for a lease that was entered into before the date
19 that is 180 days following the effective date of this Act, the
20 commissioner may approve the application only if, on that date, the
21 lease was a nonproducing lease that was not committed to a unit
22 approved by the commissioner under (m) of this section, that is not
23 part of a unit under (p) or (q) of this section, and that has not been
24 made part of a unit under AS 31.05;

25 (iii) if application for a royalty reduction is made
26 under this paragraph for a lease on which a discovery royalty was
27 claimed or may be claimed under the discovery royalty provisions
28 of former AS 38.05.180(a) in effect before May 6, 1969, the
29 commissioner shall disallow the application under this paragraph
30 unless the applicant waives the right to claim the right to a reduced
31 royalty under the discovery royalty provisions of former

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AS 38.05.180(a) in effect before May 6, 1969; and

(iv) the commissioner shall adopt regulations setting out the standards, criteria, and definitions of terms that apply to implement the filing of applications for, and the review and certification of, discovery oil and gas royalty certifications under this paragraph; and

(B) "paying quantities" means quantities sufficient to yield a return in excess of operating costs, even if drilling and equipment costs may never be repaid and the undertaking considered as a whole may ultimately result in a loss; quantities are insufficient to yield a return in excess of operating costs unless those quantities, not considering the costs of transportation and marketing, will produce sufficient revenue to induce a prudent operator to produce those quantities.

5/1/96

NO OBJ / adopted

AMENDMENT I

OFFERED IN THE HOUSE
TO: HCS CSSB 112(RES)

BY REPRESENTATIVE BROWN

1 Page 4, line 12:

2 Delete "(A)"

3 Page 5, line 6, following "paragraph":

4 Delete "; and"

5 Insert ";

6 Page 5, lines 7-13:

7 Delete all material

5/1/96

Failed 3-5

AMENDMENT 2

OFFERED IN THE HOUSE
TO: HCS CSSB 112(RES)

BY REPRESENTATIVE BROWN

- 1 Page 2, line 3, following "issued":
- 2 Insert "after the effective date of this act"
- 3 Page 4, lines 17 - 24
- 4 Delete all material
- 5 Re-number accordingly

Failed 2-5

5/11/96

(conceptual amendment
around all sections if need be)

AMENDMENT 3

OFFERED IN THE HOUSE
TO: HCS CSSB 112(RES)

BY REPRESENTATIVE BROWN

- 1 Page 3, line 31, following "that is":
- 2 Delete "~~180~~ days"
- 3 Insert "²⁷⁰ ~~one year~~ DAYS"

NO OBJ



Alaska State Legislature

Senate Resources Committee

Official Business

State Capitol
Juneau AK 99801

Sponsor Statement for:

Senate Bill 112: Discovery Royalty

When SB 112 was introduced by the Senate Resources Committee it was written for discussion purposes as the law had been when it was repealed in 1969 (1, CH 65 SLA 1969), recognizing that such terms as "in commercial quantities", "geologic structure" and "first discovery" would have to be discussed regarding their current relevance.

These vague terms resulted in litigation over the previous discovery royalty program. The committee has worked closely with the Department of Natural Resources and industry to write legislation that narrows the opportunity for litigation over who is awarded a discovery royalty under this proposal.

The new program is intended to reward not only the first person to drill a well resulting in a new discovery, but that person must also complete the well - resulting in production. The discovery royalty provision is available to all Cook Inlet Sedimentary Basin future leases and to non-producing, non-unitized leases entered into before the effective date of the act.

Lessees with leases under the old discovery royalty program may choose either that program or the new program, but not both.

It is the sponsor's intent that this legislation will encourage new activity in the Cook Inlet region.

SB112

FACTS RE: FORMER DISCOVERY ROYALTY

Former Definition

5% royalty for any production from a lease in the first 10 years following the discovery of oil and gas in commercial quantities in a geologic structure.

Timeline

1937 - 1946, 1950 - 1958: Regulations under Federal Mineral Leasing Act establish discovery royalty for Alaska only.

1959: Alaska Land Act codifies federal regulation language into state statute; state lease form copies statute's language.

1962: Cook Inlet drilling races result in two blowouts: 45 days; 14 months. State grants discovery royalty for both.

1963: State regulations adopted.

1969: State legislature abolishes discovery royalty (ch 65, SLA 1969).

Contentious

Many disputes, some over leases that never produced during the discovery royalty period.

Three Alaska Supreme Court decisions re: discovery royalty:

- Pan American, 455 P.2d 12 (Alaska 1969) (challenge by competitor)
- Union Oil, 526 P.2d 1357 (Alaska 1974) (denial of certification)
- Union Oil, 574 P.2d 1266 (Alaska 1978) (denial of certification)

Many administrative decisions by DNR.

Litigation / Administrative Appeal Issues

What constitutes "first discovery", and is spud date relevant?

What are "commercial quantities", and is a controlled well test necessary?

What is a "geologic structure?"

What is the "discovery date?"

Does a discovery royalty apply to production from all zones in a lease?

APR 25 1996



KENAI PENINSULA BOROUGH

144 N. BINKLEY · SOLDOTNA, ALASKA 99669-7599
 BUSINESS (907) 262-4441 FAX (907) 262-1892

DON GILMAN
 MAYOR

POSITION PAPER - CS SB 112 (RES)

DISCOVERY ROYALTY CREDITS

The Kenai Peninsula Borough Assembly and administration supports CSSB 112 (Res) with minimum modifications, in that, the bill should cover lease holders and discovery royalty be effective upon the effective date of the bill. We do not support a "retro-activity" section which would cover current leases which are in production upon or prior to the effective date clause.

This bill is critical to the future of the Borough at a time when oil and gas exploration is almost non-existent compared to the activity in the 1960's which help create what we enjoy in the Borough today.

The State of Alaska had a discovery royalty program in effect throughout the 1960's and was later repealed because of new discoveries in the North Slope. It is very important to us that a royalty program be reinstated and this bill does just that, at a time when encouragement is needed to renew industry activity in the Cook Inlet Basin.

We seek your support in passage of this legislation. Independents can function in the State of Alaska and create the much needed job opportunities for our skilled residents as well as give hope to local suppliers and contractors that the Kenai Peninsula Borough can have a stable future for further investment opportunity.

Kenai Peninsula Borough

Don Gilman

Don Gilman, Borough Mayor

4/25/96


Date

Andrew P. Scalzi

Andrew P. Scalzi, Assembly President

4/25/96

Date



Stewart Petroleum Company

Denali Towers North, Suite 1300
2550 Denali Street, Anchorage, Alaska 99503
(907) 277-4004 • FAX (907) 274-0424

TESTIMONY
of
WILLIAM R STEWART
before the
OIL AND GAS POLICY COUNCIL

MAY 25, 1995

Chairman Wunnicke and members of the Oil & Gas Policy Council, my name is Bill Stewart, President of Stewart Petroleum Company. I have 26 years of oil and gas industry experience in Alaska. Our company is a small Alaska based independent oil and gas exploration and production company active in Alaska and seven other states. Our primary area of interest within Alaska is Cook Inlet Basin. In late 1991, we were fortunate in discovering the West McArthur River Oil Field, a field of significant size on the west side of Cook Inlet. We are in the development stage at the present time. With a pipeline system in place, production of two wells is underway and a third well is currently drilling below 14,000' from an onshore location to an offshore bottom hole location.

According to available information, we are the first independent to establish commercial oil production in Alaska in modern times. (I say "modern times" because oil production was established by independents much earlier at Katalla in 1902. The field produced low gravity crude until their on-site refinery burned in 1933.) In fact, it may interest you to know that about 60 wells have been drilled here by independents, including the first well in Alaska. That well was drilled by a group of independents in 1898 on the Iniskin Peninsula utilizing cable tools and undoubtedly following up on natural oil seeps that still exist there today.

Back to modern times, I feel qualified because of my Alaska experience to discuss why we have very few independents here and what might attract more of them to the State. In general terms, I believe we have very few independents here for three basic reasons. Those reasons are Alaska's natural obstacles, it's man-made obstacles and its high operating costs.

1. Natural Obstacles

The natural obstacles include the obvious factors of climate, remoteness, and logistics. These are significant problems faced by both independents and major companies but they can be handled through proper planning. Without proper planning Alaska is very unforgiving. Independents without experience here fear these obstacles.

2. Man-made Obstacles

The man-made obstacles include lack of available lands (due to scarcity of fee lands, massive public interest land withdrawals in the form of riders to the Alaska Native Claims Settlement Act of 1971 and a State leasing system

which is restricted to competitive leasing only) as well as the regulatory rain forest which exists here. I mentioned earlier that we operate in seven other states. None of those states even begin to approach the kind of governmental micro management of oil and gas operations that we have here. Independent companies much larger than mine are afraid of the process and choose not to operate here.

3. High Operating Costs

The high operating costs are a function of both the natural obstacles and the man-made obstacles mentioned. I'm not sure which is the greatest contributor to these costs. Investment in our own project at West McArthur River exceeds \$50 million since 1991. Significant returns are just now beginning to be realized.

Fortunately, the story is not all bad at this point. I'm encouraged by the efforts of Governor Knowles toward attracting industry investment in Alaska and in forming this Council. I'm encouraged by the efforts of Commissioner Burden to streamline ADEC. I'm also encouraged by the oil and gas incentive programs being explored by the Alaska Legislature. At this point I would like to suggest several possible incentive programs, which may or may not be of interest to major companies, but which would definitely be of interest to independents, as follows:

1. Royalty Reduction (Existing Fields)

I've been travelling for the past couple of weeks but I understand a final revision of the royalty reduction bill (HB 207) has passed both the House, and the Senate and is awaiting signature by the Governor. Basically, I feel that while the reasoning behind that legislation is to be commended, it is (as a practical matter) far too complex.

It's the sort of thing that endless audits and lawsuits are made of. While both major companies and the State of Alaska are perhaps well equipped for endless audits and lawsuits, independents are not.

If the opportunity should arise again, I would support a much simpler approach to royalty reduction. Such an approach would involve a predetermined formula based on production much like the ELF formula which has been in place for years. ELF effectively reduces the tax burden for smaller fields by application of the predetermined formula. A similar arrangement for royalty reduction would be a tremendous incentive for new activity for companies large and small who are operating smaller fields, at least small by Alaska standards.

2. Discovery Royalty

The State of Alaska had a discovery royalty program in effect until its abolishment in the early 1970's. Under the program, royalty burden (on the discovery lease only) was reduced from 12.5% to 5% for a period of ten years. Any and all wells located on the lease received the reduction. Perhaps this program or some variation thereof could be reinstated. The incentive created would result in more aggressive development schedules. Coordination with the Royalty Reduction Program discussed earlier would be involved.

3. Acreage Availability

At about the same time the discovery royalty program ceased to be, all State lands were classified for competitive bid only and prior non-competitive

programs were eliminated. The Federal government and many oil producing states maintain non-competitive leasing programs. The mentality in Alaska has been to maximize lease bonuses. It can be better for both industry and State if those dollars go into exploration and development activities resulting in long term production of oil and gas. Non-competitive programs could include openings for over-the-counter filing in relatively unexplored areas and a simultaneous filing program similar to the Federal program in other states. Parcels which do not receive bids at competitive sale could be reclassified non-competitive. It is always possible that new geological thinking will evolve and result in new activity on such parcels.

4. Simplification of Permitting

I mentioned Alaska's regulatory rain forest earlier. The permitting system is overwhelming and often involves interagency conflict. Our operation has involved more than 40 permits to date and numerous field inspections both announced and unannounced. The system deters activity by the independent sector. Changing the system will not be easy. A "lead agency" concept for oil and gas may be a solution but not if it is simply another layer of regulation. The lead agency (probably Alaska Oil & Gas Conservation Commission) would eliminate or replace the existing permitting functions of other agencies and provide "one stop shopping" for industry. Also, reasonable time limits for issuance or rejection of a permit are needed. Considerable resistance to those concepts will be received from middle and lower level officials in the agencies. It is our experience that, while the Governor and the department heads may be working toward positive changes, the message does not filter down to the lower levels. We have

experienced on a number of occasions in our permitting efforts that the lower level officials do not simply "carry out policy" as would be expected. They "make policy" and that policy is usually "stop" or "no". These officials, of course, do not have the "answerability" of the elected or appointed officials above.

5. Reduce DEC Financial Responsibilities Requirements

These requirements were created in the wake of the Exxon Valdez incident. Even with the reductions enacted in 1994 by the Legislature, the required coverages are very hard to come by for a small company, especially with the "Direct Access" provision required under insurance policies. By the way, we have elected to exceed the required coverages at West McArthur River but that was a business decision which may not be applicable in all cases.

6. Development Funding Programs

With Alaska's high cost of operating, State funding for development activities could significantly encourage exploration and hopefully more discoveries by the independent sector. A development loan program, which would be available only after discovery in paying quantities and would not be for exploration purposes, would encourage aggressive development and benefit both the State of Alaska and industry. I know from experience that oil and gas operations do not fit the AIDA programs. A new funding mechanism would be required.

As indicated earlier, our project at West McArthur River has involved more than \$50 million in investment to date. During periods of drilling, approximately 40

full time on-site jobs are created together with approximately 20 support jobs in Anchorage and Kenai. Pipeline construction involved approximately 30 full time on-site jobs and 15 support jobs. After full development of the field, about 15 permanent on-site and support jobs will be involved in the producing operation. In addition to the taxes and royalties involved, the employment created by operations such as ours can only be good for Alaska's economy.

Despite the obstacles, independents can function in Alaska, but these types of incentives are needed. As an independent producer, we are in touch with many other independent producers. There are roughly 10,000 members in IPAA, the Independent Petroleum Association of America. Most of the IPAA members will never venture to Alaska, but in the wake of our success, we are beginning to hear expressions of interest from quite a few.

Thank you for inviting me to appear today. We look forward to continued work with the Council and we are prepared to assist with specific language to accomplish these suggested changes. In the meantime, I'll try to answer any questions you may have.

STEWART PETROLEUM COMPANY

By: 

W. R. Stewart, President

May 25, 1995



ALASKA STATE LEGISLATURE
HOUSE OF REPRESENTATIVES
RESEARCH AGENCY

Pouch Y. State Capitol
Juneau, Alaska 99811
(907) 465-1991

March 11, 1986

MEMORANDUM

TO: Representative Andre Marrou
FROM: *G. Keiser*
Gretchen Keiser
Legislative Analyst
RE: Oil and Gas Discovery Royalty Incentive
Research Request 86-126

You requested us to provide information about a former provision in State statute which allowed a lessee to pay a reduced royalty on production for ten years following the discovery of commercial quantities of oil or gas. Specifically, you wanted to know:

- when and why the provision was dropped;
- how successful the provision was with respect to encouraging exploration;
- State revenue "lost" because of the reduced royalty; and
- State revenue ultimately gained because of the production of commercial quantities which would otherwise not have been discovered.

Brief History of the Discovery Royalty

The so called "discovery royalty" provision was dropped from Alaska Statute in 1969 (S 1, Ch. 65, SLA 1969). Prior to its deletion, the provision was as follows:

"...the holder of a lease who drills and makes the first discovery of oil or gas in commercial quantities in a geologic structure shall pay a royalty on all production under the lease of five percent for 10 years following the date of discovery and thereafter the royalty rate shall be not less than 12-1/2 percent..." [AS 38.05.180(a)]

Representative Marrou
March 11, 1986
Page Three

the first place.¹ In other words, the provision generally affected the timing of drilling in a prospective area after the decision to explore had been made.

The Cook Inlet discoveries listed in Attachment A occurred during the period of extensive oil and gas exploration of the many separate geologic structures in the region. It appears unlikely that the discovery royalty provision was instrumental in encouraging exploration beyond what was already warranted based on preliminary geophysical investigations.

The discovery royalty did provide some incentive to develop, produce and market discovered commercial quantities of oil or gas as quickly as possible. However, the incentive to produce was quite small because the reduced royalty provision applied only to the single lease where the discovery occurred. In the initial unitization covering the 63 leases in the Kuparuk River Unit, for example, only 0.0206 percent of the oil produced was allocated to the discovery lease.² Generally, hydrocarbon quality, ease of extraction, the cost of transportation, and market value were much more significant factors in the decision to develop an oil or gas field.

In 1978, a provision for exploration incentive credits was included in the extensive revision of Alaska's oil and gas leasing statute [Alaska Statute 38.05.180(1)]. The Commissioner of the Department of Natural Resources can provide credits--of up to 50 percent of the cost of exploratory drilling or geophysical work--to be applied against royalties, rentals or severance taxes payable to the State. According to Ed Phillips, Petroleum Economist for the department, the current exploration incentive credits (EICs) provide a much more significant inducement to drill than the old discovery royalty provision. Not only are EICs applicable to any exploratory well drilled by a lessee, but partners in the exploratory well (who may or may not be owners of that specific lease) may also receive EICs proportional to their involvement. The EICs provide for immediate recovery of a sizable portion of the exploratory costs (e.g. 30 to 40 percent) because the credits can be applied existing rental, royalty, or severance tax obligations.

¹Affidavit of C.V. "Chet" Chatterton (Commissioner of the Alaska Oil and Gas Conservation Commission) in the Kuparuk River discovery royalty court case (BP Alaska et al. v. State of Alaska).

²Affidavit of Ed Phillips (Petroleum Economist for the Alaska Department of Natural Resources) in BP Alaska et al. v. State of Alaska.

ATTACHMENT A

Discovery Wells Granted the State Discovery Royalty Provision
(Department of Law)

Name of Well	Lessee (present names)	ADL No.	Date of Discovery ¹	First Affidavit or claim of disc- covery ⁴	Date of written decision granting discovery royalty ⁵	Effective date of the 10-year discovery royalty ⁶	Commence- ment of commer- cial pro- duction	Date 12 1/2 royalty replaced 5 1/2 discovery royalty rate	Period royalty actually reduced
Falls Creek Unit No. 1	Chevron ARCO	00590	4-10-61	12-3-63	2-18-64	5-1-61	none ⁷	no royalty ever paid	never used
Middle Ground Shoal No. 1	AMOCO Getty Phillips	17595	6-10-62	11-12-62	1-15-63	6-10-62	5-66 ⁸	6-10-72 ¹²	6 years, ¹² 1 month
● Inlet State No. 1	Phillips	17589	8-21-62	11-12-62	11-24-64	9-1-62	3-69 ⁸	9-72	3 years, 6 months
Beluga River Unit No. 1	Chevron ARCO Shell	17599	12-1-62	9-17-63	12-19-62	1-1-63	3-68 ⁸	1-73	4 years, 10 months
Granite Point No. 1	Hobill Union	18761	5-16-65	5-21-65	9-14-65	6-1-65	5-67 ⁹	6-75	8 years, 1 month
Teading Bay No. 1-A	Union Marathon	18731	5-23-65	6-18-65	8-27-65	6-1-65	1-67 ¹¹	6-75	8 years, 5 months
Grayling No. 1-A	Union Marathon	17594	9-29-65 ²	10-28-65	1-19-82	10-1-65	10-67 ¹⁰	10-75 ¹⁰	8 years, ¹⁰ 1 month
● Inlet Creek State No. 1	Texaco Superior	17598	4-28-66	5-23-66	8-19-66	5-1-66	10-68 ⁸	no production ¹³ after 1972	no more than about 4 years
Prudhoe Bay State No. 1	ARCO Exxon	28303	12-19-67 ³	3-26-68	4-7-69	1-1-68	6-20-77 ¹⁰	1/78	6 months, 11 days
Ugmi No. 1	BP, Sohio ARCO	25633	4-7-69	9-15-69	11-12-82	5-1-69	12-13-81 ¹¹	12 1/2 royalty paid from 12-13-81, the first date of production	never used

EXHIBIT NO. 2
PAGE 1 OF 2

ATTACHMENT 3

Exploration Incentive Credits Certified
by the State of Alaska

EXPLORATION INCENTIVE CREDITS
 Report Month: August 1965

ADL	WELL	COMPANY	CERTIFICATION DATE	TOTAL AMOUNT
343109	G-2 Well	Exxon	10/5/83	\$6,197,625.00
		Sohio	12/27/83	\$4,152,408.75
		BP&E	10/5/83	\$2,045,216.25
344010	Leffingwell	Arco	10/2/84	\$3,706,000.00
		Union	10/2/84	\$3,706,000.00
344033	J-1 Well	Exxon	10/31/84	\$5,119,500.00
355005	Long Island Well	Exxon	11/14/84	\$1,378,076.00
		Sohio	11/14/84	\$1,378,076.00
345126	Totek Hills	Arco Alaska	8/02/85	\$715,530.81
GRAND TOTAL				\$28,398,432.81

Source: Alaska Department of Natural Resources, Division of Oil and Gas

COOK INLET BASIN

DATA SUMMARY

FOR

STATE OF ALASKA HOUSE OF REPRESENTATIVES

FINANCE COMMITTEE HEARING

RE: SENATE BILL 112



COOK INLET BASIN

DATA SUMMARY

FOR

STATE OF ALASKA HOUSE OF REPRESENTATIVES

FINANCE COMMITTEE HEARING

RE: SENATE BILL 112

APRIL 22, 1996

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<u>PART I:</u>	Cook Inlet Basin-Data Summary
	Map of Basin
<u>PART II:</u>	Discovery rates and historical oil & gas reserves. (Discussion)
	Graph comparing drilling and discovery rates during 1959 - 1969 and subsequent years. (PLATE "A")
	Bar chart showing oil & gas reserves discovered prior to, during and after "discovery royalty" provision. (PLATE "B")
<u>PART III:</u>	Estimate of remaining undiscovered oil & gas reserves (Discussion)
	Bar chart - <u>PLATE "C": Estimated Undiscovered Oil & Gas Reserves - Cook Inlet Basin.</u>

PART IV:

Estimate of ultimate State of Alaska royalty values attributable to undiscovered oil & gas reserves. (Discussion)

TABLE "A": Estimated Value to State of Alaska Royalties on Undiscovered Oil & Gas Reserves - Cook Inlet Basin.

PART V:

Ancillary economic benefits to increased exploratory well rate. (Discussion)

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Summary and Conclusions

Data sources

COOK INLET BASIN

DATA SUMMARY

FOR

STATE OF ALASKA HOUSE OF REPRESENTATIVES

FINANCE COMMITTEE HEARING

RE: SENATE BILL 112

APRIL 22, 1996

PART I

1. BASIN DESCRIPTION

The Cook Inlet Basin is an intermontane sedimentary basin trending NE-SW, bounded by the Southern Alaska Range and the Chugach Mountains and is roughly coextensive with the present Cook Inlet waters and immediately surrounding terrain.

It is an important hydrocarbon producing area containing numerous individual oil and gas fields.

2. BASIN SIZE

It is approximately 200 x 70 miles and contains 9,000,000 (+/-) surface acres.

3. OIL & GAS FIELDS

(Oil) 7 producing fields

(Gas) 22 total fields (11 producing; 11 shut-in)

4. ESTIMATED TOTAL
PROVED
RECOVERABLE
RESERVES

(Oil) 1.35 Billion Bbls. (BBO)

(Gas) 6.6 Trillion Cu. Ft. (TCF)

5. ESTIMATED
REMAINING PROVED
RECOVERABLE
RESERVES

(Oil) 120 million BO (MMBO)
(Gas) 1.9 TCF

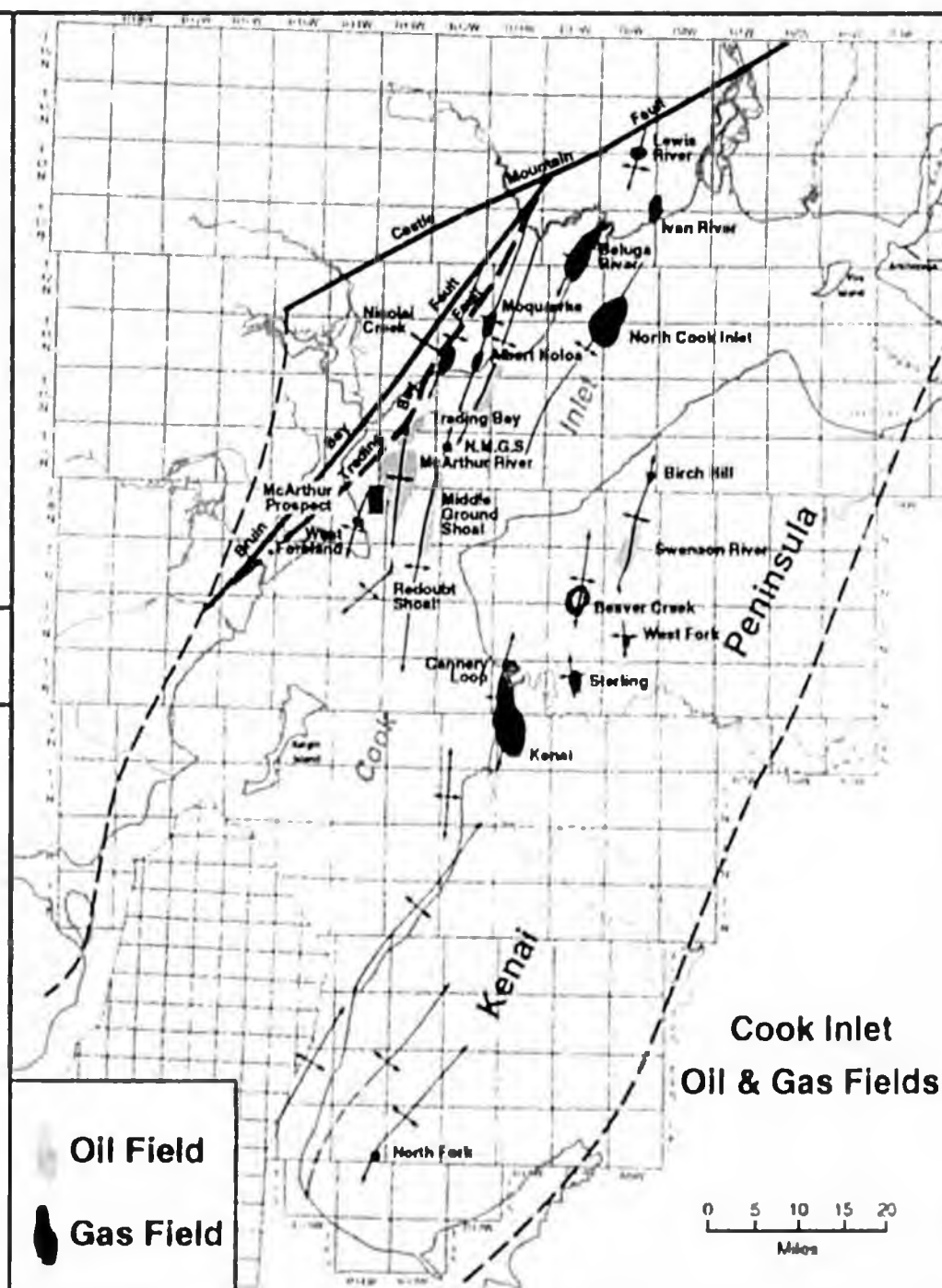
6. ESTIMATED
UNDISCOVERED OIL
& GAS RESERVES

(Oil) 1.00 Billion Bbls (BBO)
(Gas) 2.0 TCF



Alaska Vicinity Map

**Oil & Gas Fields
of the
Cook Inlet Basin
Alaska, USA**



**Cook Inlet
Oil & Gas Fields**

PART II

Cook Inlet Basin - Discovery Rates & Historical Oil & Gas Reserves

PLATE "A" is appended comparing yearly exploratory wells drilled during the "discovery royalty" period of 1959 - 1969 versus the recent period of 1985 - 1995. During the "discovery royalty" period a total of 174 exploratory wells were drilled; in the latter, "non-discovery royalty" period 16 were drilled. This represents a decrease in exploration of 92%.

The appended PLATE "B": COOK INLET PRODUCING OIL FIELDS illustrates that prior to 1959, one field, Swanson River, was discovered with estimated ultimate reserves of 235 MMBO. During the "discovery royalty" period (1959-69) discoveries were made with an estimated ultimate recovery of 1,060 (1.06 BBO). Subsequent to 1969, two discoveries have been made which will aggregate less than 30 MMBO.

Note also that the fields discovered in 1957 - 1969 are approximately 91% depleted.

Plate "A"

Cook Inlet Exploratory Wells

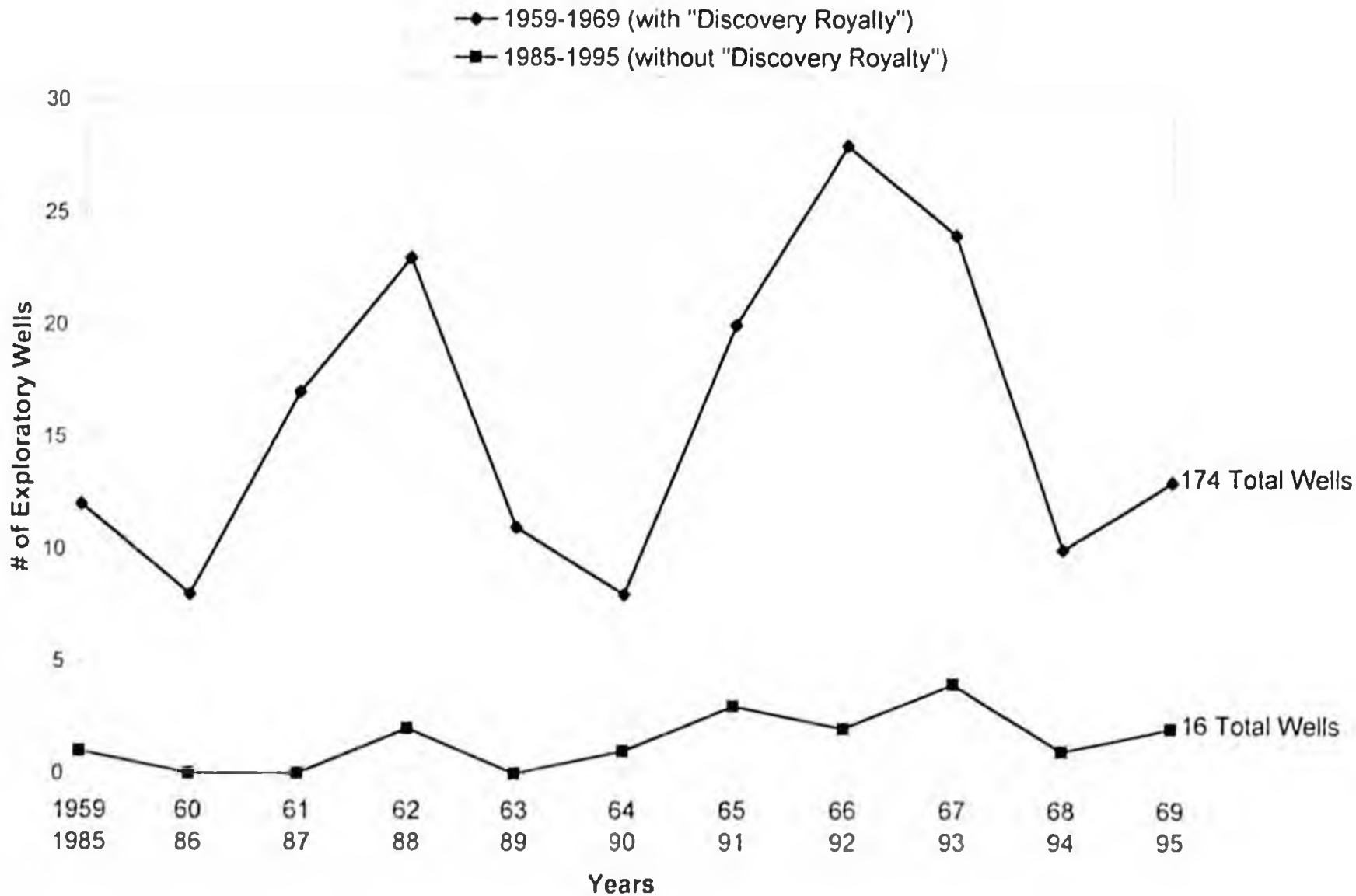
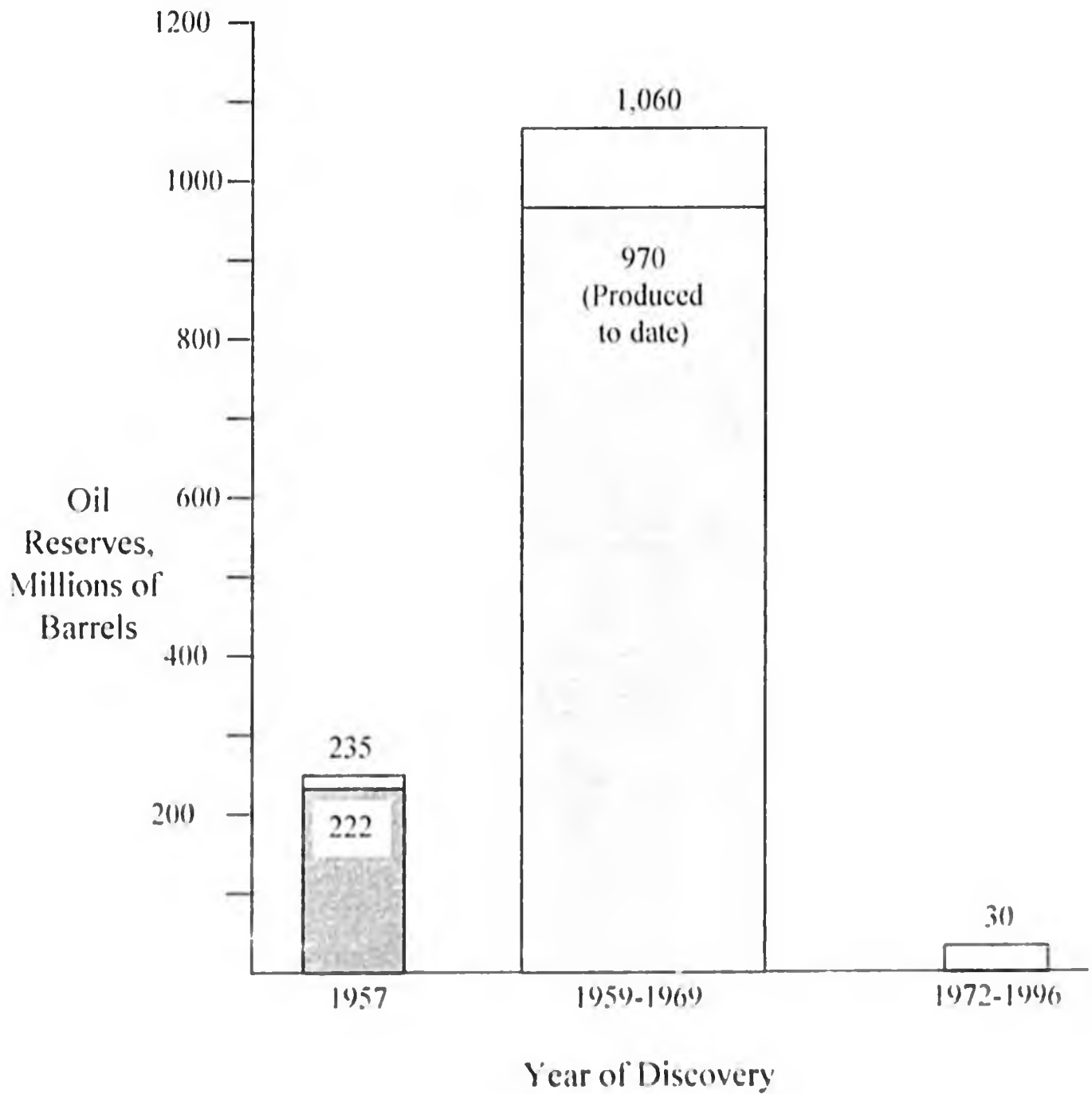


Plate "B"
Cook Inlet
Producing Oil Fields



PART III

Estimate of Undiscovered Oil & Gas Reserves

Geological estimates of undiscovered basinal reserves include basic estimates of: basin size and volume of potential reservoir rock, further quantified by consideration of: reservoir quality, volume of potential source beds, hydrocarbon content and thermal maturity of the source rocks, structural history of the basin and any known post-depositional or diagenetic changes in the reservoir rocks.

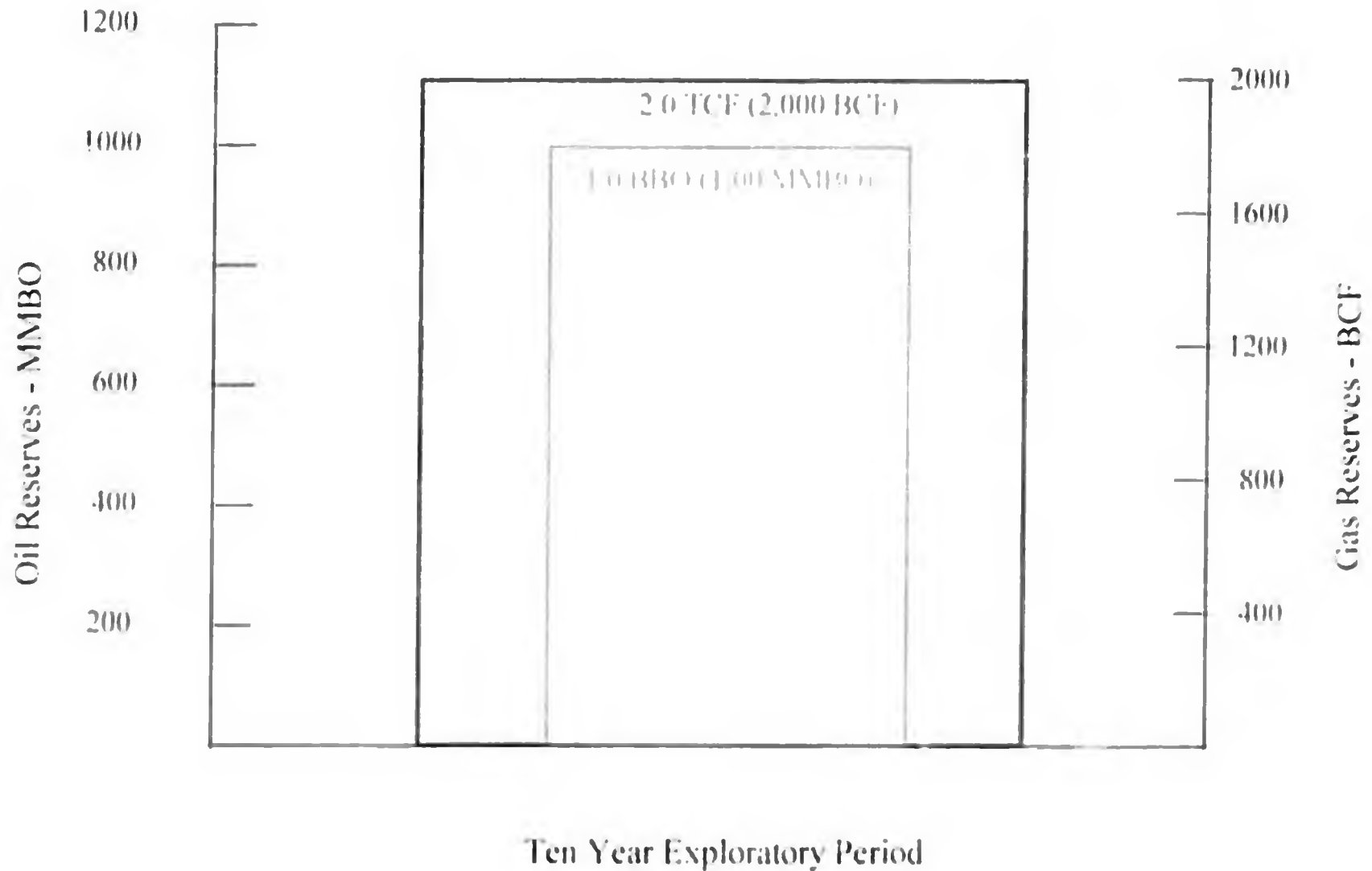
Various studies incorporating some or all of these parameters have been made and it is a generally held opinion that the Cook Inlet generating process, or "oil kitchen" generated considerably more hydrocarbons than can be accounted for in presently known resources. The unaccounted for or undiscovered portion of these reserves will not be found primarily in large, easily identifiable structural traps, but will be concentrated in more subtle traps: stratigraphic pinchouts, sub-thrust fault blocks, and diagenetically influenced reservoirs.

Exploration for these reserves will require a deeper geological understanding of historical basin processes, utilization of sophisticated seismic and other exploration systems and innovative drilling and completion techniques.

This will be an expensive search but the technology and will exists to do it. Only in this manner will these reservoirs be found.

Based upon private studies it is estimated that a reasonable figure of expectation for undiscovered oil and gas reserves is: 1.0 BBO and 2.0 TCFC. This would represent a replacement of 74% of the known oil reserves and 30% of the gas produced to date.

Plate "C"
Estimated Undiscovered Oil & Gas Reserves
Cook Inlet Basin



PART IV

Estimate of State of Alaska Royalty Values Attributable to Undiscovered Oil & Gas Reserves

Assuming that the estimate of 1.0 BBO and 2.0 TCFC (PART III, supra) is reached, and an average constant well-head price of \$15.00 per barrel for oil and \$1.70 per MCF of gas is maintained, these reserves would have a gross undiscounted value of \$15.0 billion to the oil and \$3.4 billion to the gas for a total of \$18.4 billion.

However, only a portion of the wells drilled would constitute "discovery wells"; based upon estimates of future field (and discovery tract) size, it is estimated that the "discovery royalty" of 5% would apply to no more than 20% of all wells drilled.

TABLE: "A" is appended setting forth Alaska royalty calculations for oil and gas reserves both "discovery royalty" and "regular royalty".

Note that the average royalty percentage received by the State of Alaska would be 11%. The total calculated value of these oil and gas royalties is: \$2.024 Billion.

Table "A"

Estimated Value to State of Alaska
Royalties on Undiscovered Oil Gas
Reserves - Cook Inlet Basin

ITEM	OIL	GAS
Total Reserves	1.0 BBO	2.0 TCF
Gross Value (Revenue) (\$15/BO and \$1.70/MCF)	\$15.0 Billion	\$3.4 Billion
Alaska Royalty On 20% "Discovery" Portion (5%)	\$150 Million	\$34 Million
Alaska Royalty On 80% "Non-Discovery" Portion (12.5%)	\$1.5 Billion	\$340 Million
Total Alaska Royalty (Gross Undiscounted Value)	\$1.650 Billion	\$374 Million
Average Alaska Royalty	11%	11%
Total Value Alaska Oil & Gas Royalty	\$2.024 Billion	

PART V

Ancillary Economic Benefits to Increased Exploratory Well Rate

The most obvious benefit to increased drilling is the creation of immediate jobs in and around the drilling operation. This would include primary drilling personnel and, as wells were brought on line, would also include personnel for production operations. At all times, support jobs (e.g. camp cook and catering, road maintenance, etc) would become available. These positions would be filled by local Alaskans.

The economy will benefit from injections of new dollars into the (local) capital stream and of course, real economic value will be created and tax bases increased.

It is estimated that each well drilled will create approximately 75 new jobs each of which will receive an average of \$60,000 (+/-) per year. Each calendar year of drilling activity per rig can therefore be anticipated to provide \$4,500,000 in real capital infusion, or approximately \$1,875,000 per individual well. This amounts to a total of \$28,125,000 (+/-) in direct payroll attributable to 15 exploratory wells.

PART VI

Summary & Conclusions

From the foregoing data it may be concluded that:

- 1) The Cook Inlet Basin is an important Alaskan hydrocarbon producing basin.
- 2) Presently known oil reserves of 1.35 Billion Barrels of Oil (BBO) are approximately 91% depleted.
- 3) During the years 1959 - 1969 a "discovery royalty" provision was in effect. During this period approximately 81% of the known reserves were discovered.
- 4) Discovery rates are tied directly to exploratory well rates. During 1959 - 1969 a total of 174 exploratory wells were drilled resulting in oil discoveries aggregating in excess of 1 Billion barrels of oil. During the recent period of 1985 - 1995 a total of 16 exploratory wells were drilled (a decrease of 92%) resulting in discoveries aggregating only 30 MMBO
- 5) It is estimated that the Cook Inlet Basin contains undiscovered reserves aggregating at least 1.0 BBO and 2.0 TCFG.
- 6) State of Alaska royalties received from these reserves would total approximately \$2.024 Billion.
- 7) Substantial economic benefits will accrue to local economies. Each exploratory well drilled will create approximately 75 new jobs and approximately \$1,875,000 in capital infusion on the local level.



WALTER D. WELLS

CERTIFIED PETROLEUM GEOLOGIST

American Association of Petroleum Geologists - CPG #3214
American Institute of Professional Geologists - CPG #6993
Alaska - CPG #AA-307

Data Sources

Field discovery dates were taken from the: 1994 Statistical Report Alaska Oil & Gas Conservation Commission.

Production data and estimates of remaining discovered reserves were taken from the: March, 1995 Historical and Protected Oil & Gas Consumption - Alaska Department of Natural Resources - Division of Oil & Gas.

C

HOUSE COMMITTEE REPORT

4/29/96

(9)

Date Referred to Committee: April 2, 1996

FURTHER REFERRALS:

Finance

Date of Committee Action: 4-29-96

The RESOURCES Committee considered:

CSSB 112(RES)

CS FOR SENATE BILL NO. 112(RES)

DISCOVERY ROYALTY CREDIT

"An Act establishing a discovery royalty credit for the lessees of state land drilling exploratory wells and making the first discovery of oil or gas in an oil or gas pool in the Cook Inlet sedimentary basin."

recommends it be replaced with the following committee substitute HCSCSSB 112 (RES) [x] the same title [] a new title

[] additional referral to _____ Committee [] attached amendment(s)

ADOPTS: _____ Letter of Intent

ATTACHES NEW FISCAL NOTE(S): (Dept) APPROVES PREVIOUS: (Dept/Date) [] fiscal note(s) (2) [x] fiscal note(s) Senate DNR 3-25-96 REU (indeterminate) 3-29-96

[] zero fiscal note(s) [] zero fiscal note(s)

Table with columns: SIGNING WITH RECOMMENDATIONS, DP, DNP, NR, AM. Rows include signatures and names: DAVIS, Williams, Green, Ogan, Austerman, KOTT. Summary row: (3), (2), (1)

CG- CHAIR'S SIGNATURE [Signature]