SB

112

INITIAL SECTIONAL SUMMARY

3/8/95 by Kreitzer, Committee Aide

SB 112: "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 commercial quantities."

Section 1.: Makes the first discovery royalty credit applicable under the exploration licensing program passed last year (SB 150). The royalty shall be reduced to five percent for the first 10 years following the date of first discovery of oil or gas in commercial quantities. NO definition of "commercial quantities" or "date of discovery" and how that is determined. Commercial quantities has different meaning than paying quantities- recover operating costs. Commercial quantities - need to recover investment, development, and production costs.

Section 2.: Adds back into statute the ability for the commissioner of the Department of Natural Resources to allow a royalty reduction of 5% for the first 10 years on oil or gas leases on state land. After 10 years, the royalty reverts to the leasing method chosen by the commissioner (A-G).

Alaska State Legislature

Senate Resources Committee

State Capitol
Juneau AK 99801

Official Business

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introduced by the Senate Resources Committee it was written for discussion purposes as the law had been when it was repealed in 1969 (1, CH 65 SLA 1969), recognizing that such terms as "in commercial quantities", "geologic structure" and "first discovery" would have to be discussed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

ENATE COMMITTEE REPORT
First Committee of Referral

DATE: 3/7/95 FURTHER: Finance

Date of 5-Day Notice: 3-15-95
(in accordance with Uniform Rule 23)

DATE TURNED INTO OFFICE: 3-20-96

Resources Committee considered SB 112

Establishing a discovery royalty credit for the lessees of state land drilling exploratory wells and making the first discovery of oil or gas in commercial quantities.

and recommends.

[✓] be replaced with ____ CS SB 112 (RES)
[ ] adopt previous ____ CS ____ (____)
[ ] attached amendment(s)
[ ] adopt Letter of Intent by ____ Committee
[ ] further referral to the ____ Committee

Senate Bill:
[ ] same title
[✓] new title

House Bill:
[ ] same title
[ ] technical title
[ ] new: SCR* ____

SIGNING DO PASS	DP	OTHER RECOMMENDATIONS	NR	DNP	AM
Chris C. Taylor	✓				
[illegible]					
[illegible]	✓				
CHAIR: [illegible]	✓				

NEW FISCAL NOTE(S):

TO SB

Department	Date	Zero	Fiscal
DNR/O+G			
Revenue - O/G Audit			

PREVIOUS FISCAL NOTE(S):*

Department	Date	Zero	Fiscal
~~DNR O+G~~			
~~Revenue~~			

[ ] APPROPRIATION -- no fiscal note

*Include fiscal notes accompaning Governor's bill

Alaska State Legislature

Official Business

State Capitol
Juneau AK 99801

MEMO

TO: Jack Chenoweth, Legal Services
via fax: X2029 this page only

FROM: Annette Kreitzer, Aide to
Senate Resources Committee

DATE: March 18, 1996

RE: CS SB 112(RES): Discovery Royalty

Please create a FINAL Resources committee substitute for SB 112 using 9-LS0808\K dated March 15, 1996.

There were no other changes to the bill. Please deliver the FINAL to Senator Leman's office, Room 115 of the Capitol.

Alaska State Legislature

SENATE RESOURCES COMMITTEE

Official Business

State Capitol
Juneau AK 99801

MEMO

TO: Senator Pearce, Vice Chairman
Senator Halford
Senator Frank
Senator Taylor

THROUGH: Senator Loren Leman, Chairman Loren Leman

FROM: Annette Kreitzer, Aide to
Senate Resources Committee

DATE: March 18, 1996

RE: CS SB 112(RES)

Attached is the Committee Substitute which incorporates the amendments made in Senate Resources to SB 112. Please let me know if the language beginning on page 3, line 25 through the end of the bill is <u>not</u> consistent with your interpretation of the amendments.

I will request a final committee substitute to be read across for Wednesday (March 20) and initiate a request to the Senate Finance Committee for a hearing if there are no discrepancies.

CS FOR SENATE BILL NO. 112(RES)

IN THE LEGISLATURE OF THE STATE OF ALASKA

NINETEENTH LEGISLATURE - SECOND SESSION

BY THE SENATE RESOURCES COMMITTEE

Offered:
Referred:

Sponsor(s): SENATE RESOURCES COMMITTEE

A BILL

FOR AN ACT ENTITLED

"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."

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

Allows discovery royalty to [illegible] exploration license [illegible] converted to leases. [illegible] in Cook Inlet sedimentary [illegible]

* Section 1. AS 38.05.134 is amended to read:

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

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

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

New Text Underlined [DELETED TEXT BRACKETED]

(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 certified by the commissioner to be the first to drill a well discovering oil or gas in a previously undiscovered oil or gas pool 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 discovery 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 in pipeline quality and free of all lease or unit expenses, including but not limited to separation, cleaning, dehydration, gathering, salt water disposal, and preparation for transportation off the lease or unit area;

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

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

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

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

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

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

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

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

(4) notwithstanding a requirement in the leasing method chosen of a minimum fixed royalty share, on and after a date that is 180 days following the effective date of this Act, the lessee under a lease issued in the Cook Inlet sedimentary basin who is certified by the commissioner to be the first to drill a well discovering oil or gas in a previously undiscovered oil or gas pool 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 discovery 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 reduced royalty authorized by this paragraph is subject to the following:

(A) a lessee is eligible to pay the reduced royalty authorized by this paragraph only if the lessee is the first to drill a well discovering oil or gas in a previously undiscovered oil or gas pool;

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

Conditions for discovery royalties

a lease → (C) if, under this paragraph, application is made for a royalty reduction for a lease that was entered i[illegible] before the date that is 180 days following the effective date of this Act, the commissioner may approve the application only if, on the date referred to in this subparagraph, the lease was a nonproducing lease that was not committed to a unit approved by the commissioner under (m) of this section, that is not part of a unit under (p) or (q) of this section, and that has not been made part of a unit under AS 31.05;

[illegible] (A) + (E)

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

only 1 program prevails - either old or this one.

(E) 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.

AMENDMENTS ADOPTED IN 3/11/96 SENATE RESOURCES COMMITTEE TO VERSION F OF SB 112: Discovery Royalty (Chenoweth 3/9/96)

Amendment #1

1) See attached (The committee gave staff fairly broad authority to continue to work with the Department to tighten language in the bill to reflect its purpose as a discovery royalty provision and to bring it back for Wed. 3/13). This amendment was altered slightly after further discussion with the department and begins after: (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 certified by the commissioner to be the first to drill a well discovering oil or gas in a previously undiscovered oil or gas pool 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 discovery 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).

2) Parallel language had to be added in AS 38.05.180(f)(4) as follows:
Page 2, Line 32 through Page 3, Line 9:

following "commissioner to"
[HAVE MADE] be the first to drill a well **[DISCOVERY OF]** discovering oil or gas in **[COMMERCIAL QUANTITIES FROM]** a previously undiscovered oil or gas pool shall pay a royalty of five percent on all **[LEASE]** production of oil or gas from that pool attributable to that lease for a period of 10 years following the date of discovery of that pool **[OIL OR GAS IN COMMERCIAL QUANTITIES IN THE POOL, AS CERTIFIED BY THE COMMISSIONER,]** and thereafter the royalty payable on all **[LEASE]** production of oil or gas from the pool attributable to that lease shall be determined and payable as specified in the lease; a lessee is eligible to pay the reduced royalty authorized by this paragraph only if the lessee **[MAKES]** is the first to drill a well **[DISCOVERY OF]** discovering oil or gas in **[COMMERCIAL QUANTITIES FROM]** a previously undiscovered oil or gas pool within five years of the effective date of the lease; the commissioner...

Amendment #2 (INCORPORATED ABOVE)

3) Page 3, Lines 2-3:
or gas pool shall pay a royalty of five percent on all **[LEASE]** production of oil or gas from that pool attributable to that lease for a period of 10 years following the date of discovery of oil or gas

Page 3, Lines 5-6:
thereafter the royalty payable on all **[LEASE]** production of oil or gas from the pool attributable to that lease shall be determined...

Amendment #3 (became moot with the language the committee adopted in Amendment #1 above and the parallel language found in CS SB 112 version G).

3) Replace "in commercial quantities" throughout the bill and any amendments adopted by the committee with the phrase "capable of producing in commercial quantities".

Amendment #4
4) Not adopted by the committee as written, but instructions were given to the committee staff to work with the Department to bring an amendment before the committee Wednesday, 3/13/96 to allow Discovery Royalty to be applied to all nonproducing leases and future leases as of the effective date of the bill.

AMENDMENTS ADOPTED IN 3/13/96 SENATE RESOURCES COMMITTEE TO VERSION G OF SB 112: Discovery Royalty (Chenoweth 3/13/96)

Amendment #1
1) Page 4, Line 3: Following "undiscovered oil or gas pool"
DELETE: **[WITHIN FIVE YEARS OF THE EFFECTIVE DATE OF THE LEASE;]**

Amendment #2
2) The committee adopted a conceptual amendment to limit discovery royalty to one application per lease. It doesn't matter how many partners are involved - only one discovery royalty will be allowed on the lease.

Amendment #3
3) The committee adopted a conceptual amendment to include nonunitized leases in the applicability section. However, a later amendment rewrote the applicability section and appears as Amendment #5.

Amendment #4
4) The committee wants to plainly state that on leases carrying the former discovery royalty provision, if a lessee applies under this new Discovery Royalty, the old program cannot also be used.

Amendment #5
5) The committee adopted an amendment to the effect that the provisions of AS 38.05.180(f)(4) added by sec. 2 of this Act, apply only to leases in the Cook Inlet sedimentary basin and the Act is effective on all non-producing, non-unitized leases (see Amendment #3) and future leases that are certified first discovery by the commissioner six months after the effective date of the Act.

Alaska State Legislature

Official Business

State Capitol
Juneau AK 99801

AMENDMENT #1

OFFERED IN SENATE RESOURCES
TO: CS SB 112 (LS0808\F)
DATE: 3/11/96

Adopted

Page 1, Line 5:
Following Section 1. Insert:

AS 38.05.134 is amended to read:

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

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

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

(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 certified by the commissioner to have made the first discovery of oil or gas in commercial quantities from a previously undiscovered oil or gas pool shall pay a royalty of five percent on all lease production of oil or gas from that pool for a period of 10 years following the date of discovery of oil or gas in commercial quantities in the pool, as certified by the commissioner, and thereafter the royalty payable on all lease production of oil or gas from the pool 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).

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?

ISSUES RE: REINSTATEMENT OF DISCOVERY ROYALTY

The merits of reinstating the discovery royalty should be evaluated in the context of incentives for all the stages of exploration and production:

- Vigorous acquisition of land interests that give the right to explore for oil and gas.
- Prompt exploration of acquired land.
- Early production of discovered fields.
- Full production from declining reservoirs.

Discovery Royalty was a method of encouraging early production of discovered accumulations. It supplemented the leases' fixed primary term as a method of encouraging production. The Administration's efforts to amend AS 38.05.180(j) - royalty reduction - would encourage production of marginal fields.

Discovery Royalty in Alaska was contentious, provoking strife between competing lessees, and between lessees and the State. Discovery Royalty, in comparison to the conflict it provoked, was arguably of low effectiveness. Lessees could not count on receiving a discovery royalty.

Discovery royalty proposal could be modified to encourage vigorous acquisition, exploration and production of state lands without the ambiguities inherent in the former discovery royalty:

- Blanket 5% royalty for the 10 year primary term of new leases.
- Fixed 5% royalty for the first five years of production from any leases located more than 5 miles from existing production.
- Fixed 5% royalty for the first five years of production from any new unit located more than 5 miles from existing production.

The former discovery royalty statute was implemented by regulations establishing application procedures and defining various relevant terms. Should any new statute address these issues, or leave them for regulation?

The former discovery royalty statute was made effective by lease provisions. Should any new provisions be available for current leases, or only for leases issued in the future?

Name of Well	Lessee (present names)	ADL No.	Date of Discovery[1]	First Affidavit or claim of discovery[4]	Date of written decision granting discovery royalty[5]	Effective date of the 10-year discovery royalty[6]	Commencement of commercial production	Date 12½% royalty replaced 5% 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, 1 month[12]
[illegible] 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	Mobil Union	18761	5-16-65	5-21-65	9-14-65	6-1-65	5-67[9]	6-75	8 years, 1 month
Trading Bay No. 1-A	Union Marathon	18731	5-21-65	6-18-65	8-27-65	6-1-65	1-67[9]	6-75	8 years, 5 months
Grayling No. 1-A	Union Marathon	17594	9-29-65[2]	10-20-65	1-19-82	10-1-65	10-67[10]	10-75[10]	6 years, 1 month[10]
[illegible] Creek State No. 1	Texaco Superior	17598	4-28-66	5-21-66	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]	1-26-68	4-7-69	1-1-68	6-20-77[10]	1/78	6 months, 11 days
[illegible] No. 1	BP, Sohio ARCO	25633	4-7-69	9-15-69	11-12-82	5-1-69	12-13-81[11]	12½% royalty paid from 12-13-81, the first date of production	never used

North Slope
Discovery Royalty Applications

[illegible]	Well Name	Field Name	Applicant	Date of Application	Status of Application
[illegible]	Prudhoe State # 1	Prudhoe Bay	ARCO	March 12, 1968	Granted
28263	Kuparuk State # 1	Prudhoe Bay	Mobil	December 25, 1969	Dormant(10-years over)
[illegible]	[illegible] # 1	Kuparuk	ARCO-BP	April 7, 1969	Granted
[illegible]	Put River SP 01-11-12	Prudhoe Bay	BP	July 30, 1969	Dormant(10-years over)
[illegible]514	Simpson Lagoon [illegible]	Kuparuk / Milne Pt.	Chevron	September 1, 1969	Dormant(10-years over)
[illegible]519	Kavearak Point	Milne Point	Chevron	October 9, 1969	Dormant(10-years over)
3[illegible]623	Point Storkersen # 1	Undefined	Hamilton Brothers	November 25, 1969	Dormant(10-years over)
3[illegible]024	North Prudhoe Bay St. #1	Undefined	ARCO	March 31, 1970	Dormant(10-years over)
[illegible]4533	Sag Delta #3	Endicott	BP	March 31, 1977	Withdrawn by Applicant
[illegible]4525	Niakuk #2-A	Niakuk	BP	April 11, 1977	Dormant(10-years over)
33634	Sag Delta # 1	Lisburne	BP	June 10, 1977	Dormant(10-years over)
3[illegible]533	Sag Delta # 4	Endicott	BP	February 14, 1978	Active
[illegible]535	Niakuk # 5	Niakuk	BP	April 7, 1985	Active

DRAFT

Date ____________

Information compiled April, 1988
William Van Dyke
Division of Oil and Gas

Alaska State Legislature

Official Business

State Capitol
Juneau AK 99801

MEMO

TO: Jack Chenoweth
Legal Counsel

FROM: Annette Kreitzer, Aide to
Senate Resources Committee

DATE: March 15, 1996

RE: CS for SB 112 (RES)

Please prepare a Senate Resources committee substitute with the following changes. These changes are to version G dated March 13, 1996.

Amendment #1
1) Page 4, Line 3: Following "undiscovered oil or gas pool"
DELETE: **[WITHIN FIVE YEARS OF THE EFFECTIVE DATE OF THE LEASE;]**

Amendment #2
2) The committee adopted a conceptual amendment to limit discovery royalty to one application per lease. It doesn't matter how many partners are involved - only one discovery royalty will be allowed on the lease.

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Amendment #5
5) The committee adopted an amendment to the effect that the provisions of AS 38.05.180(f)(4) added by sec. 2 of this Act, apply only to leases in the Cook Inlet sedimentary basin and the Act is effective on all non-producing, non-unitized leases (see Amendment #3) and future leases that are certified first discovery by the commissioner six months after the effective date of the Act. **As I understand this amendment, the program begins six months after the effective date of the act. This amendment deletes the G version language of Section 3 and replaces it with the language offered herein. (page 4, lines 8-17).**

Additional Suggestions to CS SB 112 from Ken Boyd/DNR

1. Does the committee intend to allow more than one discovery royalty per lease? (Could have more than one well) Or, does the committee want to leave this to DNR to define in regulation?

2. In the Applicability Section: Need to include non-unitized with non-producing.

3. Does the committee want to make plain that one can't use the old program if the new program applies? (Still leases out there with Old Discovery Royalty on them). Programs would be conflicting according to Boyd.

9-LS0808\G
Chenoweth
3/13/96

CS FOR SENATE BILL NO. 112(RES)

IN THE LEGISLATURE OF THE STATE OF ALASKA

NINETEENTH LEGISLATURE - SECOND SESSION

BY THE SENATE RESOURCES COMMITTEE

Offered:
Referred:

Sponsor(s): SENATE RESOURCES COMMITTEE

A BILL

FOR AN ACT ENTITLED

"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."

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

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

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

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

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

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

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

 WORK DRAFT WORK DRAFT

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

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

(C) [(3)] a fixed cash bonus with a royalty share reserved to the state as the bid variable but not less than 12.5 percent in amount or value of the production removed or sold from the lease;

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

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

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

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

(4) notwithstanding a requirement in the leasing method chosen of a minimum fixed royalty share, the lessee under a lease issued in the Cook Inlet sedimentary basin who is certified by the commissioner to be the first to drill a well discovering oil or gas in a previously undiscovered oil or gas pool 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 discovery 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;

a lessee is eligible to pay the reduced royalty authorized by this paragraph only if the lessee is the first to drill a well discovering oil or gas in a previously undiscovered oil or gas pool within five years of the effective date of the lease; 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.

* Sec. 3. APPLICABILITY OF SEC. 2. The provisions of AS 38.05.180(f)(4), added by sec. 2 of this Act, apply only to leases in the Cook Inlet sedimentary basin that

(1) were entered into before the effective date of the regulations adopted by the commissioner of natural resources under AS 38.05.180(f)(4) to implement the filing of applications for and the review and certification of discovery of oil and gas royalty certifications under that paragraph, and that are nonproducing leases on that effective date; or

(2) are entered into on or after the effective date of the regulations adopted by the commissioner of natural resources under AS 38.05.180(f)(4) to implement the filing of applications for and the review and certification of discovery oil and gas royalty certifications under that paragraph.

Alaska State Legislature

Official Business

State Capitol
Juneau AK 99801

MEMO

TO: Jack Chenoweth
Legal Counsel - via fax 2 pgs

FROM: Annette Kreitzer, Aide to
Senate Resources Committee

DATE: March 12, 1996

RE: CS for SB 112 (RES)

Please prepare a Senate Resources committee substitute with the following changes. These changes are to version F dated March 9, 1996.

1) Page 1, Line 5:
Following Section 1. Insert:
AS 38.05.134 is amended to read:

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

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

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

(3) must be conditioned upon a royalty in amount or value of not less than 12.5 percent of production <u>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 certified by the commissioner to be the first to drill a well discovering oil or gas in a previously undiscovered oil or gas pool 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 discovery 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).</u>

2) Page 2, Line 32 through Page 3, Line 9:

following "commissioner to"

[HAVE MADE] <u>be</u> the first <u>to drill a well</u> **[DISCOVERY OF]** discovering oil or gas in **[COMMERCIAL QUANTITIES FROM]** a previously undiscovered oil or gas pool shall pay a royalty of five percent on all **[LEASE]** production of oil or gas from that pool attributable to that lease for a period of 10 years following the date of discovery of that pool **[OIL OR GAS IN COMMERCIAL QUANTITIES IN THE POOL, AS CERTIFIED BY THE COMMISSIONER,]** and thereafter the royalty payable on all **[LEASE]** production of oil or gas from the pool attributable to that lease shall be determined and payable as specified in the lease; a lessee is eligible to pay the reduced royalty authorized by this paragraph only if the les· e **[MAKES]** is the first to drill a well **[DISCOVERY OF]** discovering oil or gas in **[COMMERCIAL QUANTITIES FROM]** a previously undiscovered oil or gas pool within five years of the effective date of the lease; the commissioner...

3) Sec. 2. APPLICABILITY. The provisions of AS 38.05.180(f)(4), added by Sec. 1. of this Act apply to then existing non-producing leases and to new leases in the Cook Inlet sedimentary basin entered into after the effective date of regulations promulgated by the Department under AS 38.05.180(f)(4).

4) As all of these amendments are to the F version, the sections will have to be renumbered and "applicability" will have to be changed to refer to the appropriate section.

9-LS0808\F
Chenoweth
3/9/96

CS FOR SENATE BILL NO. 112( )

IN THE LEGISLATURE OF THE STATE OF ALASKA

NINETEENTH LEGISLATURE - SECOND SESSION

BY

Offered:
Referred:

Sponsor(s): SENATE RESOURCES COMMITTEE

A BILL

FOR AN ACT ENTITLED

"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."

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

* **Section 1.** 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 in pipeline

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

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

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

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

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

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

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

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

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

(4) notwithstanding a requirement in the leasing method chosen of a minimum fixed royalty share, the lessee under a lease issued in the Cook Inlet sedimentary basin who is certified by the commissioner to have made the first

discovery of oil or gas in commercial quantities from a previously undiscovered oil or gas pool shall pay a royalty of five percent on all lease production of oil or gas from that pool for a period of 10 years following the date of discovery of oil or gas in commercial quantities in the pool, as certified by the commissioner, and thereafter the royalty payable on all lease production of oil or gas from the pool shall be determined and payable as specified in the lease; a lessee is eligible to pay the reduced royalty authorized by this paragraph only if the lessee makes the first discovery of oil or gas in commercial quantities from a previously undiscovered oil or gas pool within five years of the effective date of the lease; 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.

* Sec. 2. APPLICABILITY. The provisions of AS 38.05.180(f)(4), added by sec. 1 of this Act, apply only to leases in the Cook Inlet sedimentary basin that are entered into on or after the effective date of this Act.

Alaska State Legislature

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State Capitol
Juneau AK 99801

AMENDMENT #1

OFFERED IN SENATE RESOURCES
TO: CS SB 112 (LS0808\F)
DATE: 3/11/96

Page 1, Line 5:
Following Section 1. Insert:

AS 38.05.134 is amended to read:

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

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

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

(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 certified by the commissioner to have made the first discovery of oil or gas in commercial quantities from a previously undiscovered oil or gas pool shall pay a royalty of five percent on all lease production of oil or gas from that pool for a period of 10 years following the date of discovery of oil or gas in commercial quantities in the pool, as certified by the commissioner, and thereafter the royalty payable on all lease production of oil or gas from the pool 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).

9-LS0808\F.1
Chenoweth
3/11/96

AMENDMENT #4

OFFERED IN THE SENATE

TO: Draft CSSB 112( )

Page 3, line 9, after "pool":

Delete "**within five years of the effective date of the lease**"

Page 3, lines 13 - 15:

Delete all material and insert:

"* Sec. 2. RETROSPECTIVE APPLICABILITY. The provisions of AS 38.05.180(f)(4), added by sec. 1 of this Act, are retroactive and apply to discoveries of oil or gas in commercial quantities on leases in the Cook Inlet sedimentary basin made on or after January 1, 1991."

The effect of this amendment will be to set it up so current leaseholders in the Cook Inlet Basin wll fall within this royalty bill.

Without this amendment, current leassholders will not re-invest in their fields or work to bring on new fields. This consequently, will not bring jobs and growth to the Cook Inlet area, which this bill is designed to to.

Alaska State Legislature

Official Business

State Capitol
Juneau AK 99801

MEMO

TO: Jack Chenoweth, Legal Counsel
via fax: X 2029 this page only

FROM: Annette Kreitzer, Aide to
Senate Resources Committee AK

DATE: March 9, 1996

RE: CS SB 112 (RES)

Conform to 180( )
only to Cook Inlet
[illegible] 134

Please prepare a draft Committee Substitute for SB 112 using the following language. The changes are to the LS0808\C version dated March 4, 1996. I have to leave the office at 12:30 p.m., however, my home phone number is 790-3136. I'll take the file with me.

TITLE CHANGE: Page 1, Line 1: Following "lessees of state land" INSERT:
in the Cook Inlet sedimentary basin

Page 1, Line 6: Sec. 38.05.134. CONVERSION TO LEASE. As to licenses in the Cook Inlet sedimentary basin, if the licensee...

Page 2, Lines 1-7:
DELETE all.

Insert: than 12.5 percent of production, except that a lessee, who, proceeding under AS 38.05.131-38.05.134, is certified by the commissioner to have made, within five years of the effective date of the lease, the first discovery of oil or gas in commercial quantities from a previously undiscovered pool will be eligible to pay a reduced royalty of five percent on all lease production from that pool for a period of 10 years following the date of discovery certified by the commissioner. Thereafter, the royalty payable on all production from the pool in which the first discovery was made will be determined as specified in the lease;

Page 3, Lines 21-29:
DELETE all.

Insert: (4) notwithstanding a requirement in the leasing method chosen of a minimum fixed royalty share, a lessee who is certified by the commissioner to have made, within five years of the effective date of the lease, the first discovery of oil or gas in commercial quantities from a previously undiscovered pool in the Cook Inlet sedimentary basin will be eligible to pay a reduced royalty of five percent on all lease production from that pool for a period of 10 years following the date of discovery certified by the commissioner. Thereafter, the royalty payable on all production from the pool in which the first discovery was made will be determined as specified in the lease. The commissioner shall adopt regulations defining the definitions, standards, and criteria to be used in implementing the filing of applications and the review and certification of requests for discovery royalty certification under AS 38.05.134(3) and AS 38.05.180(f).

9-LS0808\C
Chenoweth
3/4/96

CS FOR SENATE BILL NO. 112( )

IN THE LEGISLATURE OF THE STATE OF ALASKA

NINETEENTH LEGISLATURE - SECOND SESSION

BY

Offered:
Referred:

Sponsor(s): SENATE RESOURCES COMMITTEE

A BILL

FOR AN ACT ENTITLED

"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."

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

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

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

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

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

(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, makes the first discovery of oil or gas in an oil or gas pool, as the term is defined in AS 31.05.170, shall pay a royalty on all production under the lease of five percent for the primary term of the lease following the date of discovery and thereafter the royalty shall be as determined under this paragraph; 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 in pipeline quality and free of all lease or unit expenses, including but not limited to separation, cleaning, dehydration, gathering, salt water disposal, and preparation for transportation off the lease or unit area;

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

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

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

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

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

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

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

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

(4) notwithstanding a requirement in the leasing method chosen of a minimum fixed royalty share, the holder of a lease who makes the first discovery of oil or gas in an oil or gas pool, as the term is defined in AS 31.05.170, shall pay a royalty on all production under the lease of five percent for the primary or initial term of the lease following the date of discovery and thereafter the royalty shall be determined and payable under (3) of this subsection; the payment of royalty under this paragraph is authorized only to a holder of a lease who first files with the department a statement of discovery setting out the information that the commissioner may, by regulation, require.

* Sec. 3. APPLICABILITY. The provisions of this Act apply only to leases that are entered into on or after the effective date of this Act.

Alaska State Legislature

Official Business

State Capitol
Juneau AK 99801

MEMO

TO: Jack Chenoweth, Legal Counsel
via fax: X2029

FROM: Annette Kreitzer, Aide to
Senate Resources Committee

DATE: March 2, 1996

RE: Committee Substitute for SB 112: Discovery Royalty

Please prepare a draft Senate Resources Committee Substitute for SB 112, Discovery Royalty, with the following provisions:

1) Page 3, Lines 21-22 are fine until we get to "oil or gas in commercial quantities in a geologic structure". This language needs to be changed so that the new provision allows for first discovery of an oil or gas pool as defined by Alaska Oil and Gas Conservation Commission (AS 31.05.170(11)) shall pay a royalty on all production under the lease of five percent for the primary term of the lease following the date of discovery and thereafter the royalty shall be determined and payable under (3)...

There is a problem with using the phrase "oil or gas in a geologic structure", because it is an undefinable term which was adopted at statehood from federal law. Technology has moved the oil/gas industry and the Department of Natural Resources farther and farther away from the effective use of that phrase.

The reason for inserting the phrase "primary term of the lease" is that the intent of this legislation is to: get people out exploring (which is why it continues to be tied to the exploration licensing program); since primary terms run 7-10 years, it forces the issue of working a lease, rather than sitting on it, and hopefully ensures a quicker return to the state.

2) This legislation should apply to new leases only. As you are aware, the discovery royalty provision still exists in leases issued prior to the repeal of that provision in 1969. If we are not specific that this provision applies to leases entered into after the effective date of the Act, DNR's concern is that there will be an issue of whether the program is retroactive.

3) The old regulations under the previous discovery royalty program required a "statement of discovery" for the royalty reduction to be granted. This would eliminate problems of dual companies drilling on the same lease and both trying to claim first discovery for the same pool.

Thank you for your assistance. Please call me at 465-4907 if you desire further clarification.

PROPOSED AMENDMENT TO
SB 112: Discovery Royalty

Page 3, lines 13-15:

DELETE ALL MATERIAL

Insert:

Sec. 2. APPLICABILITY. The provisions of AS 38.05.180(f)(4), added by sec. 1 of this Act, apply to both non-producing leases and to new leases in the Cook Inlet sedimentary basin that were entered into ~~on or~~ after the effective date of regulations promulgated by the Department under AS 38.05.180(f)(4).

Alaska State Legislature

Session:
State Capitol
Juneau AK 99801-1182

Interim:
716 W 4th Avenue
Anchorage AK 99501-2133

MEMO

TO: Ken Boyd, Deputy Director
Division of Oil and Gas, DNR
FAX (907) 562-3852

FROM: Annette E. Kreitzer, Committee Aide AK
Senate Resources Committee

DATE: March 9, 1995

RE: SB 112: Discovery Royalty Credit
****

1) SB 112 has been scheduled for Wednesday, March 15 and Friday March 17 in Senate Resources. The Wednesday hearing would be mostly background and the division answering questions about the ramifications of reinstating this credit.

2) I have asked the legislative reference library for the legislative record pertaining to the repeal of the credit by CH65 SLA 1969. I've been told it's going to be skimpy. Does your Division/Department have any information on why it was repealed? Any position papers, etc.?

3) What leases currently carry the old provisi[illegible]?

4) Wh[illegible] known fields could possibly be impacted by reinstatement of the credit?

5) Do you have any maps which would help illustrate these points?

6) Take a deep breath.

Alaskan Oil and Gas Discoveries
Since Prudhoe Bay

Oil Fields	Discovery Date	First Production	Operator
Redoubt Shoal	9/68	NA	Amoco
Kuparuk River	4/69	12/81	ARCO
Kuparuk River West Sak	4/69	8/83	ARCO
Milne Pt.- Kuparuk	8/69	10/85	BP Exploration
Milne Pt.- Schrader Bluff	8/69	3/91	BP Exploration
North Prudhoe Bay	4/70	9/93	ARCO
Beaver Creek	12/72	12/72	Marathon
Pt. Thompson	9/75	NA	Exxon
Prudhoe Bay-West Beach	7/76	4/93	ARCO
Endicott	3/78	6/86	BP Exploration
North Star Unit	1/84	NA	BP Exploration
Niakuk/W. Niakuk*	4/85	4/94	BP Exploration
Point McIntyre**	3/88	9/93	ARCO
West McArthur River	12/91	8/93	Stewart Petroleum

*Niakuk received Discovery Royalty Benefit, expired 3/95.
**Pt. McIntyre is receiving Discovery Royalty Benefit, expires 2/98.

Gas Fields			
Kavik	11/69	NA	Amoco
Kemik	6/72	NA	Forest Oil
Lewis River	9/75	9/84	Cities Service/Unocal
Stump Lake	5/78	6/90	Chevron/Unocal
Pretty Creek	2/79	11/86	Chevron/Unocal
North Trading Bay Unit	10/79	4/80	Texaco
Walakpa	2/80	9/92	Husky

COOK INLET BASIN

DATA SUMMARY
FOR
STATE OF ALASKA HOUSE OF REPRESENTATIVES
FINANCE COMMITTEE HEARING
RE: SENATE BILL 112
APRIL 22, 1996

TABLE OF CONTENTS

<u>PART IV:</u>	Estimate of ultimate State of Alaska royalty values attributable to undiscovered oil & gas reserves. (Discussion)
	<u>TABLE "A"</u>: <u>Estimated Value to State of Alaska Royalties on Undiscovered Oil & Gas Reserves - Cook Inlet Basin</u>.
<u>PART V:</u>	Ancillary economic benefits to increased exploratory well rate. (Discussion)
<u>PART VI:</u>	Summary and Conclusions
	Data sources

COOK INLET BASIN

DATA SUMMARY

FOR

STATE OF ALASKA HOUSE OF REPRESENTATIVES

FINANCE COMMITTEE HEARING

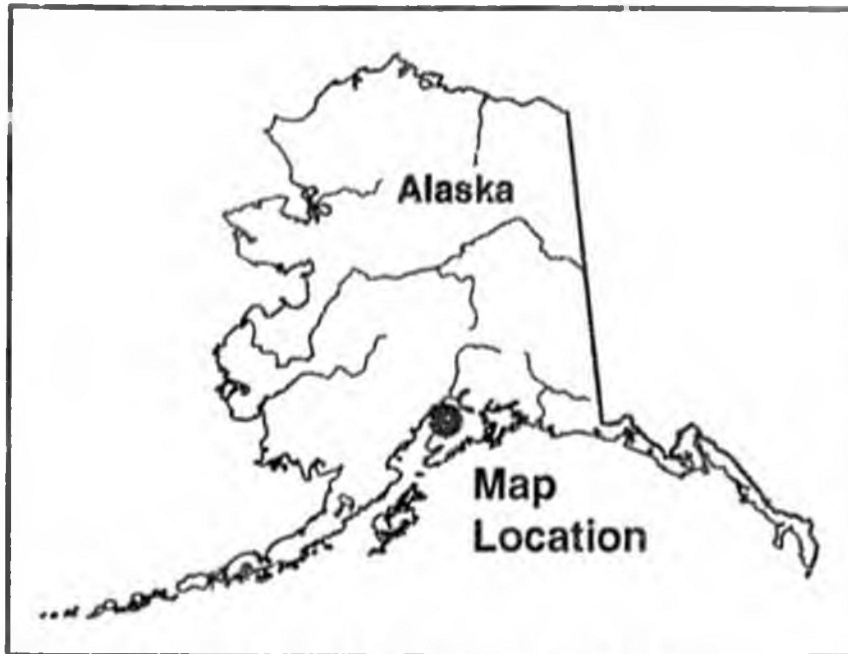
RE: SENATE BILL 112

APRIL 22, 1996

PART I

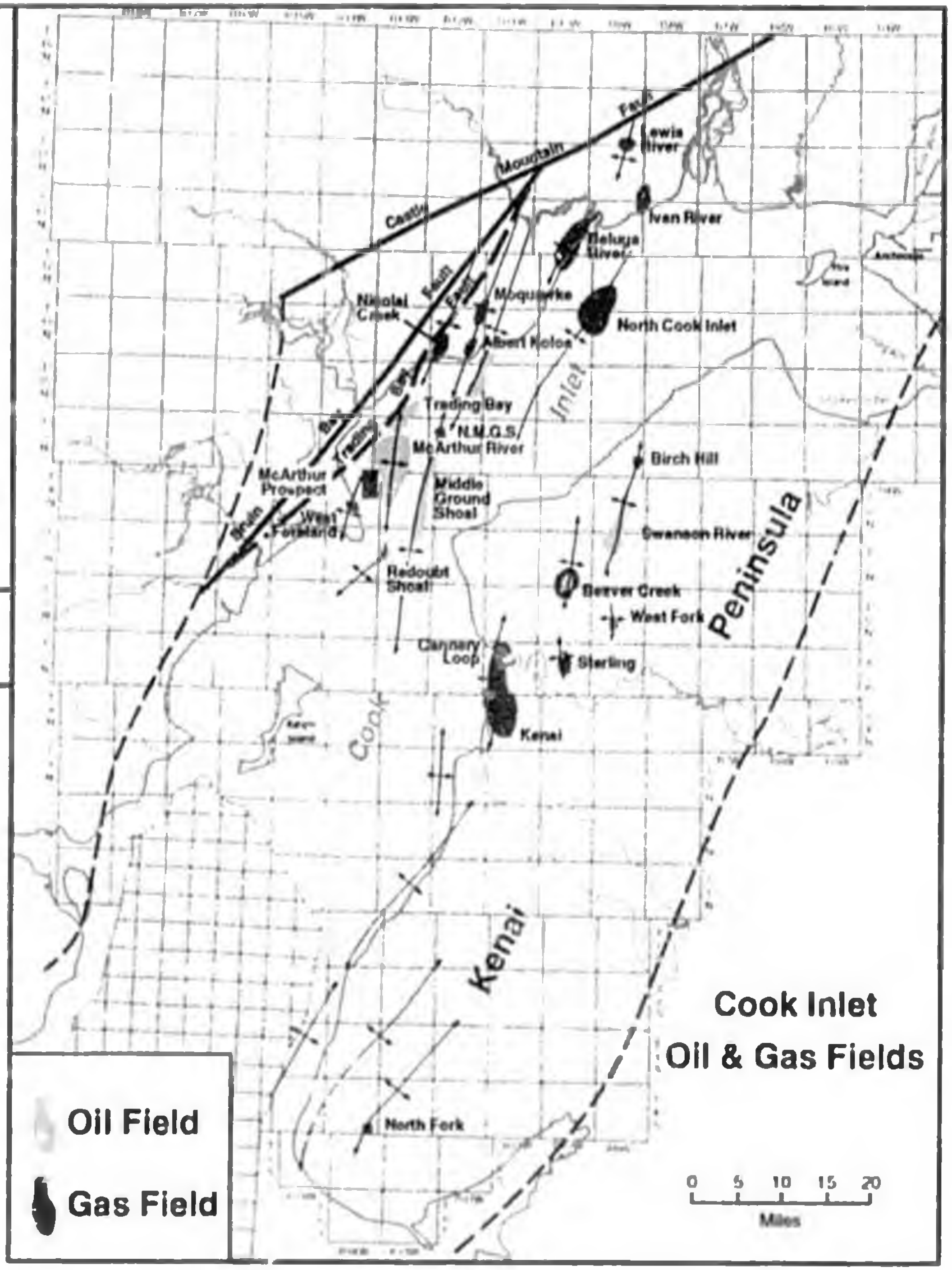
1. BASIN DESCRIPTION	The Cook Inlet Basin is an intermontane sedimentary basin trending NE-SW, bounded by the Southern Alaska Range and the Chugach Mountains and is roughly coextensive with the present Cook Inlet waters and immediately surrounding terrain. It is an important hydrocarbon producing area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



PART II

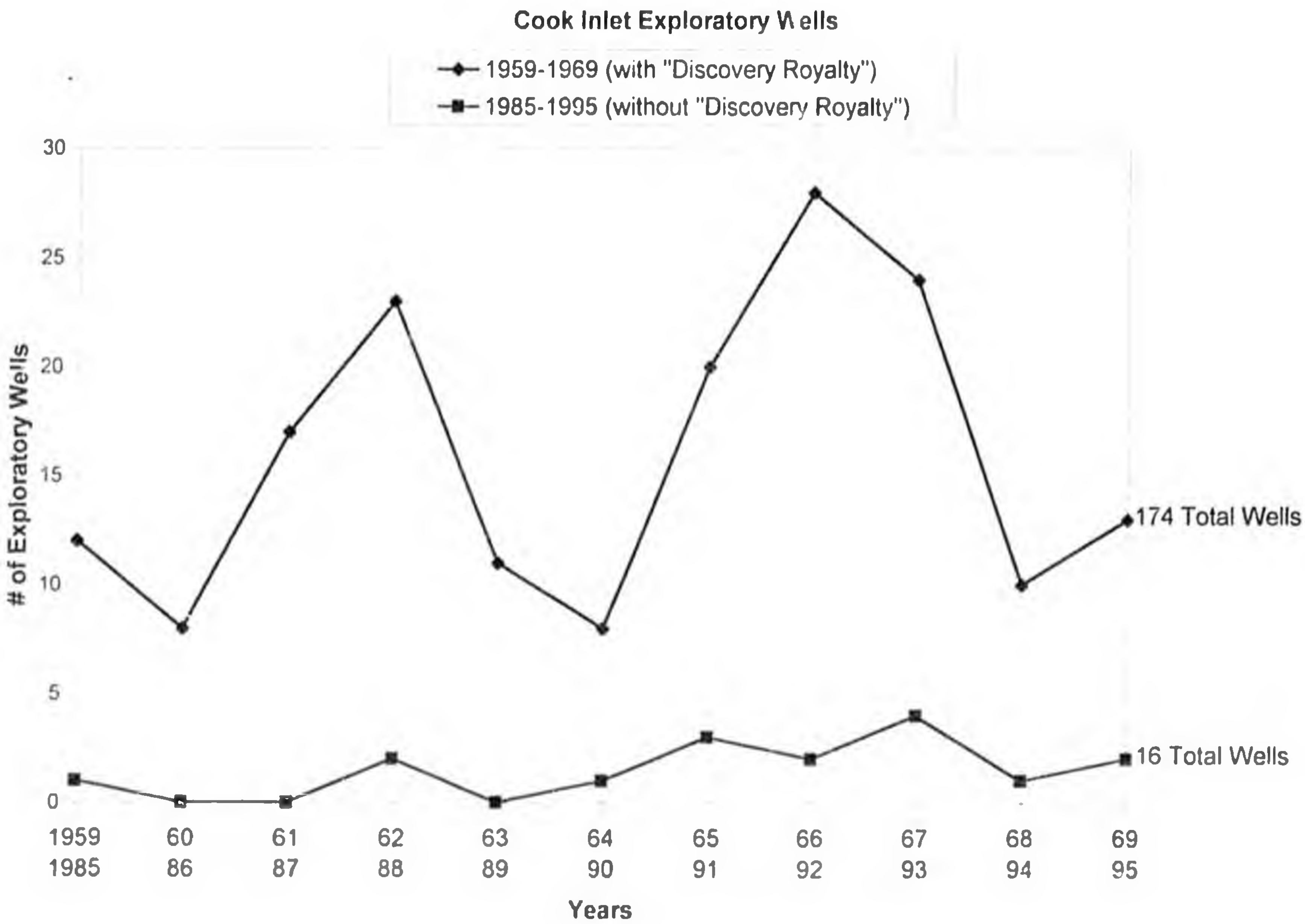
Cook Inlet Basin - Discovery Rates & Historical Oil & Gas Reserves

PLATE "A" is appended comparing yearly exploratory wells drilled during the "discovery royalty" period of 1959 - 1969 versus the recent period of 1985 - 1395. 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.

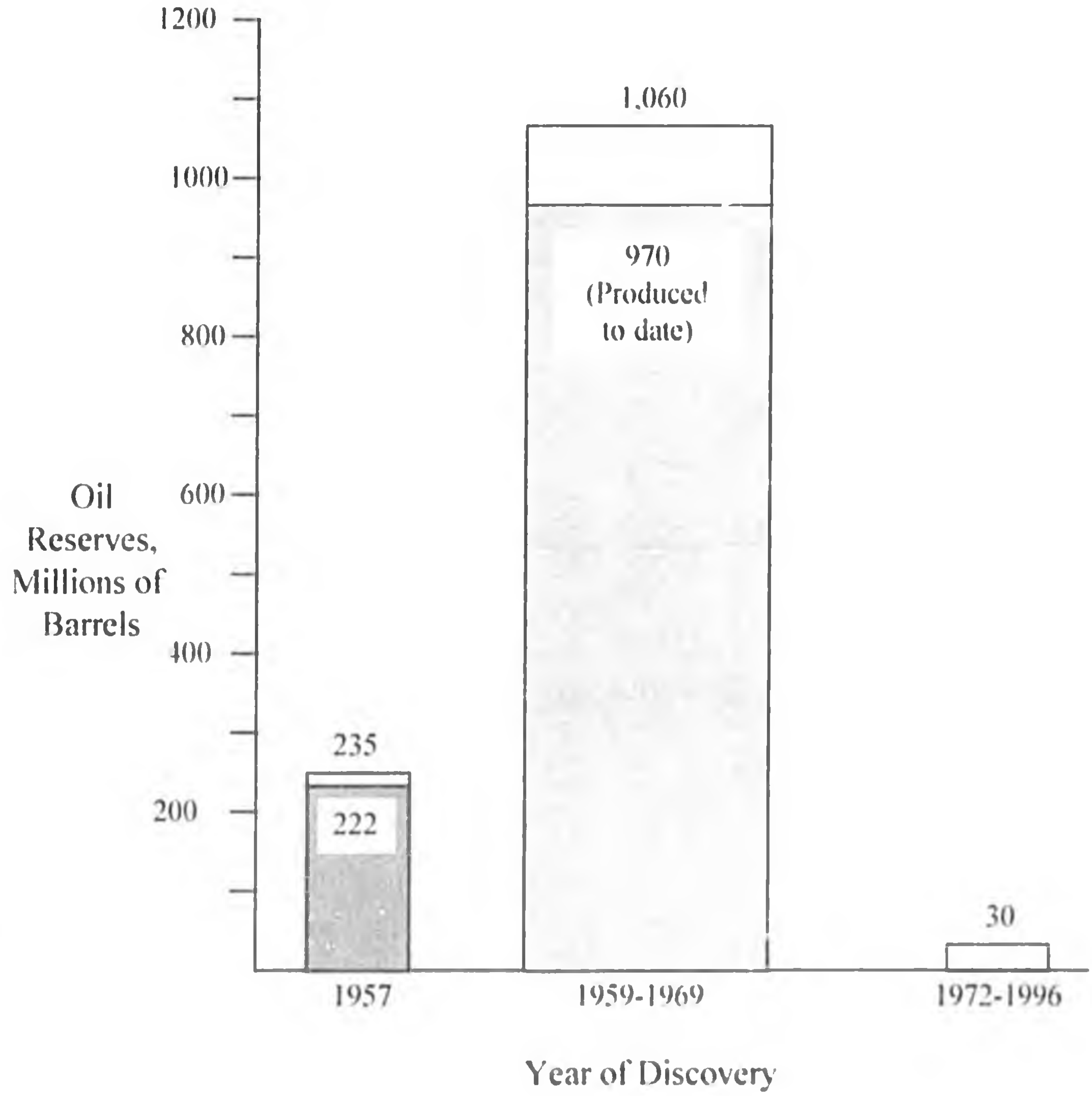
Note also that the fields discovered in 1957 - 1969 are approximately 91% depleted.

Plate "A"



Cook Inlet Exploratory Wells
1959-1969 (with "Discovery Royalty")
1985-1995 (without "Discovery Royalty")
# of Exploratory Wells
30
25
20
15
10
5
0
174 Total Wells
16 Total Wells
1959 1985
60 86
61 87
62 88
63 89
64 90
65 91
66 92
67 93
68 94
69 95
Years

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.

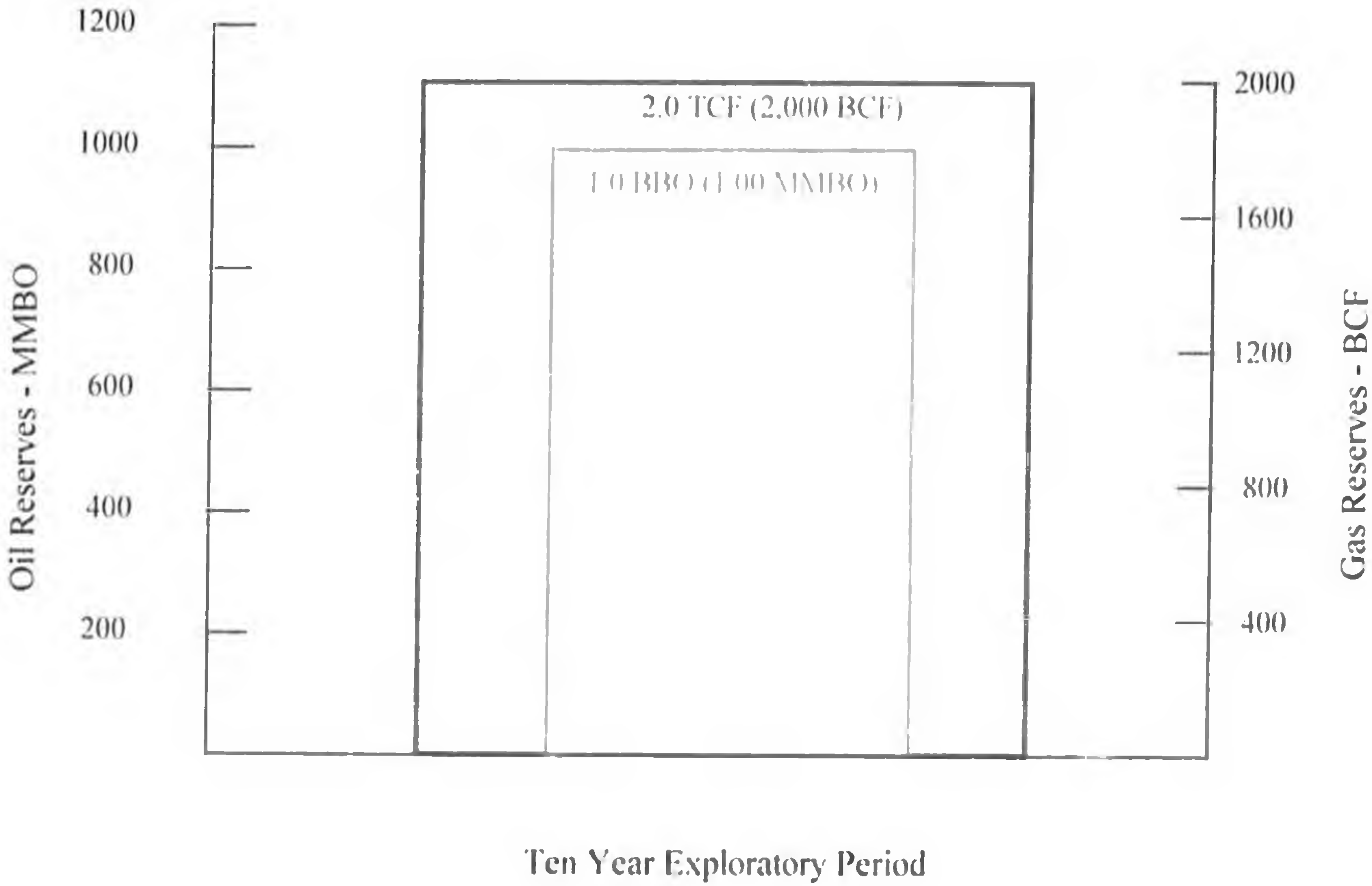
Various studies incorporating some or all of these parameters have been made and it is a generally held opinion that the Cook Inlet generating process, or "oil kitchen" generated considerably more hydrocarbons than can be accounted for in presently known resources. The unaccounted for or undiscovered 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

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.

By:
Stewart
Petroleum

SENATE BILL NO. 112

IN THE LEGISLATURE OF THE STATE OF ALASKA

NINETEENTH LEGISLATURE - FIRST SESSION

BY THE SENATE RESOURCES COMMITTEE

Introduced: 3/7/95
Referred: RES. FIN

A BILL

FOR AN ACT ENTITLED

"An Act establishing a discovery royalty for the lessees of state land located in Cook Inlet Basin, Alaska's oldest petroleum producing province, who drill exploratory wells and make the first discovery of oil and/or gas in commercial quantities."

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

***Section 1.** AS 38.05.180 is amended by addition of a new section (cc) to read:

(cc) The holder of a lease who drills and makes the first discovery of oil and/or gas in commercial quantities in a geologic structure shall pay a royalty on all production under the lease of five percent for the first 10 years following the date of discovery and thereafter the royalty shall be payable as originally provided in such lease at date of issue; provided, however, that such lease shall not upon expiration of said 10 year period be disqualified from benefit under other available royalty reduction or incentive programs, if any, for which it may qualify.

The provisions of this section shall apply only to discoveries made after January 1, 1991 within the Cook Inlet sedimentary basin, effective upon date of discovery. Any previous royalty payments paid subsequent to such discovery date which are in excess of the five percent royalty provided hereunder, shall constitute a credit against future royalty payments under this section.

9-LS0808\A

SENATE BILL NO. 112

IN THE LEGISLATURE OF THE STATE OF ALASKA

NINETEENTH LEGISLATURE - FIRST SESSION

BY THE SENATE RESOURCES COMMITTEE

Introduced: 3/7/95
Referred: RES, FIN

A BILL

FOR AN ACT ENTITLED

"An Act establishing a discovery royalty [credit] for the lessees of state land [drilling] exploratory wells and make [making] the first discovery of oil and/ or gas in commercial quantities."

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

* Section 1. AS 38.05.[134] 180 is amended by addition of a new section (cc) (??) to read:

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

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

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

(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, 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 the first 10 years following the date of discovery and thereafter the royalty shall be as determined under this paragraph;

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

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

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

~~(B) [(2)] a cash bonus bid with a fixed royalty share reserved~~

[to the state of not less than 12.5 percent in amount or value of the production removed or sold from the lease and a fixed share of the net profit derived from the lease of not less than 30 percent reserved to the state;

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

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

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

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

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

(7) (cc) [~~(4) notwithstanding a requirement in the leasing method chosen of a minimum fixed royalty share, the~~] The holder of a lease who drills and makes the first discovery of oil and ~~or~~ gas in commercial quantities in a geologic structure shall pay a royalty on all production under the lease of five percent for the first 10 years following the date of discovery and thereafter the royalty shall be [~~determined and~~] payable [~~under (2) of this subsection~~] as originally provided in such lease at date of issue; provided, however, that such lease shall not upon expiration of said 10 year period be disqualified from benefit under other available royalty reduction or incentive programs, if any, for which it may qualify.

The provisions of this section shall apply only to discoveries made after January 1, 1991 within the Cook Inlet sedimentary basin, effective upon date of discovery. Any previous royalty payments paid subsequent to such discovery date which are in excess of the five percent royalty provided hereunder, shall constitute a credit against future royalty payments under this section.

SENATE BILL NO. 112

IN THE LEGISLATURE OF THE STATE OF ALASKA

NINETEENTH LEGISLATURE - FIRST SESSION

BY THE SENATE RESOURCES COMMITTEE

Introduced: 3/7/95
Referred: RES, FIN

A BILL

FOR AN ACT ENTITLED

"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 commercial quantities."

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

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

Sec. 38.05.134. CONVERSION TO LEASE. If the licensee requests and the commissioner determines that the work commitment obligation set out in an oil and gas exploration license issued under AS 38.05 132 has been met, the commissioner shall convert to one or more oil and gas leases all or part, as the licensee may indicate, of the area described in the exploration license that remains after the relinquishments, removals, or deletions required by AS 38.05.132(d)(2). A lease issued under this section

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

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

(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, 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 the first 10 years following the date of discovery and thereafter the royalty shall be as determined under this paragraph;

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

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

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

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

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

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

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

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

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

(4) notwithstanding a requirement, in the leasing method chosen, of a minimum fixed royalty share, the holder of a lease who 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 the first 10 years following the date of discovery and thereafter the royalty shall be determined and payable under (3) of this subsection.

ALASKA STATE LEGISLATURE
HOUSE OF REPRESENTATIVES
RESEARCH AGENCY

Pouch Y, State Capitol
Juneau, Alaska 99811
(907) 465-3991

March 11, 1986

MEMORANDUM

TO: Representative Andre Marrou

FROM: Gretchen Keiser G. 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.

<u>Brief History of the Discovery Royalty</u>

The so called "discovery royalty" provision was dropped from Alaska Statute in 1969 (§ 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)]

This condition, which allowed a lessee to pay a reduced royalty to the State, stems from similar provisions on federal leases in Alaska dating back to enactment of the Mineral Leasing Act of 1920. The reduced royalty was unique to Alaska and was intended to provide special incentives to encourage oil and gas production in Alaska. A discovery royalty provision was adopted by the territorial government and subsequently incorporated into Alaska Statute in the Alaska Lands Act of 1959.

According to Mark Worcester, the Assistant Attorney General who handled the most recent legal dispute (in the early 1980s) regarding discovery royalty in the Kuparuk River oil field, the provision was apparently dropped in the late 1960s because it: 1) was not a useful incentive for oil and gas exploration; 2) was costing the State money; 3) created an administrative burden for the State; and 4) generated considerable disputes between the State and the oil and gas companies in Cook Inlet oil and gas fields. To the best of our knowledge, no specific study analyzing the effect of the discovery royalty provision was prepared at that time.

Attachment A presents a list of the ten discovery wells which were granted a discovery royalty by the State. These wells occur in eight Cook Inlet fields discovered in the early to mid 1960s and in the Prudhoe Bay and Kuparuk oil fields which were discovered in the late 1960s. Some of the discovery well requests were contested by other oil companies or by the State. The Cook Inlet well Grayling No. 1-A (Union-Marathon), for example, was discovered in 1965 and finally granted the discovery royalty in 1982 after more than a decade of litigation. Much of the legal dispute in Cook Inlet revolved around the determination of whether a discovery well occurred in an "unknown geologic structure" when the area had already been rather extensively explored.

About the time the discovery royalty provision was dropped in 1969, it was becoming apparent that the provision could begin to cost the State a great deal because: 1) the Prudhoe Bay State No. 1 well had been granted the reduced royalty; and 2) the Ugnu No. 1 had just discovered the Kuparuk River oil field. In retrospect, the discovery royalty provision was used for production from only eight wells statewide for an average period of 5 and 1/3 years.

Discovery Royalty as an Exploration Incentive

The discovery royalty provision has been characterized as providing an incentive to explore <u>only</u> to the extent that it encouraged a company to drill in a particular formation before its competitors rather than an incentive which justified exploring that possible formation in 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(i)]. 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.

---

[1]Affidavit of C.V. "Chat" 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).

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

State Revenue Loss/Gain Under the Discovery Royalty Provision

Unfortunately, no report exists which summarizes the revenue given up by the State because of the reduced royalty payments for production from the eight aforementioned discovery wells. Litigation over two of the wells lead to cash settlements by the State of $36 million in the late 1970s (the Grayling No.1 well) and $950,000 in the early 1980s (the Ugnu No. 1 well).

In order to determine the lost revenue, one would have to obtain monthly royalty reports for each specific field during the period 1966-1978 from the Department of Natural Resources.[3] Specific information necessary would include:

- the monthly total production for each field;
- the percent of monthly production allocated to each discovery well; and
- the monthly average in-value price for each field.

There is also no report estimating the revenue ultimately gained by the State as a result of the discovery royalty provision. As mentioned in the previous section of this memorandum, this provision was not the key factor leading to the exploration and discovery of new oil and gas fields. We suggest, therefore, that there has been no revenue gain to the State which could be specifically attributed to the discovery royalty provision.

Under the current exploration incentive credits system, the Department of Natural Resources had certified (as of August 1985) $28.4 million in exploration costs incurred at five wells as eligible for EICs (Attachment B). These EICs represent a future revenue loss to the State since the companies can deduct the credits from royalties, rentals and taxes once production commences from any of the five wells.

* * * * *

I hope this information is useful. Please call me if you have any questions or would like me to provide further information.

GK

Attachments

---

[3]At this time, it is uncertain whether royalty records dating back to the 1960s would be available from archives.

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 discovery[4]	Date of written decision granting discovery royalty[5]	Effective date of the 10-year discovery royalty[6]	Commencement of commercial production	Date 12½% royalty replaced 5% 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, 1 month[12]
L[illegible]. 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	Mobil Union	18761	5-16-65	5-21-65	9-14-65	6-1-65	5-67[9]	6-75	8 years, 1 month
Trading Bay No. 1-A	Union Marathon	18731	5-23-65	6-18-65	8-27-65	6-1-65	1-67[8]	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, 1 month[10]
Nicolai 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
Ugnu No. 1	BP, Sohio ARCO	25633	4-7-69	9-15-69	11-12-82	5-1-69	12-13-81[11]	12½% royalty paid from 12-13-81, the first date of production	never used

EXHIBIT NO. 2
PAGE 1 OF 2

1 Dates as set forth in the respective public notices unless otherwise specified.

2 Date is from the affidavit of first discovery. See Exhibit 7A to Affidavit of William Van Alen.

3 Although ARCO claimed a discovery date of March 12, 1968, the decision granting the discovery royalty found that the discovery actually occurred on December 19, 1967.

4 See Exhibits 1A, 2A, A, 4A, 5A, 6A, 7A, 8A, 9A, and 10A to Affidavit of William Van Alen.

5 See Exhibits 1C, 4D, 5D, 6D, 7E and 8D to Affidavit of William Van Alen, and Exhibits 2B and 9D to Affidavit of Romaine Clark with regard to Cook Inlet No. 2, the date is estimated based upon dates of related documents. See Exhibits 3F to Affidavit of William Van Alen and Exhibits 3C and 3D to the Affidavit of Romaine Clark.

6 Date provided for in respective decisions granting discovery except in the case of Grayling 1-A, where no date was provided, and the date was derived from the royalty settlement calculations. See Affidavit of Ed Park.

7 See Affidavit of C. V. "Chat" Chatterton and Exhibit 1-D to William Van Alen Affidavit.

8 See Affidavit of Harry Kugler.

9 See Exhibit 5E to Affidavit of Romaine Clark.

10 See Affidavit of Edward W. Park.

11 See Appellants Brief at page 27.

12 The oldest retained royalty report (11-72) reflects payment at 12½%. See Affidavit of Edward W. Park. Presumably the switch from the 5% discovery royalty to the 12½% royalty occurred 10 years after the commencement date of the discovery royalty date.

13 See Affidavit of Edward W. Park.

EXHIBIT NO. 2
PAGE 2 OF 2

ATTACHMENT B

Exploration Incentive Credits Certified
by the State of Alaska

EXPLORATION INCENTIVE CREDITS
Report Month: August 1985

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
		BPAE	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

State of Alaska
Department of Natural Resources
Division of Oil and Gas - Director's Office
3601 C Street, Suite 1380, Anchorage, Alaska 99503
Phone (907)762-2549 Fax (907)562-3852

Fax tr smittal

To: Bill Van Dyke

Fax: 463-5139

From: Mike Kotowski

Date & Time:

Pages (including cover sheet): ~~3~~ 4

Comments: The OLD Discovery Royalty Regs.

(1979)

11 AAC 83

the payment was determined in accordance with the rental or acreage figure stated in the lease or in a bill, decision, notice or letter by the division of lands and the figure is found to be in error, or if the director finds that the deficiency was otherwise justifiable and not due to a lack of reasonable diligence on the part of the lessee, the lease shall be reinstated if the lessee corrects the deficiency within 15 days of receipt of notice of the deficiency. (Eff. 9/20/74, Reg. 51)

Authority: AS 38.05.020
AS 38.05.035(b)(2)
AS 38.05.145(a)

11 AAC 83.180. DEFAULT. (a) Whenever the lessee of a lease on which there is no well capable of producing oil or gas in paying quantities fails to comply with any provision of the lease or applicable regulations other than the payment of rental and the failure to comply continues for 60 days after receipt of notice to the lessee of the failure to comply, the director may terminate the lease by mailing notice of the termination to the lessee. Termination is effective upon giving the notice.

(b) Whenever the lessee of a lease on which there is a well capable of producing oil or gas in paying quantities fails to comply with any of the provisions of the lease or applicable regulations and the failure continues for a period of 60 days following notice to the lessee of the failure to comply, the lease may be cancelled by judicial proceedings instituted for that purpose in any court of competent jurisdiction having jurisdiction over the land covered by the lease or any part of it. (Eff. 9/20/74, Reg. 51)

Authority: AS 38.05.020
AS 38.05.035
AS 38.05.145(a)

ARTICLE 2. OIL AND GAS LEASES DISCOVERY ROYALTY

Repealed in May 6 1969

Section

11 AAC 83.200. DISCOVERY LEASE. A operator who by time and date first encoun sufficient evidence of oil or gas in a partic geologic structure covered by any state oil gas lease issued prior to April 20, 1967, to ca the operator diligently to continue in good fa testing, reworking, drilling or other operati on that lease, whether in the same hole or ot holes, in an effort to establish production of or gas in the same structure, is qualified fo discovery well certification under the terms said state lease if he completes a well a establishes production in commercial quanti in the same zone in which oil or gas was fi encountered. (Eff. 9/20/74, Reg. 51)

Authority: AS 38.05.020
AS 38.05.145(
AS 38.05.180

11 AAC 83.205. DISCOVERY ROYALT DEFINITIONS. In secs 200–230 of this chapt and applicable provisions in state leases

(1) "discovery" means the first acceptab evidence in a drilling well of the existence of o or gas which can be produced in commerci quantities after well completion;

(2) "geologic structure" means any structur and/or stratigraphic entrapping mechanis containing one or more intervals, zones, strat formations, or fault blocks which has th necessary physical characteristics to accumulat and prevent the escape of oil or gas; it i intended that this definition be similar to tha used by the United States Geological Survey i the administration of the federal Mineral Leasin Act of February 25, 1920 (41 Stat. 437), a amended;

(3) "completed well" means a well which is cased and controlled and in which al underground work has been finished, and the well is capable of producing oil or gas;

(4) "commercial quantities" means those amounts of oil or gas which after well completion would appear to a reasonable and prudent operator to be sufficient to recover ordinary costs of drilling, completing and producing an additional well on the same geologic structure at an offset location with a reasonable profit to the operator, if a market were available;

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ANCHORAGE, ALASKA

ACU 1357003

(5) "committee" means the Alaska Oil and Gas Conservation Committee as defined in 11 AAC 22.510 of the Alaska Oil and Gas Conservation Regulations. (Eff. 9/20/74, Reg. 51)

Authority: AS 38.05.020
AS 38.05.145(a)
AS 38.05.180

11 AAC 83.210. DISCOVERY ROYALTY FILING REQUIREMENTS. (a) To establish priority as to time and date of discovery, an operator must furnish the committee with a sworn statement and substantiating evidence, acceptable to the committee, that oil or gas has been encountered in sufficient showing to cause a reasonable and prudent operator to conduct further operations in an effort to complete a well in the discovery zone so that the well can be tested for potential oil or gas production in commercial quantities. The statement must include the time and date of first discovery, the exact location of the well, the precise interval of discovery, and the Alaska Division of Lands' lease number on which the well is located. The statement shall be furnished to the committee as soon as possible, but not later than 30 days after the date claimed for the discovery.

(b) To establish and prove oil or gas in commercial quantities, the operator shall

(1) conduct a potential test of the discovery zone within one year after completion of a discovery well;

(2) notify the committee or its designated representative five days in advance of the scheduled potential test and furnish transportation (if requested) for a designated representative of the committee to witness the test; the committee may at its option or at the option of its designated representative waive the witnessing of the test and require sworn evidence to establish the results of the test; the sworn evidence shall be delivered to the committee or its designated representative within 30 days after the test.

(c) To establish the geologic structure from which the oil or gas can be produced, the operator must furnish pertinent data to the committee which will enable it to determine the geologic structure from which the oil or gas is being produced. This may include, but is not limited to, geophysical data, total depth, casing records, perforation data, electric logs, drilling and mud logs, core analyses, sample cuttings and sample logs and the operator's interpretation thereof, together with any other records and interpretations the operator deems pertinent. This data shall be supplied within 90 days after the date of the potential test required in (b) of this section. (Eff. 9/20/74, Reg. 51)

Authority: AS 38.05.020
AS 38.05.145(a)
AS 38.05.180

11 AAC 83.215. CERTIFICATION AFTER COMPLIANCE AND APPLICATION. After compliance with sec. 210 of this chapter, the operator may apply to the director for discovery well certification. Within 10 days of receipt of the request, the director will publish notice of the application allowing 30 days for any interested party to object to or protest the application. If no protest or objection is received by the director, the director will, within 70 days after the receipt of an application, either certify the well as in (1) or deny the application as in (3) of this section. If any protest or objection is made, it must be submitted in writing to the director within the specified 30 day period. After receipt of the protest or objection, the director will advertise and hold an open public hearing in accordance with the Alaska Land Act (AS 38.05) and in accordance with the Alaska Administrative Procedure Act (AS 44.62.300 – 44.62.630). Within 30 days after the hearing, the director will do one of the following:

(1) certify the well in question a first discovery well which has established oil or gas in commercial quantities in (name geologic structure) as of (time) on (date), and specify the date of commencement of the 10 year-5 percent discovery royalty term, which date shall be the first of the next month after the established date of initial discovery; after discovery well certification, no other well, regardless of when drilled, is eligible for consideration for certification for the same geologic structure;

(2) continue the hearing at a later specified date;

11 AAC 83

(3) deny the application for discovery well certification. (Eff. 9/20/74, Reg. 51)

Authority: AS 38.05.020
AS 38.05.145(a)
AS 38.05.180

11 AAC 83.220. CANCELLATION. If, after discovery well certification, any information supplied to the committee is proven false or erroneous and the information would have affected the decision of the director to the extent that the original application for certification would have been denied, the certification shall immediately be revoked. A certification may also be revoked when it is determined that the error was caused by failure to disclose full and complete knowledge available to the operator at the time of application for certification. After a certification is revoked, royalty payment of 7½ percent on production prior to revocation is due and payable, and 12½ percent royalty on all subsequent production shall be paid. Should the royalty due not be paid on demand, the state will take legal steps to cancel the lease involved. (Eff. 9/20/74, Reg. 51)

Authority: AS 38.05.020
AS 38.05.145(a)

11 AAC 83.225. TERMINATION. In the event of the termination of a discovery lease for any cause, the five percent discovery royalty terminates and will not be allowed or reinstated on the same geologic structure. (Eff. 9/20/74, Reg. 51)

Authority: AS 38.05.020
AS 38.05.145(a)
AS 38.05.180

11 AAC 83.230. FIVE PERCENT DISCOVERY ROYALTY. A "First Discovery Well Certification" secures the five percent royalty rights for the holder of the state lease on which the well is located on all production from all zones, strata, formations and structures under and within the exterior boundaries of the lease. If, before or after discovery well certification, the state lease on which the well is located is subject to or made a part of a development unit or pooling or consolidation contract, the five percent discovery royalty rate will apply only to the production allocated to the lease under the agreement. (Eff. 9/20/74, Reg. 51)

Authority: AS 38.05.02[illegible]
AS 38.05.14[illegible]
AS 38.05.18[illegible]

ARTICLE 3. UNITIZATION

Section

11 AAC 83.300. APPLICATION FC DESIGNATION OF AREA. An application f designation of an area as logically subject development under a unit agreement and f determination of the depth of a test well may l filed by any proponent of a unit agreement. Tl application must be accompanied by

(1) a map or diagram on a scale of not le than one inch to one mile outlining the ar sought to be designated, indicating federal, stat and privately owned lands by distincti symbols or colors and identifying Alaska leas and lease applications by serial numbers; and

(2) geologic information, including th results and interpretations of any geophysic surveys and any other available informatin showing that unitization is necessary an advisable in the public interest; if requested geologic and geophysical information furnishe with the application will be treated a confidential. (Eff. 9/20/74, Reg. 51)

Authority: AS 38.05.020
AS 38.05.145(a

11 AAC 83.305. DESIGNATION; EFFECT The designation of an area does not create ar exclusive right to submit a unit agreement for the area, nor preclude the inclusion of the area

AGO 1357085

Discovery Royalty Provision

STATE OF ALASKA
DEPT OF NATURAL RESOURCES

TYPE	FILE NUMBER		ACRES	UNIT CODE	UNIT DESCRIPTION
ADL	[illegible]	1	[illegible]	KE	KENAI RIVER
ADL	577 ✓	1		FC	FALLS CREEK
ADL	[illegible]	1	[illegible]	KE	KENAI RIVER
ADL	571	1	[illegible]	KE	KENAI RIVER
ADL	793	1	[illegible]	NF	NORTH FORK
ADL	[illegible]	1	[illegible]	NF	NORTH FORK
ADL	[illegible]	1	[illegible]	CL	CANNERY LOOP
ADL	2111		[illegible]	KE	KENAI [illegible]
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ADL	[illegible]		[illegible]	BR	BELUGA RIVER
ADL	[illegible] ✓		[illegible]	TB	TRADING BAY
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ADL	[illegible]	1	560.000	NT	NORTH TRADING BAY
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ADL	[illegible] ✓		[illegible]	BR	BELUGA RIVER
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			[illegible]	SL	[illegible] LAKE
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ADL	21125	1	120.000	BR	BELUGA RIVER
ADL	[illegible]	1	580.000	BR	BELUGA RIVER

✓ DR Granted

—— Within Discovered Fields

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STATE OF ALASKA
DEPT OF NATURAL RESOURCES

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STATE OF ALASKA
DEPT OF NATURAL RESOURCES

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				1,550,000	PB	PRUDHOE BAY
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FISCAL NOTE

STATE OF ALASKA **BILL NO. CSSB112(RES)**

1996 LEGISLATIVE SESSION

Revision Date:	Original	Dept Affected:	Natural Resources
Title:	An Act establishing a discovery royalty credit for the lessees of state land drilling exploratory wells and...	BRU:	Resource Development
		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
CHANGE IN REVENUES ()						

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:		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 problem 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.

Alaska State Legislature

Official Business

State Capitol
Juneau AK 99801

MEMO

TO: Nico Bus/DNR (X3886)
Chuck Logsdon/Revenue/Oil & Gas Audit (278-5026)
via fax: 5 pages

FROM: Annette Kreitzer, Aide to
Senate Resources Committee

DATE: March 18, 1996

RE: Fiscal notes to CS SB 112(RES): Discovery Royalty

Please create new fiscal notes to the Resources committee substitute for SB 112 using 9-LS0808\K dated March 15, 1996 (attached). This CS was passed from committee March 13.

9-LS0808\K
Chenoweth
3/15/96

CS FOR SENATE BILL NO. 112(RES)

IN THE LEGISLATURE OF THE STATE OF ALASKA

NINETEENTH LEGISLATURE - SECOND SESSION

BY THE SENATE RESOURCES COMMITTEE

Offered:
Referred:

Sponsor(s): SENATE RESOURCES COMMITTEE

A BILL

FOR AN ACT ENTITLED

"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."

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

* Section 1. AS 38.05.134 is amended to read:

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

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

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

(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 certified by the commissioner to be the first to drill a well discovering oil or gas in a previously undiscovered oil or gas pool 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 discovery 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 in pipeline quality and free of all lease or unit expenses, including but not limited to separation, cleaning, dehydration, gathering, salt water disposal, and preparation for transportation off the lease or unit area;

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

 WORK DRAFT WORK DRAFT

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

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

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

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

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

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

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

(4) notwithstanding a requirement in the leasing method chosen of a minimum fixed royalty share, on and after a date that is 180 days following the effective date of this Act, the lessee under a lease issued in the Cook Inlet sedimentary basin who is certified by the commissioner to be the first to drill a well discovering oil or gas in a previously undiscovered oil or gas pool 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 discovery 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 reduced royalty authorized by this paragraph is subject to the following:

(A) a lessee is eligible to pay the reduced royalty authorized by this paragraph only if the lessee is the first to drill a well discovering oil or gas in a previously undiscovered oil or gas pool;

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

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

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

(E) 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.

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

Sec. 31.05.170. Definitions. In this chapter, unless the context otherwise requires

(1) "and" includes "or" and "or" includes "and";

(2) "correlative rights" mean the opportunity afforded, so far as it is practicable to do so, to the owner of each property in a pool to produce without waste the owner's just and equitable share of the oil or gas, or both, in the pool; being an amount, so far as can be practically determined, and so far as can practicably be obtained without waste, substantially in the proportion that the quantity of recoverable oil or gas, or both under the property bears to the total recoverable oil or gas or both in the pool, and for such purposes to use the owner's just and equitable share of the reservoir energy;

(3) "commission" means the Alaska Oil and Gas Conservation Commission;

(4) "cubic foot" of natural gas means the volume of gas contained in one cubic foot of space measured at a pressure base of 14.65 pounds per square inch absolute and a temperature base of 60 degrees Fahrenheit;

(5) "field" means a general area which is underlain or appears to be underlain by at least one pool, and includes the underground reservoir containing oil or gas; and the words "pool" and "field" mean the same thing when only one underground reservoir is involved, but "field" unlike "pool" may relate to two or more pools;

(6) "gas" includes all natural gas and all hydrocarbons produced at the wellhead not defined as oil;

(7) "landowner" means the owner of the subsurface estate of the tract affected;

(8) "oil" includes crude petroleum oil and other hydrocarbons regardless of gravity which are produced at the wellhead in liquid form and the liquid hydrocarbons known as distillate or condensate recovered or extracted from gas, other than gas produced in association with oil and commonly known as casinghead gas;

(9) "owner" means the person who has the right to drill into and produce from a pool and to appropriate the oil and gas the person produces from a pool for that person and others;

(10) "person" includes a natural person, corporation, association, partnership, receiver, trustee, executor, administrator, guardian, fiduciary or other representative of any kind, and includes a department, agency or instrumentality of the state or a governmental subdivision of the state;

(11) "pool" means an underground reservoir containing, or appearing to contain, a common accumulation of oil or gas. Each zone of a general structure which is completely separated from any other zone in the structure is covered by the term "pool";

(12) "producer" means the owner of a well or wells capable of producing oil or gas or both;

AK Copy

Senator Loren Leman
SB 112
Senate Resources Committee

This is additional information for SB 112: Discovery Royalty Credit.
Please put this information in your committee packet for SB 112.

Delivered 3/15

Union Marathon / Grayling No. 1
3/10/82

ALASKA DEPARTMENT OF NATURAL RESOURCES

IN THE MATTER OF THE APPLICATION
FOR DISCOVERY ROYALTY BY THE UNION
OIL COMPANY OF CALIFORNIA AND
MARATHON OIL COMPANY (ADL 17594)

State of Alaska
Department of Natural Resources

OPINION IN SUPPORT OF DECISION

This decision concerns the application made by the Union Oil Company of California and Marathon Oil Company, co-lessees of state oil and gas lease ADL 17594, for discovery well certification of the Grayling No. 1-A well. On January 19, 1982, I issued a written decision confirming my November 13, 1981, determination which granted the application. This opinion contains my findings and conclusions which support the discovery royalty award to Union and Marathon.

In order to provide a context for the issues addressed by this decision, a chronological review of all pertinent events also will be presented. This review covers (1) the geologic evolution of Cook Inlet and the formation of the features which produced the hydrocarbons at issue, (2) antecedent federal laws and regulations concerning discovery royalties and geologic structures, (3) the laws and programs adopted by Alaska at statehood, (4) the leasing and development of Cook Inlet for oil and gas purposes, and (5) the sequence of discovery royalty applications and awards considered under the state discovery royalty program. Finally, this decision will evaluate the Union-Marathon application and the issues pertaining to it.

I. INTRODUCTION.

On May 9, 1965, Union Oil Company of California and its partner, Marathon Oil Company ("Union-Marathon"), commenced a well, Trading Bay No. 1, in Cook Inlet on state lease ADL 18731. This well was plugged and abandoned the same day because the surface casing being set in the well parted. On May 10, Union commenced the Trading Bay No. 1-A well from the same location. At the time, the State of Alaska had an incentive program in the form of a discovery royalty to encourage oil and gas development in the state. A discovery royalty reduced the normal 12.5% royalty rate to 5% for ten years from the date of "discovery" for all production from the lease where a lessee had made the first discovery of commercial hydrocarbons on a new geologic structure. Sec. 18, Ch. 30, SLA 1964.*/ Union-Marathon's Trading Bay No. 1-A well encountered commercial quantities of oil in what became known as the Trading Bay Field. They were awarded a discovery

*/ The applicable law at the time was AS 38.05.180(a). The relevant provisions of this law were first enacted as subsection 7, section 3, article VIII, chapter 169, SLA 1959, which was amended by section 18, chapter 30, SLA 1964. Legislative amendment in 1967 curtailed the discovery royalty program, which was abolished in 1969. 1967 Alaska Sess. L., ch. 91, § 2; 1969 Alaska Sess. L., ch. 65, § 1.

royalty for this lease by the Department of Natural Resources ("department") on August 27, 1965.

Union-Marathon, after further defining their Trading Bay discovery with two additional wells, moved their drilling barge approximately five miles south and commenced the Grayling No. 1 well on September 2, 1965. This well, too, was plugged and abandoned as a result of mechanical problems. The Grayling No. 1-A well was commenced immediately. Again, Union-Marathon found commercial quantities of hydrocarbons in what was to become known as the McArthur River Field. They filed an application for discovery royalty with the department on November 15, 1965, for state lease ADL 17594, which is adjacent to state lease ADL 18731.

It is at this point that the controversy giving rise to this decision began. Under the law, only one discovery royalty could be issued on any new geologic structure found to contain commercial hydrocarbons. 11 AAC 83.215(1) (repealed November 9, 1979).*/ The dispute has centered around whether the Trading Bay and McArthur River fields are separate geologic structures, which would permit discovery royalty certification of both the Trading Bay No. 1-A and Grayling No. 1-A wells, or are both part of a single dominant geologic structure, in which case approval of

*/ Formerly 11 AAC 505.745(a).

Union-Marathon's application on the Grayling No. 1-A well would not be permissible.

On January 26, 1966, the department issued a decision denying the Union-Marathon discovery royalty application for the Grayling No. 1-A well on the ground that insufficient information existed to determine that the Trading Bay and McArthur features were not part of a single structure. Specifically, department geologists were concerned that shallow productive sands might continuously overlap the larger Hemlock reservoirs on both features, even though the Hemlock zones appeared to be separated by a major fault system and displaced by more than 3,000 feet.

Although the scant geologic data at the time prevented a definitive conclusion on the overlap questions, discovery royalty regulations required that information in support of an application be filed within 90 days after the well had been tested for commercial quantities (which had taken place from November 6-8, 1965). 11 AAC 83.210(c) (repealed November 9, 1979).*/ The denial was based on the information submitted within that 90-day time frame.

On February 14, 1966, Union-Marathon petitioned the department for reconsideration and interpretation of its decision

*/ Formerly 11 AAC 505.744.

of January 26, 1966, denying the Grayling No. 1-A discovery royalty application. Their petition was made at least partially in response to encouragement from members of the department. Because of disagreement within the department over procedural and substantive questions relating to discovery royalties, no reply was given until October 31, 1968, at which point the commissioner granted Union-Marathon 60 days in which to submit more information. On December 30, 1968, Union-Marathon filed additional geologic information developed during the period since January 1966 and requested that the matter be set for hearing. On February 26,. 1970, then natural resources commissioner Kelly established a hearing date of April 17, 1970, but notified Union-Marathon that only the information filed or developed within the original 90-day period would be considered. At the hearing, Union-Marathon submitted more new geologic information, and thereafter sent the commissioner a letter stating why he should consider the evidence acquired after the original 90-day period had expired. On October 7, 1970, Commissioner Kelly issued a decision denying Union-Marathon's application for the discovery royalty based on the evidence submitted within the 90-day period.

Union-Marathon then sought review in the superior court, which remanded the matter to the commissioner for a new decision, including a statement of the basis for the decision. On February 17, 1972, the commissioner reaffirmed his earlier decision on the basis that insufficient information was submitted within the 90-day period to determine whether or not there were two separate structures. Union-Marathon again sought review in superior court. The court dismissed the appeal on grounds of lack of jurisdiction. Union-Marathon then appealed to the supreme court which reversed on the jurisdictional issue and remanded the case for further consideration. Union Oil Co. of Cal. v. State Dept. of Nat. Resources. 526 P.2d 1357 (Alaska 1974). On remand the superior court concluded that the commissioner of natural resources could not legally consider the after-acquired evidence and that the original decision was sustainable on the basis of the evidence submitted within the 90-day period. From that decision, entered July 31, 1975, Union-Marathon again appealed to the supreme court.

In its decision, dated February 10, 1978, the Alaska supreme court remanded certain questions relating to this application to the commissioner of natural resources for determination. Union Oil Co. of Cal. v. State. 574 P.2d 1266 (Alaska 1978). The threshold question was whether the 90-day limit of 11 AAC 505.744 (recodified as 11 AAC 83.210(c) (repealed November 9, 1979)) on submitting data regarding geologic structure was unreasonable as applied to Union and Marathon. If so, the commissioner was ordered to receive additional evidence regarding geologic structure and to rule on the application on the basis of all the data submitted.

In compliance with the supreme court's order, I first determined that the 90-day limitation, as applied to the applicants in this case, was unreasonable.*/ Thereafter, I received additional evidence concerning the issue of whether the Grayling 1-A well was the first discovery of oil or gas in a new geologic structure.

With the goal in mind of sustaining Commissioner Kelly's decision, several officials of the Alaska Department of Law (including then deputy attorney general Wilson L. Condon and then assistant attorneys general Susan A. Burke and Jeffrey B. Lowenfels) undertook an extensive effort to gather evidence which would challenge the validity of Union's and Marathon's claims. As part of this effort, they traveled extensively throughout the United States and conducted numerous interviews with federal officials employed by the United States Department of the Interior, including the United States Geologic Survey ("USGS"), who were intimately familiar with implementation of the federal discovery royalty program and the concept of a "known geologic structure of a producing oil and gas field" ("KGS"). Interviews were conducted with Interior official in Washington, D. C., and USGS officials in Langley, Virginia; Casper, Wyoming; Denver, Colorado; and Los Angeles, California. Among those federal officials interviewed was Emmett A. Finley, former chief of the Minerals Classification

*/ See Part VI of this opinion.

Branch of USGS and author of USGS Circular 419, which purported to codify USGS practice in administering the KGS system. Interviews were also conducted within Alaska with state officials from the departments of Revenue and Natural Resources who were familiar with the state's discovery royalty program.

The Department of Law also compiled a glossary of all geologic terms relevant to the definition of the term "geologic structure" and prepared a comprehensive documentary history, in seven volumes, describing the development and administration of the discovery royalty provision of AS 38.05.180(a). Volume I (entitled "Summary of Documents") is a summary of their findings; it discusses certain federal oil and gas leasing practices (summarized in Section III of this opinion); describes the evolution of the Alaska Land Act and the Alaska oil and gas lease form (summarized in Section IV of this opinion); and traces the history of early oil and gas discoveries in the Cook Inlet region, the development of regulations governing discovery royalties, and the administration of those provisions with respect to applications for discovery awards on state leases in the Cook Inlet region (summarized in Section V of this opinion). Volume II describes the territorial and state administrative organization for the oil and gas from 1958 to 1970 (Appendix A), the evolution of the oil and gas lease form (Appendix B), and oil and gas development in the Cook Inlet region (Appendix C) and contains copies of the relevant affidavits (Appendix D). Volumes

III - VII are an extensive compilation of the correspondence and other documents which are summarized in Volume I.

Beginning March 13, 1980, I held a hearing to enable the applicants to submit additional evidence in support of their application. In preparation for that hearing, I had reviewed the following materials:

1. the Summary of Documents and appendices;

2. the documents referred to in the summary;

3. a videotape of a deposition of Emmett A. Finley and the exhibits submitted at that deposition;

4. the maps submitted in support of the applications for discovery certification of Union-Marathon's Trading Bay State No. 1-A well, Union-Marathon's Kustatan No. 1 and 1-A wells, Atlantic Richfield's West Foreland Unit No. 3 well, Texaco's Trading Bay No. 1 and 1-A wells, and the Grayling No. 1 and 1-A wells;

5. information submitted in support of the application for discovery well certification of Atlantic Richfield's Trading Bay State No. 1 well, including: the baroid mud log and dual induction laterolog submitted with the affidavit of

establishment of priority as to time and date on June 7, 1967; the materials submitted to the Oil and Gas Conservation Committee on September 27, 1967, to establish a separate geologic structure, including an evaluation of the mechanical logs (Exhibit 1), a structure contour map (Exhibit 2), a structural cross section -- $A\text{-}A^1$ (Exhibit 3), completion information drafted on an electric log (Enclosure 1), and a core analysis -- cores 1-10 (Enclosure 2); additional information supporting the application transmitted on December 30, 1968, including a structure contour map (Exhibit 1), an east-west cross section -- $A\text{-}A^1$ (Exhibit 2), and an east-west cross section -- $B\text{-}B^1$ (Exhibit 3); and exhibits presented at the hearing before the commissioner of natural resources on April 16, 1970, including a structural contour map of the Hemlock formation in the Trading Bay and North Trading Bay fields (Exhibit 1) and a structural contour map of the Hemlock formation showing producing trends in the Cook Inlet Basin (Exhibit 2);

6. all materials submitted by Union-Marathon through March 13, 1980, including the "blue box" and accompanying geologic reports; the light blue folders submitted at the April 17, 1970, hearing; and Volume III of the green folders, dated September 28, 1979, including the redrawn maps which were submitted later; and

7. all available information from Union-Marathon's Trading Bay State No. 2 and No. 3 wells which were drilled in the

late summer of 1965 and Union-Marathon's A-20 well drilled from their Monopod Platform on July 24, 1977.

Also in preparation for the hearing, I interviewed Tom Marshall, a petroleum geologist formerly employed by the state Oil and Gas Conservation Committee, regarding state administrative practices relating to discovery royalty applications and his understanding of Cook Inlet geology; William Van Alen, a petroleum geologist from the Alaska Oil and Gas Conservation Commission, on the structural history of the Trading Bay area; and William Van Dyke, a reservoir engineer employed by the division of minerals and energy management, regarding his interpretation of the well data in state files and Union-Marathon's interpretation of that data as depicted in their exhibits.

At the hearing testimony was given by Thomas Wilson, Jr., who worked as a geologist for Marathon Oil Company and had participated in joint Union-Marathon exploratory work in the Cook Inlet area since 1958 (he discussed the results of Marathon's exploratory and drilling work in the Trading Bay and McArthur River fields from 1959 through 1965); Richard A. Lyon, who worked as the Alaska District Exploration Manager for the Union Oil Company from 1963 through 1966 (he gave his perceptions of Alaska's discovery royalty program and its impact on Union's early exploration efforts in Alaska); Robert C. Warthen, who worked as a geologist for Union Oil Company (he presented a compilation of all geologic information collected in the area by Union and Marathon to date, including updated geologic information not previously submitted to the state); Kenneth Zerda, a reservoir engineer for Union Oil Company (he compared the reservoir characteristics of the McArthur River and Trading Bay fields); Gerould H. Smith, a geochemist employed by Union (he compared the geochemical characteristics of the oil found at Trading Bay with the oil found at McArthur River); Ed Hall, a geologist from Union (he presented maps he had prepared based on examples of KGSs he had collected from several USGS offices); Charles M. Schwartz, a geologist in charge of Union's exploration and production activities in Alaska (he compared the physical characteristics of the two fields and hypothesized regarding the structural growth of these areas); and Joseph David "Red" Cerkel, Jr., a retired geologist who had served as chief of the Minerals Classification Branch of the USGS. Tom Cook, then director of the division of minerals and energy management; K. Daniel Hinkle, Marathon Oil Company's attorney; and Arden Page and John Sedwick, Union Oil Company's attorneys, also attended the hearing.

On April 23, 1981, I took testimony from William Van Alen, who gave a presentation on the geologic history of the Cook Inlet sedimentary basin and formation of the ancestral Trading Bay anticline (summarized in Part II of this opinion) and Thomas R. Marshall, who discussed the application of the Greater Trading Bay Structure concept to the award of discovery royalties by the

Oil and Gas Conservation Committee. Also present were Assistant Attorney General Michael E. Arruda, Mr. Page, and Mr. Sedwick.

As a result of the efforts of the Department of Law and Union-Marathon, examination of the issues in this case was extremely thorough. For the reasons set forth in my decision, however, I determined that this matter should be resolved in favor of the applicants.

More specifically, I determined that there is sufficient subsurface information to determine that the McArthur River feature, on which the Grayling 1-A well is located, is not overlapped by the previously certified Trading Bay feature and, furthermore, is a separate geologic structure within the meaning of then applicable 11 AAC 83.200 and 11 AAC 83.205(2) (repealed November 9, 1979).*/ On this basis, the application for discovery well certification of the Grayling 1-A well was granted.

II. GEOLOGIC EVOLUTION OF THE COOK INLET SEDIMENTARY BASIN AND THE TRADING BAY AND MCARTHUR GEOLOGIC FEATURES.

The Trading Bay and McArthur River geologic features which are the subject of this case are located within the Cook Inlet sedimentary basin, a major oil and gas province.

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*/ Formerly 11 AAC 505.74 and 11 AAC 505.741(b), respectively.

PAGES 13-22 ARE AVAILABLE FROM KEN BOYD, DNR/DO&G. THESE PAGES CONTAIN GEOLOGIC INFORMATION FROM THE EARLY JURASSIC PERIOD TO THE PLEISTOCENE PERIOD.

A SUMMARY OF THESE PAGES IS ON PAGE 23, WHICH FOLLOWS THIS PAGE.

H. Summary

In summary, the Cook Inlet Basin as we know it today began with the deposition of volcaniclastic materials (the Talkeetna formation) nearly 200 million years ago. Approximately 175 million years ago, sediments and organic matter were deposited in the Tuxedni Group, which became the source rock for most of the hydrocarbons in Cook Inlet. Over the succeeding 100 million years, additional coarse materials were deposited in the area which experienced the alternating uplift and subsidence, mountainous formation and folding conducive to generating the lateral and vertical compression and geothermal heat required for the formation of petroleum hydrocarbons in the Tuxedni source rock. At or slightly before the beginning of Tertiary time (65 million years ago) and thereafter, the area experienced (1) downwarping of the Cook Inlet trough exposing the westward and eastward ends of the Tuxedni source rock and forcing the migration of oil upwards; (2) the creation of the present day Alaska, Chugach and Kenai mountain ranges, creating a further depositional environment in Cook Inlet beginning with the Larimide revolution; (3) deposition of sedimentary materials constituting the West Foreland formation and the Kenai group, which became the reservoir rock formations receiving upward migrating oil from the exposed Tuxedni source rock; (4)general east-west folding of stratigraphic layers in the Cook Inlet Basin caused by mountain formation and the underthrusting of the North Pacific Oceanic Plate, initially establishing north-south anticlines which became entrapping mechanisms for hydrocarbons and, through further foldings, steepening the flanks of those anticlines (including Trading Bay) to the point that reverse faulting occurred; (5) the counterclockwise rotational movement of the Alaskan (North American) Continental Plate and subjacent thrusting of the North Pacific Oceanic Plate causing right-lateral strike-slip faulting along major regional faults (for example, the Castle Mountain fault) and similar movements along subordinate faults (for example, the Bruin Bay and Trading Bay faults). The last of these forces caused the upper portion of what was once a single Trading Bay anticline to migrate eastward approximately three and one-half miles. Therefore, through the composite action of folding, reverse faulting, normal faulting and strike-slip faulting occurring over the past 25 million years, the Trading Bay anticline has evolved from a simple fold into a complex structure with the Trading Bay field portion offset from the McArthur River Field portion.

III. ANTECEDENT FEDERAL LAWS AND REGULATIONS.

Alaska statutes and regulations adopted at statehood provided for a discovery royalty to be awarded to a lessee that was the first to encounter commercial quantities of oil and gas on a new geologic structure. Neither the concept of a discovery royalty nor of using the term "geologic structure" for oil and gas regulatory purposes was without precedent. The term "KGS" had been used by the USGS since 1920 to determine whether land would be leased competitively or noncompetitively for oil and gas purposes. From 1937 to 1958, the term "geologic structure" was used for purposes of establishing reduced royalties on noncompetitive leases under regulations implementing the Alaska Oil Proviso of the Federal Mineral Leasing Act of 1920. */ Therefore, the use by federal officials of the term "geologic structure" and the federal discovery royalty provide some background for interpretation of the provisions of Alaska law contested in this case.

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*/ A discovery incentive program was initiated by the federal government in 1942 to encourage petroleum discoveries in the interest of national defense. This program, authorized by the so-called O'Mahoney Amendment to the Mineral Leasing Act on December 24, 1942, Pub. L. No. 832, Stat. 1080 (1942), placed a 12½ percent ceiling on royalty rates for discoveries of a "new oil or gas field or deposit." The amendment had the effect of reducing royalties on oil and gas production. The federal program was, in many ways, much easier to administer than the state's "new geologic structure" program because it was administered in a way that looked only to whether a discovery was made in a new "deposit." See Appendix 1. The concept of a separate field or deposit is much more easily defined than the concept of a separate geologic structure. The United States Department of the Interior never adopted specifications to administer this program until it was further amended in 1946. The six diagrams in Appendix 1 of this decision entitled "Possible Interpretations Under Act of December 24, 1942," clearly illustrate how the program was in fact administered.

A. Competitive-Noncompetitive Leasing Determinations.

In 1920 Congress passed the Federal Mineral Leasing Act, 41 Stat. 437 (1920), which was the organic statute governing oil and gas leasing in the United States. Under the act, land could be leased for oil and gas purposes either competitively or noncompetitively. The law required that land be leased competitively if it were located on a KGS. From then on, USGS geologists followed petroleum exploration activities in the United States, drawing and platting KGSs as new discoveries were made. Oil and gas rights to land not covered by a KGS could be obtained noncompetitively.

Although the USGS plotted hundreds of KGSs over the years after 1920, no regulations defining a KGS were adopted until 1970. In 1959, however, Emmett A. Finley authored a document entitled, "The Definition of Known Geologic Structures of Producing Oil and Gas Fields" (Circular 419).. This document was considered the principal reference in making KGS determinations.

B. Discovery Royalties.

The 1920 Federal Mineral Leasing Act also contained a section known as the "Alaska Oil Proviso." This section authorized the secretary of the United States Department of the

Interior to establish special lowered royalty rates on leases issued in the State of Alaska in order to encourage oil and gas development in this frontier area. Although regulations implementing the Alaska Oil Proviso were amended several times (which usually changed the lowered royalty formula), by 1950 they provided for payment of a 5% royalty (compared to the normal 12.5%) for ten years following the date of discovery by any lessee that made the first discovery of oil or gas in commercial quantities in a new geologic structure. The Alaska Oil Proviso was virtually identical to a provision of the discovery royalty statute enacted by the Alaska legislature in 1959 except that the Proviso applied to noncompetitive land only. The Alaska Oil Proviso was repealed in 1958.

In summary, at the time of statehood, the term "known geologic structure" had been used by the USGS since 1920 to determine whether land would be leased competitively or noncompetitively. During the same period, the term "geologic structure" had been used for purposes of awarding discovery royalties under the Alaska proviso, but on noncompetitive leases only.

IV. DEVELOPMENT OF A STATE DISCOVERY ROYALTY PROVISION.

Because the territorial government had no land to manage, territorial land officials had little experience with land management, including oil and gas leasing. With the approach of statehood, these officials began the massive preparation necessary for the transition from territorial status and the problems which statehood would bring, including problems associated with the receipt of immediate title to 45 million acres of tide and submerged land and the selection of 103,350,000 acres of upland.

In order to assume their new responsibilities, territorial officials began developing programs for the selection, management, and disposal of state land and its resources. Special attention was given to the leasing and management of land containing oil and gas resources because of its potential for generating revenue for the cash-poor state. The major concern was development of a well-conceived leasing program which would avoid land speculation in areas of oil and gas potential.

During the two years before statehood, there was continued activity by territorial officials debating the provisions to be included in the Statehood and Alaska Land acts. Much of the discussion centered on the extent to which the state would competitively lease land with oil and gas potential. Although the territorial land board retreated from its initial proposal to competitively lea[illegible] all sedimentary basins, their final proposal required competitive leasing on a broader scale than the federal act had. There also was considerable discussion regarding adoption of a discovery royalty program by the state. The oil industry advocated its adoption on the ground that the federal royalty program had attracted the industry to Alaska in the first place.

The Alaska Land Act passed in 1959. Unlike the federal act which limited competitive oil and gas leasing to land containing a KGS, the state act required competitive leasing on land known or believed to contain oil or gas. The state act also contained a discovery royalty provision virtually identical to the terms of the Alaska Oil Proviso. Under this provision a lease holder that drilled and made the first discovery of oil or gas in commercial quantities in a geologic structure could be rewarded by paying a discovery royalty of only five percent of the value of oil and gas extracted for the first ten years, after which the normal rate of 12½ percent was applicable. The new state oil and gas leasing form also contained a provision which repeated verbatim the discovery royalty provision included in the state act.

V. IMPLEMENTATION OF THE STATE'S DISCOVERY ROYALTY PROGRAM IN THE COOK INLET REGION.

A. Early Leasing Activity.

Although Alaska received a large entitlement of land at statehood, this was a nonliquid asset. The state was cash poor and unable to adequately operate the government and provide essential public services. To obtain the revenue needed to run the new state, state officials quickly began implementing programs which would generate cash from the land. High on their list of activities was oil and gas leasing, as evidenced by the quick succession of legislation (the Alaska Land Act was signed on May 2, 1959), regulations (effective September 15, 1959), and lease sales (the first was conducted in December of 1959).

From 1959 through 1966 the state conducted 17 competitive oil and gas lease sales. All major oil discoveries and most major natural gas discoveries in Cook Inlet were made on leases sold at the seventh and ninth lease sales (held on December 19, 1961 and in July of 1962, respectively). Virtually all subsequent discovery royalty determinations involved leases sold in these two sales.

Most land opened by the state for oil and gas exploration, development, and production activities in the upper Cook Inlet area was leased by a small number of oil companies in combination. Pan American Petroleum Corporation and its partners (the Pan American group) leased by far the greatest amount of acreage in the seventh and ninth competitive lease sales. The SRS group (consisting of the Shell Oil Company, the Richfield Oil Company, and the Standard Oil Company of California) acquired the second largest amount of acreage. Union Oil Company of

California and Marathon Oil Company, as partners, acquired four leases in these sales and a fifth by assignment. Union also acquired an interest in two other leases in partnership with Mobil. Texaco and Superior together obtained three leases. Atlantic Refining Company obtained eight leases.

B. Initial Exploratory Efforts Affecting Land in the Seventh and Ninth Competitive Oil and Gas Lease Sales.

Given the large amount of land leased by the Pan Am group and the SRS group in the seventh and ninth competitive oil and gas lease sales and the close proximity of these leases to one another, it was likely that these two groups would compete for discovery royalty awards if oil or gas were found in the area. During the summer of 1962, even before the ninth lease sale was held, four wells (two by the Pan Am group and two by the SRS group) were commenced to test the potential of the leases in this area.

On May 15, 1962, the Pan American group spudded its Middle Ground Shoal State No. 1 well from a drilling barge on lease ADL 17595 in the area now known as the Middle Ground Shoal Field. This well blew out one week later while it was being drilled at a depth of 1,132 feet. It was brought under control on the same day. While being drilled at a depth of 5,216 feet, the well blew out again upon encountering a high pressure gas zone. The well remained out of control for 45 days, and a large gas flow erupted through the inlet floor 700 feet from the well. During this period Pan Am pumped into the well 25,265 barrels of mud and lost circulation material, 16,480 sacks of cement, 975 sacks of Cal Seal, and a large quantity of diesel gel cement, topped off by burlap sacks, parachutes, gravel, sand, and sawdust. Finally, on July 25, 1962, the well was controlled. It was then plugged and abandoned.

On May 30, 1962, Shell, as operator for the SRS group, spudded a well, State No. 1, on lease ADL 17582. This well was drilled roughly halfway between what is now known as the Middle Ground Shoal Field and Cook Inlet Gas Field. The well was drilled to a depth of 14,401 feet and completed on September 14, 1962. Although shows of oil were found in various tests of the well, no commercial discovery was made.

On May 31, 1962, Pan Am, on behalf of the Pan Am group, spudded a second well, Cook Inlet State No. 1, on lease ADL 17589 in the area now known as the Cook Inlet Gas Field. While it was being drilled at a depth of 12,237 feet, this well also blew out. Because of the high volume and pressure of escaping hydrocarbons, the drilling barge had to move off the well and the escaping gas and oil had to be ignited. A relief well was spudded about 1,500 feet to the northeast one week later. The initial well continued to blow ignited for almost fourteen months before it was finally controlled by pumping salt water down the relief well.

On April 19, 1962, at an onshore location on a federal lease adjacent to lease ADL 17599, the Standard Oil Company of California, as operator for the SRS group, spudded a well. The well was tested on December 1, 1962. On December 4, Standard announced that it had discovered what became known as the Beluga River Gas Field.

C. Development of the Discovery Royalty Regulations.

The drilling of the four wells described above led representatives of the Pan Am group and the SRS group to ask the department about the policies and procedures for making discovery royalty awards. The state, as lessor, and the oil companies, as lessees, were all faced with the same problem: neither the statute authorizing discovery royalty awards, the regulations adopted to implement the statute, nor the state lease form defined what was meant by the terms "first discovery," "commercial quantities," or "geologic structure."

The need to define the terms "first discovery" and "commercial quantities" was brought to a head by the advent of Pan Am's two blowouts. This situation made plain that the state had implemented a discovery royalty program without adequately considering the practical problems which materialize after a program is put into practice. After four wells had been drilled, the department began to attempt to untangle the confusion which the lack of specifics in the regulations had created. There followed extensive exchanges of memoranda, position papers, and other communications among members of the department, oil companies, and the Western Oil and Gas Association as they attempted to work out acceptable solutions. Concurrently, Pan American applied for discovery royalty awards for leases covered by the two wells that had blown out the previous summer, and SRS applied for a discovery royalty for the gas discovery in their Beluga River well (Appendix 4 summarizes all state discovery royalty applications in Cook Inlet). While the department did not want to make hasty discovery royalty awards, state officials were also concerned that drilling races would result from the department's failure to answer essential questions on discovery royalty awards where there was mixed ownership of leases over a potential structure.

Further confusion occurred within the department because of differing views on the problems caused by the absence of detailed discovery royalty regulations. While aware of the problems relating to the definitions of "first discovery," "commercial quantities," and "geologic structure," the commissioner's office was also concerned about whether a discovery royalty award applied to all production from within the lease, all production from only a particular pool or interval, or all production from within the exterior boundaries of the discovery structure on the lease.

On January 15, 1963, the department issued a decision granting Pan Am's application for the Middle Ground Shoals well on state lease ADL 17595 (for the structure only). (A map prepared by the Union Oil Company which accompanied the testimony of E.A. Hall and illustrates federal and state discovery royalty awa[illegible]s generally is attached to this opinion as Appendix 2.) The award was contested by SRS. Concurrently, the Western Oil and Gas Association was urging the department to define discovery royalty terms by regulations in a manner which would clear up any misunderstandings.

Subsequently, department officials conducted hearings on proposed discovery royalty regulations. These hearings were characterized by acrimony and disagreement between oil companies and other organizations. Although most of the discussion concerned the meaning of the term "first discovery" (because of Pan Am's two blowout wells), there was also some discussion of the definition of "geologic structure," although a factu[illegible] dispute involving this term had not yet arisen.

A hearing was held in June of 1963 to consider new department draft regulations put out at the end of May. After the hearing some revisions were made. The final regulations were filed in July and became effective in August. Those regulations read as follows:

505.73 Royalty.

The royalty rate on production under competitive leases will be fixed in the lease form for each lease offer and shall not be less than 12 1/2 percent in amount or value of the production removed or sold from the leased lands, except as provided in Section 505.74.

505.74 Discovery Lease.

Any operator who by time and date first encounters sufficient evidence of oil and/or gas in a particular geologic structure covered by any State oil and gas lease to cause said operator diligently to continue in good faith testing, reworking, drilling or other operations on said lease, whether in the same hole or other holes, in an effort to establish production of oil and/or gas in the same structure shall be qualified for a discovery well certification under the terms of said state lease should he complete a well and establish production in commercial quantities in the same zone in which oil and/or gas was first encountered.

505.741 Definitions.

With regard to regulations 505.74 through 505.748 and applicable provisions in State leases, the following terms shall have the meanings indicated.

(a) "Discovery" shall be the first acceptable evidence in a drilling well of the existence of oil and/or gas which can be produced in commercial quantities after well completion.

(b) "Geologic Structure" shall be any structural and/or stratigraphic entrapping mechanism containing one or more intervals, zones, strata, formations, or fault blocks which has the necessary physical characteristics to accumulate and prevent the escape of oil and/or gas. It is intended that the meaning shall be similar to that as used by the United States Geological Survey in the administration of the Federal Mineral Leasing Act of February 25, 1920 (41 Stat. 437) as amended.

(c) "Completed Well" shall be a well which is cased, controlled and in which all underground work in connection therewith has been finished and such well is capable of producing oil and/or gas.

(d) "Commercial Quantities" shall be those amounts of oil and/or gas which after well completion would appear to a reasonable and prudent operator to be sufficient to recover ordinary costs of drilling, completing and producing an additional well on the same geologic structure at an offset location with a reasonable profit to the operator, if a market were available.

(e) "Committee" shall be the Alaska Oil and Gas Conservation Committee composed of the Director of Mines and Minerals (Chairman), the State Petroleum Geologist, the State Petroleum Engineer and the Deputy Commissioner of the Department of Natural Resources or his designee.

505.742 Establishment of Priority as to Time and Date.
To establish priority as to time and date of discovery, an operator must furnish the Committee with a sworn statement substantiating evidence, acceptable to the Committee, that oil and/or gas has been encountered in sufficient showing to cause a reasonable and prudent operator to conduct further operations in an effort to complete a well in the discovery zone so that such well can be tested for potential oil and/or gas production in commercial quantities. Such statement must include the time and date of first discovery, the exact location of the well concerned, the precise interval of discovery and the Alaska Division of Lands lease number on which said well is located. Such statement should be furnished to the Committee as soon as possible, but not later than thirty (30) days after the date claimed for the discovery.

505.743 Establishment of Commercial Quantities.
To establish and prove oil and/or gas in commercial quantities, operator must: (a) Conduct a potential test of the discovery

zone within one year after completion of a discovery well. (b) Notify the Committee or its designated representative five days in advance of such scheduled potential test and furnish transportation (if requested) for a designated representative of the Committee to witness such test. The Committee may at its option or at the option of its designated representative waive the witnessing of the test and require sworn evidence to establish results of said test. Any such sworn evidence shall be delivered to the Committee or its designated representative within thirty (30) days after such test.

505.744 Establishment of Geologic Structure.

To establish the geologic structure from which the oil and/or gas can be produced, the operator must furnish pertinent data to the Committee which will enable it to determine the geologic structure from which the oil and/or gas is being produced. This may include but is not limited to, geophysical data, total depth, casing records, perforation data, electric logs, drilling and mud logs, core analyses, sample cuttings and sample logs, and the operator's interpretation thereof, together with any other records and interpretations the operator deems pertinent. This data must be supplied within ninety (90) days after the date of the potential test as required in Section 505.743. All such data submitted shall be held confidential for a period of 24 months unless written authorization from the operator for the release of same is secured.

505.745 Certification After Compliance and Application.

After compliance with Sections 505.742 through 505.744 inclusive, the operator may apply to the Director for discovery well certification. Within ten (10) days of receipt of such request the Director will publish notice of such application allowing thirty (30) days for any interested party to object to or protest the application. If no protest or objection is received by the Director, the Director will, within seventy (70) days after the receipt of an application, either certify the well as in (a) or deny the application as in (c) of this section. If any protest or objection is made it must be submitted in writing to the Director within the specified thirty (30) day period. After receipt of said protest or objection the Director will advertise and hold an open public hearing in accordance with the Alaska Land Act (AS 38.05) and in accordance with the Alaska Administrative Procedures Act (AS 44.62.300 - AS 44.62.630). Within thirty (30) days after such hearing the Director will do one of the following.

(a) Certify the well in question a first discovery well which has established oil and/or gas in commercial quantities in (name geologic structure) as of (time) on (date), and specify the date of commencement of the 10 year 5 per cent discovery royalty term which date shall be the first of the next succeeding month from the established date of initial discovery. After discovery well certification, no other well, regardless of when drilled, shall be eligible for consideration for certification as to the same geologic structure.

(b) Continue the hearing at a later specified date.

(c) Deny the application for discovery well certification.

505.746 Cancellation.

At any time after discovery well certification should any information supplied to the Committee be later proven false or erroneous and such information would affect the decision of the Director to the extent that the original application for certification would have been denied on such basis, the certification shall be immediately revoked. Such action also may be taken when it is determined that error was caused by failure to disclose full and complete knowledge available to the operator at the time of application for certification. After such certification is revoked royalty payment of 7 1/2 per cent on production theretofore shall be immediately due and payable and 12 1/2 per cent royalty on all subsequent production shall be paid. Should the royalty due not be paid on demand, the State shall take legal steps to cancel the lease involved.

505.747 Termination.
In the event of the termination of a discovery lease for any cause, the 5 per cent discovery royalty terminates and will not be allowed or reinstated on the same geologic structure.

505.748 Five Per Cent Discovery Royalty.
A "First Discovery Well Certification" shall secure the 5 per cent royalty rights for the holder of the State lease on which such well is located on all production from all zones, strata, formations and structures under and within the exterior boundaries of said lease. If at any time before or after discovery well certification, the State lease on which such well is located is subject to or made a part of any development unit, pooling or consolidation contract, the 5 per cent discovery royalty rate shall apply only to the production allocated to said lease under such agreement.

In 1973 the state's discovery royalty regulations were recodified. 11 AAC 84.152 -- 11 AAC 84.168 were the discovery royalty provisions applicable to competitive leases and 11 AAC 84.407 -- 11 AAC 84.422 were the discovery royalty provisions applicable to noncompetitive leases. In 1974 these two sets of regulations were combined into one set of discovery royalty provisions generally applicable to all oil and gas leases, 11 AAC 83.200 -- 11 AAC 83.230. These regulations were repealed on November 9, 1979.

D. The Dispute Between Pan Am and Shell Over the Middle Ground Shoal Discovery Royalty Award.

In May of 1963 the SRS group spudded a well in the Middle Ground Shoal area immediately to the south of the lease on which Pan Am had drilled the gas blowout the previous year and for which Pan Am and its partners had been awarded a discovery royalty in January. The first day the new regulations on discovery royalties were in effect, SRS filed an affidavit of first discovery based on encountering oil sands in various intervals in the area. Their application was denied by the department in December of 1963.

SRS requested reconsideration by the department and concurrently filed a document claiming that Pan Am's discovery award was not valid because the well was a blowout and, therefore, ought to be revoked. Several documents were filed on both sides.

The department issued a decision in May of 1965 upholding the original discovery royalty award to Pan Am and denying Shell's petition. This matter was then appealed to the courts. In 1969 the Alaska supreme court upheld the department's decision. <u>Pan American Petroleum Corp. v. Shell Oil Co</u>., 455 P.2d 12 (Alaska 1969).

E. Discovery Royalty Awards for North Cook Inlet, Beluga River, and Falls Creek.

1. North Cook Inlet award.

On November 12, 1962, the date Pan American had applied for discovery award for the Middle Ground Shoal No. 1, Pan Am also applied for a discovery award on ADL 17589 on the basis of the Cook Inlet No. 1 blowout. The department decided not to act on this application until after the discovery royalty regulations went into effect.

In August of 1963 (after the new regulations became effective), Pan Am was informed that a potential test to verify the existence of commercial quantities would be required. No testing was possible until the summer of 1964.

In the interim Shell protested any award of discovery benefits to Pan Am for the Cook Inlet No. 1 well and spudded a well on the lease immediately to the north of the lease where Pan Am had drilled the Cook Inlet No. 1 and No. 1-A wells.

In June and July of 1964, the Cook Inlet No. 1-A well was tested by Pan Am. In December of 1964, Pan Am was granted a discovery royalty for lease ADL 17589 based on the discovery made in the Cook Inlet No. 1 well and the potential test of the Cook Inlet No. 1-A well.

2. Beluga River and Falls Creek awards.

The SRS group had requested a discovery royalty in December of 1962 in conjunction with its Beluga discovery. Action on this request was initially delayed because the commissioner of natural resources believed that the Beluga discovery might be on the same structure as Pan Am's North Cook Inlet blowout. The SRS group contended, however, that it had an automatic right to an award because the state had recognized the Beluga discovery for the purpose of reclassifying adjoining state upland acreage from noncompetitive to competitive. There was an exchange of information between the department and the SRS group over this application at the same time as the deliberations on the adoption of the discovery royalty regulations were occurring.

In May of 1963 the SRS group applied for a discovery royalty for lease ADL 00590 on the basis of the gas discovery made in the Falls Creek Unit Number 1 well in April of 1961. When the department decided to defer action on both the Falls Creek and Beluga River applications until after the discovery royalty regulations were adopted, The SRS group objected that it was being treated unfairly.

In September and October of 1963, the SRS group reapplied for Beluga discovery certification. It was awarded on the same day that the SRS application for the Middle Ground Shoal oil discovery was denied.

In December of 1963 an application was submitted for the Falls Creek lease. It was processed under the new regulations, and a discovery royalty award was made on February 18, 1964.

F. Application for and Award of Discovery Royalty Certifications in the Trading Bay, McArthur River, and Nicolai Creek Areas.*/

1. Introduction.

In 1965, for the first time, offshore wildcat wells were drilled along the west shore of Cook Inlet on leases issued during the seventh and ninth competitive lease sales. Mobil and Union drilled the Granite Point No. 1 well on lease ADL 18761 from April 5, 1965, to August 5, 1965. The well resulted in discovery of the Granite Point oil field. The companies applied for a discovery royalty for the lease, which was awarded on September 14, 1965.

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*/ A map depicting the top of the Hemlock gelogic formation and illustrating app .cations for discovery royalty awards in the Trading Bay and McArthur River areas is attached to this opinion as Appendix 3. Appendix 2 should be referenced to locate the Nicolai Creek area for which a discovery royalty award was also sought.

During this same drilling season Union (on behalf of itself and its co-lessee, Marathon) drilled four wells in the Trading Bay-McArthur River area. These wells and others which followed encountered oil in almost every instance in reservoirs contained in the Hemlock formation, which also contained the major oil reservoirs in the Middle Ground Shoal and Swanson River fields.

A number of exploratory wells were drilled in the Trading Bay-McArthur River area during the 1966 drilling season. Filings for five of these wells were made with the state, which initiated the discovery royalty certification process.

2. Application for and award of a discovery royalty certification for the Union Trading Bay No. 1-A well.

On May 9, 1965, Union, on behalf of itself and Marathon, spudded the first well on lease ADL 18731. The well (Trading Bay No. 1) was drilled to a depth of 747 feet. The casing parted at a depth of 126 feet while it was being set in the well, and the well was plugged and abandoned. On May 23, 1965, Union spudded another well from the same location, Trading Bay No. 1-A. In drilling this well Union discovered oil in the Trading Bay field. The well was completed at a depth of 6,832 feet on June 25, 1965.

Union and Marathon applied for a discovery royalty for lease ADL 18731 based on this discovery. The department found that Union and Marathon had adequately established a discovery date of May 23, 1965, and that the potential test conducted on June 17, 1965, had established that the Trading Bay No. 1-A well was capable of producing commercial quantities. The department also found that the Trading Bay feature was a separate structure. The application for this discovery award was processed and certified on August 27, 1965.

3. Application for a discovery royalty certification of the Grayling No. 1-A well.

Union and Marathon drilled two more wells from locations on lease ADL 18731 after the Trading Bay No. 1-A discovery. In the late summer of 1965 the drilling barge which had been used to drill these wells was moved to lease ADL 17594 immediately to the south, also a Union-Marathon lease. Union commenced the Grayling No. 1 well here on September 2, 1965. As a result of mechanical problems encountered in the early stages of drilling, the well had to be plugged and abandoned at a depth of 817 feet.

Grayling No. 1-A was commenced immediately and tested for commercial quantities from November 6 to November 8, 1965. An application for discovery royalty certification was submitted on November 15 and amended on November 19. Oil and gas sands were encountered intermittently in this well from depths of 3,305 feet to 9,770 feet, including a 400-foot pay interval from 9,370 to 9,770 feet in the Hemlock zone.

The department found that the date of discovery for the Grayling No. 1-A well was October 24, 1965, and that commercial quantities had been encountered within the Hemlock zone. However, for the first time since the discovery royalty program was commenced, there was a serious question as to whether the discovery had been made on a new geologic structure. The decision issued on January 26, 1966, concluded:

> Insufficient subsurface information exists to determine that the McArthur River feature on which the Grayling No. 1-A well is located is not overlapped by the previously certified Trading Bay geologic feature. Thus, the well does not satisfy the requirement for being a discovery well on a geologic structure previously uncertified, and the application on the Grayling No. 1-A well is hereby denied.

On February 10, 1966, a meeting took place in Anchorage between Union-Marathon officials and department officials to discuss the decision denying Union-Marathon's request for discovery certification. In one meeting Tom Marshall of the division of mines and minerals told Union-Marathon officials that he was concerned about the possibility that shallow productive sands continuously overlaid both the Trading Bay structure and the Grayling structure. Marshall also told one of the oil company representatives that his view of the McArthur River application relied heavily on the "dominant structure concept" referred to in USGS Circular 419. Another meeting was held with Erle Mathis, chief of the minerals section of the division of lands, who encouraged Union and Marathon to request time to submit additional evidence.

On February 14, 1966, Union filed a document with the division of lands entitled, "Petition for Reconsideration and Interpretation of Decision of the Director of the Division of Lands Dated January 26, 1966, in the Matter of Discovery Well Certification Grayling No. 1-A well -- ADL 17594." In this petition Union requested that applicable regulations be interpreted to permit Union to submit additional and supporting information at a later time or to allow reconsideration by the director of his decision on the basis of additional supporting information then available, including evidence satisfying the criteria used for the determination of geologic structures by the USGS in administering the Mineral Leasing Act of February 25, 1920.

Erle Mathis prepared a proposed decision responding to Union's petition. He conferred with Tom Marshall about it before sending it to the commissioner. The proposed decision denied Union's request for reconsideration on the ground that the state's oil and gas leasing regulations would not permit it. However, the proposed decision permitted Union to submit any additional supporting information and authorized an award of discovery royalty if that information established that Grayling No. 1-A was on a separate geologic structure. This proposed decision was never issued.

Beginning on February 16, 1966, Tom Marshall provided Jim Williams, director of the division of mines and minerals and chairman of the Oil and Gas Conservation Committee, with a series of reports regarding his February 11 meeting with Union-Marathon. In these reports Marshall stated that the discussion was limited to the state's interpretation of the definition of geologic structure and that USGS Circular 419 was the principal basis used for determining geologic structure. He outlined a number of problems regarding the definition of geologic structure, including the complicating effects of stratigraphically controlled production, dominant structure, trends of folding, the interpretation and accuracy of seismic records, and the absence of subsurface data.

In his reports Marshall reiterated that the main problem with the Grayling application was the occurrence of undefined stratigraphic traps in the shallow horizons. He felt that it would be a mistake to award a discovery royalty for the Grayling well before the extent and continuity of those traps were known. He mentioned the other problem of determining how much vertical displacement along faults is required to separate geologic structures, and wondered what development of the field

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would provide sufficient subsurface information to resolve this problem.

Marshall also said that the procedures used by the USGS in determining KGSs were discussed and that the point was made that the state regulations did not allow the state to make a tentative determination regarding geologic structure, unlike federal regulations which allowed federal officials to delineate an undefined KGS. He noted that state officials were without the benefit of surface geology available to persons working in uncovered upland areas. He explained that the USGS makes its final KGS determination after an evaluation of all controlling factors, but that like information was not available to the state with respect to the Trading Bay and McArthur River areas at this time.

On March 2, 1966, the commissioner of natural resources responded to Earl Mathis' suggested reply to Union-Marathon's petition for reconsideration. In his response the commissioner concluded that there were two separate geologic structures present, but expressed concern about the problem of one lease covering a portion of two separate structures -- an entirely different issue than that being dealt with by Marshall, Williams, and Mathis. He felt that the time limit imposed by the regulations could be circumvented if the petition were accepted by the commissioner rather than the division of lands, thus enabling a study of the problem to be made. He also indicated that the attorney general had been requested to review the question of whether a five percent royalty would apply to the entire lease if a discovery well were drilled in a new structure where the area of the lease also covered a second structure that had been previously certified as a discovery on a different lease. It is apparent from this opinion request that the commissioner was concerned with lease boundaries (the legal interpretation of the words "all production from the lease") rather than a question involving the boundaries of a geologic structure.

On August 26, 1966, an opinion was issued by the attorney general's office which resolved the question of lease boundaries. The conclusion was that all production from the lease should enjoy the benefits of discovery royalty even though it were derived from a structure which was previously the subject of a discovery royalty on another lease. However, the principal questions of whether or not Trading Bay and McArthur River were separate structures was not addressed by this opinion.

There was no further active consideration of the Union-Marathon application until 1968.

4. Discovery royalty certification of the Nicolai Creek State No. 1 well.

Because the term of the leases issued in the seventh and ninth competitive sales was five years, there were a large number of wells drilled and several discovery well certification applications filed in the 1966 drilling season.

The first discovery royalty request in the 1966 drilling season came for a well drilled by Texaco -- Nicolai Creek State No. 1. Texaco had spudded this well in the fall of 1965. On May 23, 1966, Texaco submitted evidence in support of an April 28, 1966, priority date. In early May the well was tested and found to be capable of producing commercial quantities of gas. Texaco applied for discovery well certification on June 13, 1966, which was approved on August 19, 1966.

5. Discovery affidavit for the SAS Foreland Channel State No. 1 well.

On June 10, 1966, Shell (on behalf of itself, Standard Oil of California, and Atlantic Richfield) filed an affidavit of first discovery for the SAS Foreland Channel State No. 1 well. No potential tests were conducted on this well, and no discovery certification application was filed.

6. Discovery affidavit for the Pan Am North Redoubt Well No. 1.

Pan Am drilled the North Redoubt Well No. 1 for the Pan Am group in the spring and summer of 1966. According to the affidavit filed on June 23, 1966, the depth in that well corresponded very closely to the Hemlock discovery in Union's Grayling No. 1-A well. Although geologic structure boundary information and evidence of commercial quantities were submitted in early September, Pan Am did not actually apply for discovery royalty certification.

7. Application for discovery royalty certification of the Kustatan No. 1-A well.

Meanwhile, Union had been drilling the Kustatan No. 1 well on Union-Marathon's lease ADL 18729, immediately to the south of their Grayling lease. This well was drilled to 11,600 feet during April, May, and June 1966. Union filed affidavits to establish priority of time and date of discovery for this well. During the period August 5 to 7, 1966, a commercial quantities test was witnessed by the state. On September 6, 1966, Union formally applied for discovery certification. One week later Union withdrew the application pending submission of additional information, which was submitted on October 7, 1966. Union withdrew this application in December 1966 before any action on it had been taken by the department.

8. Application for discovery royalty certification of the West Foreland Unit No. 3 well.

Atlantic Richfield drilled the West Foreland Unit No. 3 well on lease ADL 18777 into the upper left arm of the McArthur River Hemlock reservoir. On August 3, 1966, an affidavit of first discovery was filed in support of a July 25, 1966, discovery date with the Oil and Gas Conservation Committee. A commercial quantities test was conducted on August 16, 1966.

On September 28, 1966, Atlantic Richfield submitted its geologic structure boundary evidence to the Conservation Committee. In an explanatory letter which accompanied this evidence, Atlantic Richfield explained why it believed the Hemlock reservoir, in what it labeled the "Foreland Field," was separate from the Hemlock reservoir encountered by Union in Grayling No. 1-A. The explanation claimed that a barren syncline separated the Hemlock field encountered by the Grayling 1-A well from that encountered by the West Foreland Unit No. 3 well and that the hydrocarbon accumulation in the McArthur River structure was not in communication with that of West Foreland No. 3.

On September 30, 1966, Atlantic Richfield formally applied to the division of lands for certification of discovery royalty of the West Foreland Unit No. 3 well. On the basis of this submission, there was further discussion within the department on the definition of geologic structure and whether the concept of dominant structure, originally advanced by Tom Marshall from USGS Circular 419, was the best interpretive approach to solving this issue.

On December 9, 1966, a decision was issued by the director of the division of lands denying Atlantic Richfield's request for discovery royalty certification on the ground that the well was on the Greater Trading Bay structure for which a discovery royalty had been previously awarded. He made this decision notwithstanding the fact that the earlier denial of Union-Marathon's application was on the basis that there was insufficient evidence to determine whether the Trading Bay and McArthur River features were separate structures. On December 30 Atlantic Richfield filed a petition for reconsideration of the director's decision. There was discussion within the department on whether and when to consider the petition for reconsideration (Atlantic Richfield was in favor of delay until further information from drill reports from subsequent operations became available). Like the Union-Marathon request for reconsideration, there is no indication in the record that any thought was given to the matter until a year later.

9. Application for discovery royalty certification of Texaco's Trading Bay State No. 1 well.

In the late summer of 1966 Texaco, on behalf of itself and Superior Oil Company, commenced the Trading Bay State No. 1 well on lease ADL 17597. On September 27, 1966, the well was tested for commercial quantities. This test also served as the basis for an affidavit of first discovery. The well was drilled through the oil bearing zones in both the Kenai and Hemlock formations.

On March 7, 1967, denial of Texaco's application was issued by the director of the division of lands on the grounds that the well was not capable of producing oil in commercial quantities and that it was located on the Greater Trading Bay structure on which discovery certification was previously granted.

10. Application for discovery royalty certification of Atlantic Richfield's Trading Bay State No. 1 well.

Another discovery was claimed in the McArthur River-Trading Bay area in the summer of 1967. This claim was made by Atlantic Richfield for the Trading Bay State No. 1 well on lease ADL 34531. According to the affidavit of first discovery, evidence of first discovery was encountered in the well on June 7, 1967. The well was drilled into the Hemlock accumulation north of the McArthur River Hemlock reservoir on the downthrown side of the Trading Bay fault. Atlantic Richfield named this accumulation the Ivan Bering Field. A commercial quantities test was conducted on June 25, 1967. Application for discovery royalty certification was filed on September 27, 1967. The application was then considered by state officials.

The decision of the Oil and Gas Conservation Committee issued to the division of lands recommended that certification be denied on the ground that drilling the Trading Bay State No. 1 well had not resulted in the first discovery on a new geologic structure. The relevant portion of the committee's decision stated:

> Section 505.744 - Establishment of Geologic Structure: It is the opinion of the Oil and Gas Conservation Committee that the Ivan Bering Field discovered by the Trading Bay State #1 well is controlled by a fault or faults associated with the Greater Trading Bay Structure. Inasmuch as a discovery royalty was previously awarded to the Trading Bay Structure, the Committee does not consider that the Trading Bay State #1 well is the first discovery on the dominant geological structure.

On December 7, 1967, the decision denying Atlantic Richfield's application for discovery royalty certification of the Ivan Bering field was issued. By letter dated December 21, 1967, Atlantic Richfield requested reconsideration of the decision rejecting their application and permission to submit additional data. This petition was supplemented on December 28, 1967.

11. Application for discovery royalty certification for Redoubt Shoal No. 2.

There was one more discovery well certification application considered by the state for a well drilled in the Trading Bay vicinity. In the summer of 1968, Pan American drilled Redoubt Shoal Unit No. 2 well on lease ADL 29690. This well was drilled into a Hemlock accumulation 4 1/2 miles south of the McArthur River Hemlock reservoir. An affidavit to establish priority of discovery was filed in early October 1968. The formal application for discovery certification was filed on November 12. The committee concluded that commercial quantities had been encountered but that the Redoubt Shoal feature was a downfaulted nose subsidiary to the Trading Bay dominant geologic structure which had been previously awarded a discovery royalty. Pan American filed a notice of appeal to the superior court on February 19, 1969, but the appeal never proceeded to a disposition on the merits.

12. Reconsideration of the Grayling No. 1-A, West Foreland Unit No. 3, and Atlantic Richfield Trading Bay State No. 1 applications for discovery royalty certification.

Atlantic Richfield's application for reconsideration of the denial of discovery royalty certification for the discovery in the Ivan Bering field prompted Pedro Denton, chief of the minerals section of the division of lands, to change his mind about how much time should be given to discovery certification applicants to prove the boundaries of geologic structures. On January 29, 1968, he wrote to then Commissioner Thomas E. Kelly that the cutoff period established by the regulations provided a reasonable time period, that holding discovery royalty applications in abeyance would cause serious financial administrative problems, and that no evidence gathered after the time limit should be accepted. He was concerned that if the period were unlimited, some companies would continue to demand refunds or credit many years after the ten year term from first encounter had expired, with severe adverse effects on state fiscal planning.

On October 31, 1968, the commissioner sent out three decisions with respect to these three long-standing discovery royalty applications, Union-Marathon's Grayling 1-A (ADL 17594), ARCO's West Foreland No. 3 (ADL 18777) and ARCO's Trading Bay State No. 1 (ADL 35431). Each of these decisions provided as follows:

1. On the basis of the information available at this time, the Director's decision was proper.
2. Adequate time has been allowed the applicant to submit supporting information as requested in their petition for reconsideration.
3. That applicant's request for an opportunity to submit supporting information is reasonable.

> Therefore, the applicant is granted 60 days from receipt of this decision in which to supply supporting information or to schedule a hearing at a time mutually agreeable to the state and the applicant. If no supporting information or hearing is scheduled within the time allowed, the Director's decision will be affirmed.

Atlantic Richfield filed a letter, three exhibits, two enclosures, and a copy of the notice describing the well tests ending July 1, 1967, with Commissioner Kelly in response to these decisions on December 26, 1968. The letter suggested a meeting with state officials to discuss and develop technical data supporting the application. The technical data submitted with this letter included Exhibit 1, an evaluation of mechanical logs; Exhibit 2, a structure contour map; Exhibit 3, a structural cross section A-A[1]; Enclosure 1, well completion information drafted on an electric log; and Enclosure 2, a core analysis -- cores 1-10. They all pertained to lease ADL 34531 and the Ivan Bering field and purported to show that the field was on a separate structure from both the Trading Bay and McArthur River fields. Atlantic Richfield filed nothing with respect to lease ADL 18777 and the West Foreland Unit No. 3 well. These letters were followed up on January 26, 1968, with a legal brief from Theodore F. Stevens and Russell H. Holland, representing Atlantic Richfield. The brief was almost word-for-word the same as the one filed a year earlier in support of Atlantic Richfield's discovery royalty application for the West Foreland Unit No. 3 well.

On December 30, 1968, Union supplemented their application for certification of the Grayling No. 1-A well by filing a blue box which was labeled, "Appendix Geologic Reports and Exhibits." In the box were maps and exhibits and a narrative interpretation explaining the maps and exhibits. Union requested that the matter be set for a hearing at the earliest possible time.

On January 9, 1969, Pedro Denton forwarded to the commissioner his arguments on why the 90-day time limit on geologic structure information ought to be strictly enforced.

On February 7, 1969, Atlantic Richfield was notified that the decision of December 9, 1966, denying discovery certification of the Foreland field was affirmed because no additional information had been submitted.

On June 5, 1969, the Oil and Gas Conservation Committee informed the director of lands that they had reviewed the documents and exhibits submitted to the division of lands on December 30, 1968, and found that this additional information did not warrant a change in the committee's original decision dated January 1, 1966. This letter was signed by Tom Marshall and O. K. Gilbreth, Jr. The results of the review were never forwarded to Union-Marathon.

No further action was taken on either Union's or ARCO's application until February 26, 1970. At that time the commissioner sent out decisions to both Atlantic Richfield and Union-Marathon establishing hearing dates of April 16, 1970, and April 17, 1970, for the pending certification applications. In this notice Commissioner Kelly notified both sets of applicants that his review would be limited to information which was filed within the original 90-day period.

The Atlantic Richfield hearing was conducted on April 16, 1970. At the hearing additional information was presented to show that the Ivan Bering field was one of several entrapping mechanisms on separate structures, each of which should be entitled to discovery royalty certification.

The Union-Marathon hearing was conducted on the next day. At this hearing Union and Marathon introduced a light blue folder full of new exhibits corresponding with Volumes 1 and 2 of the exhibits later submitted on September 28, 1969.

On June 8, 1970, Union-Marathon sent Commissioner Kelly a letter stating the legal reasons why he should look at the after-acquired evidence. Pedro Denton then sent the commissioner a copy of his January 7, 1969, notes which argued that after-acquired evidence should be disregarded.

In August of 1970 the Conservation Committee sent Commissioner Kelly a memorandum which concluded that the original Union-Marathon decision was correct. Pedro Denton then drafted a decision to send to Union-Marathon which contained a lengthy justification for disregarding the after-acquired evidence. The commissioner did not sign Pedro Denton's proposed decision. Rather, he signed a final decision prepared by the Attorney General's office. This decision, again denying Union-Marathon's application for discovery certification, was sent on October 7, 1970.

On November 5, 1970, the chief of minerals forwarded to the commissioner for signature a proposed decision denying Atlantic Richfield's discovery royalty application for ADL 35431. The commissioner signed the decision on December 3, 1970, and the decision was sent to Atlantic Richfield.

13. Judicial review of the decisions denying discovery royalty for Union's Grayling No. 1-A well and Atlantic Richfield's Trading Bay State No. 1 well.

Both Union-Marathon and Atlantic Richfield appealed to the courts. Union and Marathon sought review of the commissioner's October 7, 1970, decision in the superior court, which remanded the matter to the commissioner for a new decision including a statement of the basis for the decision. The commissioner issued a decision on February 17, 1972, denying discovery well certification on the grounds that insufficient information had been submitted within the 90-day period prescribed by the regulations to determine whether the Grayling well was on a separate geologic structure and that evidence submitted after the 90-day period could not be considered. The companies again sought review in the superior court which dismissed the appeal on the ground that the court lacked jurisdiction. Union-Marathon then lodged their first appeal with the supreme court, which reversed and remanded the matter for further consideration. Union Oil Co. of Cal. v. State Dept. of Nat. Resources, 526 P.2d 1357 (Alaska 1974).

On remand, the superior court affirmed the administrative decision and concluded that the commissioner could not legally consider the after-acquired evidence offered by the applicants, that the commissioner had not granted them the right to submit after-acquired data, and that the director's decision denying discovery royalty certification was clearly sustained by the evidence. Union-Marathon appealed to the supreme court for the second time. The court concluded that the commissioner could legally consider after-acquired evidence and remanded the matter to the commissioner for a determination of the reasonableness of the 90-day limit and to receive additional data and rule upon the basis of all data submitted if, under the circumstances, the limit were found to be unreasonable.. Union Oil Co. of

Cal. v. State Dept. of Nat. Resources, 574 P.2d 1266 (Alaska 1978).

The Atlantic Richfield case was stayed in the superior court by stipulation pending resolution of the Union-Marathon application. Atlantic Richfield Co. v. State Dept. of Nat Resources, No. 3AN-70-3789 Civ.

VI. THE 90-DAY LIMITATION.

In its 1978 decision the supreme court addressed the question of whether the commissioner has the power to consider new evidence of geologic structure which is supplied after the 90-day deadline established by 11 AAC 505.744 (recodified as 11 AAC 83.210(c) (repealed November 9, 1979). The court concluded that the unreasonableness of the 90-day limitation could not be answered on the basis of the record before it. Therefore, it ordered that Union-Marathon be given the opportunity on remand to demonstrate that the 90-day limitation, as applied to them in this case, was unreasonable.

In its decision the supreme court discussed some of the factors which are pertinent to a determination of whether the 90-day requirement should be waived in this case. 574 P.2d at 1272-74. These factors included the advantages of finality, the desire for stability, the importance of administrative freedom to reformulate policy, the extent of party reliance upon the first decision, the degree of care or haste in making the first decision, and the general equities of each problem, among others.

I determined this issue without affording Union-Marathon the opportunity to demonstrate that the 90-day limitation, as applied to them was unreasonable. My consideration of the factors raised by the supreme court led to my conclusion that I should waive the 90 day limitation and consider data submitted after that period where that data contains evidence of facts in existence at the time the original decision was made. I reached that conclusion for the following reasons.

1. Prompt adjudication of discovery royalty applications was of some importance given the incentive nature of the discovery royalty program. Early decisions on awards would tend to maximize the incentive from the standpoint of applicants and other lessees. Delays in processing applications would have diluted the incentive were they to become a consistent pattern. However, most of the applications were relatively routine. Therefore, permitting occasional delays for the submission of additional evidence on unusually difficult applications would not have significantly dampened the incentive. Moreover, the state experienced no trend in false submissions requiring expeditious denial as an enforcement mechanism.

2. Agencies often request additional specified information if the information in the original submittal is not sufficient to provide grounds for a firm decision. In this case, the applicable regulations plainly did not guarantee conclusive determinations in every instance because the evidence in support of a geologic structure determination was largely left to the discretion of the applicant. For example, 11 AAC 83.210(c) (repealed November 9, 1979)*/ states that this evidence may include the "operator's interpretation" of geophysical and other specified data in addition to the data itself. Other than a definition of the term "geologic structure," there are no set criteria establishing the guidelines for the state's decision. 11 AAC 83.200 - 11 AAC 83.230 (repealed November 9, 1979).**/ The exercise of some latitude in the handling of each application is therefore implicit in the content of these regulations. Under the circumstances, an extension of time to submit additional evidence would not be considered unusual as a matter of agency practice. Moreover, the supreme court strongly suggested that there would be no prejudice to the public interest in considering data obtained after the 90-day period where the data (in this case subsurface geology) would not change over time. See 574 P.2d at 1273.

*/ Formerly 11 AAC 505.744.

**/ Formerly 11 AAC 505.74 -- 11 AAC 505.741.

3. During the early years of the discovery royalty program in Cook Inlet, the government had little or no information other than the data submitted by the applicant. In the case of the Grayling No. 1-A application, Union-Marathon submitted during the 90-day peiod unusually complete information which included a cross-sectional interpretation of the data. It was this cross section which led Tom Marshall to postulate a possible overlap in the shallow Middle Kenai sands extending into the Trading Bay feature. See Section V.F.3 above. This was only an hypothesis; later-acquired evidence proved it to be incorrect. Nevertheless, Marshall's hypothesis led the department to deny the discovery royalty application on the ground that insufficient subsurface information existed to determine that the McArthur River feature was not overlapped by the previously certified Trading Bay geologic structure.

It is only logical to permit the submission of additional evidence when (1) the applicant submitted unusually detailed information originally, (2) the information generated possible doubt about the validity of the application but could not be proved, (3) the government could only deny the application based on insufficient (rather than contrary) evidence with in the 90-day period, and (4) the regulatory requirements governing submission of evidence were vague and judgmental. In order to establish procedural finality, the government could have set a cutoff date for any further evidence. However, while

Union-Marathon appealed the initial denial of January 26, 1966, on February 4, 1966, the Department took no action at all for 2½ years, at which time it granted Union 60 days to submit more information. On December 30, 1968, Union submitted additional information and requested a hearing.

The department did not hold a hearing until April 17, 1970, almost five years after the 90-day period had elapsed. Half a year after the hearing, on October 7, 1970, the commissioner summarily affirmed the original decision. His decision was appealed to the superior court, which remanded the matter to the commissioner for a new decision, including the basis for the decision. On February 17, 1972, the commissioner denied certification on exactly the same grounds as the original 1966 decision, namely that insufficient information was submitted during the 90-day period to determine whether Grayling No. 1-A was on a separate structure.

In summary, although the state's decision not to consider evidence beyond the 90-day period may initially have been reasonable, by virtue of its subsequent behavior it has waived any opportunity to confine additional evidence to a limited period. Further, the discovery royalty program was repealed in 1969, so there is a limited potentially adverse precedent to consider.

Therefore, it is appropriate to consider all geologic evidence submitted by Union-Marathon in conjunction with this case to determine whether they are entitled to a discovery royalty on the grounds that the McArthur River feature is a separate geologic structure from the previously certified Trading Bay geologic structure.

VII. GEOLOGIC STRUCTURE.

A. Applicable Law.

At the time that Union-Marathon applied for discovery well certification of their Grayling No. 1-A well, the holder of a state oil and gas lease that drilled and made the first discovery of oil or gas in commercial quantities in a geologic structure could be rewarded by paying a discovery royalty of only five percent for the first ten years, after which the normal rate (12 1/2 percent of the value of the oil and gas produced) was applicable. AS 38.05.180(a). The pertinent portion of AS 38.05.180(a) provided:

> . . . the holder of a lease who drills and makes the first discovery of oil or gas in commercial quantities <u>in a geologic structure</u> shall pay a royalty on all production under the lease of five per cent for 10 years following the date of discovery and thereafter the royalty rate shall be not less than 12 1/2 per cent.

(Emphasis supplied.)

The regulations contained at 11 AAC 83.230 (repealed November 9, 1979) (formerly 11 AAC 505.74--11 AAC 505.748) specified the procedures for proving the three elements required by AS 38.05.130(a) for discovery well certification: date of discovery, commercial quantities, and geologic structure. 11 AAC 83.210(c) (repealed November 9, 1979) (formerly 11 AAC 505.744) specified the procedure for establishing geologic structure, the only criterion at issue here. The relevant portion provided:

> To establish the geologic structure from which the oil or gas can be produced, the operator must furnish pertinent data to the committee which will enable it to determine the geologic structure from which the oil or gas is being produced. This may include, but is not limited to, geophysical data, total depth, casing records, perforation data, electric logs, drilling and mud logs, core analyses, sample cuttings and sample logs and the operator's interpretation thereof, together with any other records and interpretations the operator deems pertinent. This data must be supplied within 90 days after the date of the potential test as required in (b) of this section.

Additional guidance was provided by 11 AAC 83.205(2) (repealed November 9, 1979) (formerly 11 AAC 505.741(b)), which defined the term "geologic structure" as:

> any structural and/or stratigraphic entrapping mechanism containing one or more intervals, zones, strata, formations, or fault blocks which has the necessary physical characteristics to accumulate and prevent the escape of oil and/or gas. It is intended that the meaning shall be similar to that

used by the United States Geological Survey in the administration of the Federal Mineral Leasing Act of February 25, 1920 (41 Stat. 437) as amended.

The discovery royalty system was curtailed and finally abolished by legislative amendments in 1967 and 1969. 1967 Alaska Sess. L., ch. 97, §2; 1969 Alaska Sess. L., ch. 65, §1.

B. Historic Background.

In 1959 Alaska was a cash-poor state. At this time, exploitation of the state's oil and gas resources was thought to be the best avenue for remedying this situation. The cash would come from bonuses from lease sales and from royalties from leases producing hydrocarbons in commercial quantities. An active leasing program and aggressive exploration activities by lessees were therefore desired goals. Against this background the state's discovery royalty program (which made its first appearance as section 3(7), article VIII, chapter 169, SLA 1959) was adopted to provide a substantial incentive to oil companies to come to Alaska (which was, at the time of statehood, a frontier area from the standpoint of its oil and gas potential) and conduct exploratory drilling operations for and produce oil and gas on state leased land.

The discovery royalty program was plainly successful. It is obvious from the attention devoted to including the discovery royalty program in the 1959 Alaska Land Act, the active participation of oil companies in the drafting of the discovery royalty regulations, and the disputes among the companies over controversial awards that discovery royalty provided an incentive for oil companies to come to Alaska. It is also evident that the discovery royalty program generated drilling races between competing companies on neighboring leases. Undoubtedly, Cook Inlet would have been explored and developed by the oil companies even without the discovery royalty program. However, the state's discovery royalty program definitely accelerated exploration and development activities on state oil and gas leases, thus helping to satisfy the state's objective of obtaining cash as quickly as possible after statehood to fund the state government and finance the provision of essential public services.

C. Decision Criteria.

In considering the issue of geologic structure, there were several approaches suggested in the course of the hearings which I did not consider a valid basis for determining the issue.

First, I did not use the predeposition approach advanced by Mr. William Van Alen. Under this approach Mr. Van Alen constructed a paleostructure map depicting the greater Trading Bay feature at the time hydrocarbons were deposited in the reservoir rock. This paleostructure map was constructed using all available well data by (1) restoring all fault blocks to the positions they occupied before faulting took place, (2) undoing the effects of compression acting on the structure, and (3) restoring the location of sediments to their original position. The result was that Mr. Van Alen demonstrated the existence of an ancestral Trading Bay anticline dating back approximately 60 million years. The Trading Bay and McArthur River features which exist today evolved from a once undistorted anticline similar in general appearance to that at Middle Ground Shoal. Were I to adopt Mr. Van Alen's approach, I would deny the Union-Marathon application on the ground that both the Trading Bay No. 1-A and Grayling No. 1-A wells penetrated features the origin of which was a single anticline.

I have accepted the accuracy of Mr. Van Alen's paleo-structure map as well as his outstanding analysis of the general development of Cook Inlet geology notwithstanding some contrary interpretations submitted by Union-Marathon. However, I do not believe that the existence of an ancestral Trading Bay anticline is pertinent to this decision. Given the incentive nature of the discovery royalty program, it is my belief that the determination should be made on the basis of the geology as it existed at the time of the alleged discovery, regardless of whether that geology was substantially different at an earlier period in time. Otherwise, the program might not have accomplished its purpose of encouraging the discovery of new geologic structures.

KGS

Second, I did not employ the KGS concept used by the USGS in the administration of the Federal Mineral Leasing Act of February 25, 1920, 41 Stat. 437, as amended, as described further in USGS Circular 419. That the KGS concept is not dispositive of the issue is demonstrated by the conflicting testimony of Emmett Finley and Joseph David "Red" Cerkel, both formerly serving as chief of the Minerals Classification Branch of the USGS, the agency responsible for making KGS determinations.

Based upon well completion reports from the original Trading Bay No. 1-A well, Mr. Finley drew the KGS boundary around the 7000 foot contour (essentially describing the Trading Bay feature). When shown the well completion reports from the other Trading Bay wells and the Grayling No. 1-A well, Mr. Finley stated that USGS practice would have been to extend the KGS boundary to encompass both areas. Thus, his opinion was that only one KGS would have been drawn around the Trading Bay and McArthur River features by the USGS. Mr. Finley adhered to this conclusion even after reviewing Union's after-acquired evidence graphically displaying the best current geologic understanding of the Trading Bay and McArthur River fields.

However, based on the information available at the time of Union-Marathon's discovery royalty application for the Grayling No. 1-A well, Mr. Cerkle testified that he would have placed an undefined KGS around each feature. When presented with the updated information, he testified that it was sufficient to completely define the areas and warranted their formal promulgation as two separate defined KGSs.

Further, Mr. Ed Hall, a witness appearing on behalf of Union-Marathon, systematically reviewed USGS KGS determinations in various oil and gas provinces around the United States and demonstrated conclusively that USGS practice varied substantially from area to area. He proved that either Mr. Finley's or Mr. Cerkle's approach might have been used in this case. Moreover, the KGS concept was used by the USGS to make determinations as to whether lands would be leased competitively or noncompetitively, not for discovery royalty awards. The competitive determination is considerably less crucial than a decision as to whether a lessee is to receive a discovery royalty award, and substantial flexibility in applying the KGS for its original intended purpose is acceptable, since the principal effect is on prospective rather than existing lessees. This may explain why the UGS did not feel compelled to issue Circular 419 until 1959 despite the use of the KGS concept in thousands of competitive/noncompetitive determinations since 1920, and the observation in Circular 419 that no phrase in the 1920 Mineral Leasing Act "has resulted in more speculation as to its precise meaning than the phrase 'known geologic structure of a producing oil and gas field.'" In essence, the KGS concept was far less precise than the task it was expected to accomplish in circumstances such as presented by this case. It worked adequately in obvious cases and not well at all in closer ones. Therefore, while the authors of Alaska's discovery royalty statute and regulations may have intended to follow federal practice, the KGS concept did not provide sufficiently specific criteria to properly found a decision.*/

A third approach which did not present a sufficient basis for determination of this case was the "dominant structure" concept used by the department during the early 1960s on a number of discovery royalty applications. This concept, developed by Thomas Marshall, was used as the basis for rejecting discovery royalty applications filed by Atlantic Richfield for certification of its West Foreland Unit No. 3 and Trading Bay State No. 1 wells, by Texaco for its Trading Bay State No. 1 well, by Amoco for the Redoubt Shoals well, and by Union-Marathon for the Grayling No. 1-A well. All of these applications except the Grayling application were rejected on the basis that the geologic structure on which each well was located was part of the previously certified Greater Trading Bay geologic structure. The Grayling application was rejected on the basis that insufficient

*/ In addition, none of the regulations implementing the Alaska Oil Proviso, the federal counterpart to Alaska's discovery royalty program, ever used the term "known geologic structure of a producing oil and gas field." Rather, like Alaska's discovery royalty provision, the term "geologic structure" was used. There is, therefore, no express application of the Circular 419 KGS methodology contained in either federal or state law governing discovery royalties.

subsurface information existed to determine whether or not the McArthur River feature was overlapped by the Greater Trading Bay structure.

Mr. Marshall testified that this approach was designed to treat essentially intact anticlinal areas as dominant structures for purposes of aggregating discovery royalty applications. It was devised in response to the inherent ambiguity of the discovery royalty statute. The statute provided for the award of a discovery royalty to the first well drilled on a new "geologic structure" which, from the standpoint of geology, could be as large as Cook Inlet or as small as a microfold. Two competing objectives needed to be reconciled in the context of the inherent ambiguity of the statute: (1) the provision of a sufficiently strong incentive to encourage the oil industry to venture expeditiously into a frontier oil and gas province, and (2) the need to avoid a discovery royalty approach which would result in the award of a discovery royalty for every new accumulation of oil that was found.

Generally, the department did an excellent job in the award of discovery royalties; a review of all discovery royalty awards for Cook Inlet shows that only one was made for each major anticline in the Cook Inlet area. Any other approach would have resulted in too few or too many awards to have successfully meshed the competing objectives mentioned above. However, all of the other anticlines in Cook Inlet are relatively intact and undisturbed; the Trading Bay/McArthur River features constitute a geologic exception to the pattern of reservoirs discovered in Cook Inlet. The "dominant structure" concept is simply overly general to provide a conclusive answer to a situation where a once single anticline was subsequently severely compressed, distorted, and offset into two distinct features. As a result, the "dominant structure" concept does not provide a sufficient basis to deny a discovery royalty award solely on a finding that a well is located on the same essentially intact anticlinal area as a previously certified discovery well.

Consequently, in order to determine whether the Grayling No. 1-A well was drilled on the same "geologic structure" as the Trading Bay No. 1-A well, there must be an inquiry based on a common sense analysis of the purposes of the discovery royalty program. I have determined that this inquiry must have two parts:

Predrilling Expectation: Did the lessee's opportunity to drill the Grayling No. 1-A well on the McArthur River prospect, based on the information available at the time the decision was made, constitute a proposition of sufficient risk with respect to the possible discovery of a new reservoir such that the state would wish to encourage it by providing a discovery royalty incentive?

Post-drilling Verification: Did the geologic evidence generated after the Grayling No. 1-A well was drilled tend to confirm the lessee's initial belief that the McArthur River feature was relatively distinct from the Trading Bay feature, and that a decision to drill constituted a risk which should be rewarded by granting the discovery royalty incentive?

The Predrilling Expectation inquiry is necessary because the discovery royalty incentive operates at the time a lessee is faced with a decision to commence a well on a new prospect. If the geologic information then available indicated a magnitude of difference in the characteristics of the Trading Bay and McArthur River features, the potential award of a discovery royalty could substantially influence the outcome of the decision on whether and when to drill the well, which was the purpose of the discovery royalty program.

The Post-drilling Verification inquiry is required to demonstrate that the Predrilling Expectation, as contained in the lessee's geologic interpretation of the area, was not seriously in error as a result of substandard evaluation efforts and that a distinct structure has been discovered.

The Predrilling Expectation factor is important; reliance solely on geologic information acquired long after a well has been drilled to adjudicate an application would render the discovery royalty concept a mere sporting proposition. The Post-drilling Verification factor is equally necessary; inadequate geophysical evaluation at the time of a decision to drill a well could make a gamble out of what would be a virtual certainty for a prudent lessee, and the incentive would be promoting inefficiency. Therefore, both inquiries must be satisfied to justify the discovery royalty award.

D. Analysis

1. Predrilling Expectation. The decision by Union-Marathon to drill the Grayling No. 1-A well was accompanied by sufficient risk with respect to discovery of a new major reservoir, given the information available at the time, as to justify the provision of an incentive by the state, for the following reasons:

a. Union-Marathon's recognition of the existence of two separate features in the Trading Bay area resulted from data provided by their 1959 offshore seismic survey of Cook Inlet. The results of offshore gas exploder seismic surveys conducted in 1960-1961 in preparation for a 1961 state lease sale further defined these two structures. At this time, the companies assigned separate code names to both prospects. Although evidence indicated that Union-Marathon was aware of the discovery royalty implications inherent in the designation of two structures rather than one collective Trading Bay structure, it is apparent that the companies considered these separate features with differing characteristics. Mr. Richard Lyon testified that the seismic data on the Trading Bay feature consistently showed a sharply defined and attractive potential entrapping mechanism. The data for McArthur River, however, was less consistent. While indicating the presence of an anticline which might be a considerable reservoir, the anticline was shallow and less well defined with a substantial possibility that insufficient closure existed to contain any hydrocarbons which might have been produced. As a result, Union-Marathon bid ten times the bonus money to acquire the tract overlying the Trading Bay feature as it did for the tract covering the McArthur River feature.

b. Seismic work done in 1963 and 1964 further defined these two prospects and was used to locate sites for test wells. Predrilling interpretations of this seismic data showed the existence of two features separated by faulting and a syncline at both the shallow and deep horizons. In 1964 separate AFEs (authorizations for expenditure) were prepared for management approval of the test wells to be drilled on each geologic prospect. Mr. Lyon testified that the presence of a discovery royalty provided him with additional support within his company in the competition to obtain AFEs for both wells.

c. In 1965 three wells (including the Trading Bay No. 1-A discovery well) were drilled to locate the accumulation limits of the Trading Bay structure and to define the boundaries of the Trading Bay structural trap. While the Trading Bay discovery did confirm that the Hemlock was a producing zone within at least part of the collective Trading Bay area as it was elsewhere in Cook Inlet, the evidence of substantial faulting between Trading Bay and McArthur River (and therefore the likelihood of noncommunication between any productive zones) was, if anything, reinforced. Moreover, doubts regarding closure of the McArthur River anticline were in no way diminished.

d. While it may have been logistically convenient for Union-Marathon to move its drilling barge south from Trading Bay to drill the Grayling No. 1-A well, Tom Marshall testified that this action definitely represented a stepping out by Union-Marathon into an area of very considerabl~~y~~e uncertainty. It must be remembered that the seismic data and even well data at this point were very scarce and relatively unreliable. Moreover, all of the wells in this area were offshore, and there was no surface geology which could be used to assist in confirming seismic data interpretations. Most important, although it is difficult to appreciate now that platforms are a routine part of the landscape, Cook Inlet was a frontier area during the years shortly after statehood. With the presence of ice, severe tides, and highly adverse weather conditions, there was no assurance that the area would be successfully developed even if hydrocarbons were present. It was viewed, therefore, much as the Beaufort Sea or the Chukchi Sea are looked at now as potential oil and gas provinces.

e. While the Hemlock zone which produced oil at Trading Bay was considered prospective, Union-Marathon were more attracted by structures at shallower horizons. Thus, the prime target with respect to potential reservoir rock was different at McArthur River than at Trading Bay, increasing the risk factor.

f. In summary, the McArthur River prospect was very much the type that the state would have wanted to have explored. The area was definitely doubtful despite a discovery at Trading Bay, but the potential returns were large given the size of the prospect. Seismic data existing at the time before the drilling of the area indicated two separate prospects of considerably different characteristics and risk, and would have been so viewed by any competent lessee. Under these circumstances, the application of an incentive to obtain early and expeditious drilling of the McArthur River prospect was plainly in the state's interest.*/

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*/ Whether the discovery royalty program actually caused or influenced Union-Marathon's decision to drill the Grayling 1-A well is irrelevant. To deny an award based on the fact that the particular lessee would have drilled the well anyway for its own reasons would be unjustly punitive. The question is whether there was sufficient risk or doubt regarding success that the state would have wanted to encourage an affirmative decision to drill.

2. <u>Post-Drilling Verification.</u> The after-acquired evidence submitted by Union-Marathon demonstrates that the situation occurring at the Pre-Drilling Expectation stage was as perceived, and that the risk involved at the time justified the application of the discovery royalty incentive. In fact, the after-acquired evidence substantiates that the separateness and differing characteristics of the respective reservoirs was somewhat greater than believed in 1965. This conclusion is warranted by the following factors:

a. Evidence presented by the applicant demonstrates that there is no overlap in any gas or oil formation between the Trading Bay and McArthur River features.

b. The extensive number of wells drilled in the intervening area between the Trading Bay and McArthur River features establishes that there is no communication between hydrocarbon accumulations in either of the features.

c. Although both the Trading Bay and McArthur River features possess oil bearing sands in the Hemlock formation, there are both gas (above D zone) and oil (West Foreland) producing horizons in the McArthur River feature which are not present in the Trading Bay feature.

d. The geochemistry for McArthur River hydrocarbons differs significantly for parafins, aromatics, and napthenes from that discovered at Trading Bay.*/

e. The area between the Trading Bay and McArthur River features is transected by a massive strike slip fault. The area within the Trading Bay feature which at the time of the ancestral anticline was opposite the McArthur river featureis now 3 1/2 miles to the east. Moreover, there is a very large displacement of the Hemlock zone to the extent that it is 3,500 feet deeper in McArthur River than in the Trading Bay feature.

It is the last factor which is most persuasive. When looking at the oil and gas fields discovered in Cook Inlet, they are nearly all readily discernable and intact anticlines with primarily a single defined reservoir within each. One discovery royalty was awarded for each of these anticlines. While nearly all of these anticlines contain some local faulting, no discovery royalty was awarded before or after the Grayling 1-A well on the

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*/ While the applicant claimed that this resulted from different geologic origins of Trading Bay and McArthur River, it is my opinion that the McGoon and Claypool report (referenced in Exhibit 1 to Mr. Van Alen's testimony) is more likely correct. It is their belief that variations in geochemistry resulted from differing bacterial deterioration rates of accumulated hydrocarbons during the post-deposition stage rather than from a totally different geologic origin in the context of source rock. However, this does not affect my conclusion that the once existing Trading Bay ancestral anticline developed into two very distinct structures.

AGO 1341646

basis that local faulting created separate structures (in fact, most applications initially filed on this basis were later withdrawn). The greater Trading Bay/McArthur River area, however, is the one heavily distorted and displaced anticline in Cook Inlet, the only one in which major oil accumulations are divided by a large regional fault (in fact, the only regional fault present in Cook Inlet), and substantially offset in vertical distance as well.

In the context of Cook Inlet geology, the pattern of discovery royalty awards, the purpose of the discovery royalty system, and the potential risk of drilling on the McArthur River feature (which appeared very different from the Trading Bay feature before drilling and was confirmed to be very different after drilling) justifies the conclusion that (1) both the Predrilling Expectation and Post-drilling Verification analyses confirm the propriety of applying a discovery royalty from the standpoint of the purpose of the program, (2) McArthur River is, therefore, a separate geologic structure from the structure at Trading Bay within the meaning of the discovery royalty statutes and regulations, and (3) Union-Marathon is, therefore, entitled to a discovery royalty award for all production from lease ADL 17594.

Dated August 10th, 1982, in Juneau, Alaska.

Geoffrey Haynes
Deputy Commissioner
Department of Natural Resources

APPENDIX 1

3 pages

Fax to: Annette c/o Sen. Leman 3810
From: Brian / Leg. Library

Original sponsor: The Rules Committee
Request of the Governor

Offered: [illegible]/10/69

IN THE SENATE BY THE COMMERCE COMMITTEE

CS FOR SENATE BILL NO. 81

IN THE LEGISLATURE OF THE STATE OF ALASKA

SIXTH LEGISLATURE - FIRST SESSION

A BILL

For an Act entitled: "An Act relating to oil and gas leases; and providing for an effective date."

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

Section 1. AS 38.05.180(a) is amended to read:

(a) All tide and submerged lands, mental health lands, school lands, and university lands shall be leased by competitive bidding, and whenever oil or gas is discovered in commercial quantities, the commissioner shall determine the extent of the area of lands in addition to tide, submerged, mental health lands, school, or university lands in the same general area of the discovery well which, by reason of the discovery, the commissioner reasonably believes to be capable of producing oil or gas, and the additional lands shall be leased to the highest responsible qualified bidder by competitive bidding under general regulations, in units of not exceeding 2,560 acres (except that tide and submerged lands shall be leased in units of not exceeding 5,760 acres), which shall be as nearly compact in form as possible, upon the payment by the lessee of such bonus as may be accepted by the commissioner and of such royalty as may be fixed in the lease which shall not be less than 12 1/2 per cent in amount or value of the production removed or sold from the lease. [HOWEVER, 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 PER CENT FOR 10 YEARS FOLLOWING THE DATE OF DISCOVERY AND THEREAFTER THE ROYALTY RATE SHALL BE NOT

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LESS THAN 12 1/2 PER CENT, PROVIDED, HOWEVER, THAT THE ROYALTY RATE FOR THE FIRST DISCOVERY IN ANY UNPROVEN AREA OF THE COOK INLET SEDIMENTARY BASIN SHALL NOT BE LESS THAN 12 1/2 PER CENT UNLESS THE COMMISSIONER SPECIFICALLY PROVIDES THAT SUCH ROYALTY SHALL BE LESS AT THE TIME SUCH LANDS ARE OFFERED FOR LEASE AND IN NO EVENT SHALL SUCH ROYALTY BE LESS THAN FIVE PER CENT.] All lands other than those above provided to be leased by competitive bidding may be leased competitively or noncompetitively as determined by the commissioner to be in the best interests of the state. Noncompetitive leases shall be issued in units of not exceeding 2,560 acres in any one lease. Noncompetitive leases shall be conditioned upon the payment by the lessee of a royalty of 12 1/2 per cent in amount or value of the production removed or sold from the lease. [HOWEVER, 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 PER CENT FOR 10 YEARS FOLLOWING THE DATE OF DISCOVERY AND THEREAFTER THE ROYALTY RATE IS 12 1/2 PER CENT.] Competitive leases issued under this subsection shall be for 10 years <u>except that in the Cook Inlet sedimentary basin, leases shall be for a primary term of not more than 10 years and not less than five years at the discretion of the commissioner,</u> and shall continue so long thereafter as oil or gas is produced in paying quantities. Noncompetitive leases issued under this subsection shall be for a primary term of five years and shall continue so long thereafter as oil or gas is produced in paying quantities. If drilling has commenced on the expiration date of the primary term of the lease and is continued with reasonable diligence, such operations to include redrilling, sidetracking or other means necessary to reach the originally proposed bottom hole location, the lease shall continue in effect until 90 days after drilling has ceased and for so long thereafter as oil or gas is produced in paying quantities. If all or part of the lands covered by the lease are lands that have been selected by the state under laws of the United States granting lands to the state and a patent has not been issued thereon, a conditional lease may be issued. However, no term extension may be granted for the period during which the lease was conditional.[CONDITIONAL LEASE WAS ISSUED THEREON, THE TERM OF THE LEASE SHALL BE EXTENDED FOR A PERIOD EQUAL TO THE PERIOD DURING WHICH THE LEASE WAS CONDITIONAL]

* Sec. 2. This Act takes effect on the day after its passage and approval or on the day it becomes law without approval.

LAWS OF ALASKA

1969

Source	Chapter No.
CSSB 81 am H	65

AN ACT

Relating to oil and gas leases; and providing for an effective date.

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

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

(a) All tide and submerged lands, mental health lands, school lands, and university lands shall be leased by competitive bidding, and whenever oil or gas is discovered in commercial quantities, the commissioner shall determine the extent of the area of lands in addition to tide, submerged, mental health lands, school, or university lands in the same general area of the discovery well which, by reason of the discovery, the commissioner reasonably believes to be capable of producing oil or gas, and the additional lands shall be leased to the highest responsible qualified bidder by competitive bidding under general regulations, in units of not exceeding 2,560 acres (except that tide and submerged lands shall be leased in units of not exceeding 5,760 acres), which shall be as nearly compact in form as possible, upon the payment by the lessee of such bonus as may be accepted by the commissioner and of such royalty as may be fixed in the lease which shall not be less than 12 1/2 per cent in amount or value of the production removed or sold from the lease. All lands other than those above provided to be leased by competitive bidding may be leased competitively or noncompetitively as determined by the commissioner to be in the best interests of the state. Noncompetitive leases shall be issued in units of not exceeding 2,560 acres in any one lease. Noncompetitive leases shall be conditioned upon the payment by the lessee of a royalty of 12 1/2 per cent in amount or value of the production removed or sold from the lease. Competitive leases issued under this subsection shall be for 10 years except that in the Cook Inlet sedimentary

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Co.	Co.
Dept.	Phone # 3808
Fax # ~~[illegible]~~ 3810	Fax # 4844

basin, leases shall be for a primary term of not more than 10 years and not less than five years at the discretion of the commissioner, and shall continue so long thereafter as oil or gas is produced in paying quantities. Noncompetitive leases issued under this subsection shall be for a primary term of five years and shall continue so long thereafter as oil or gas is produced in paying quantities. If drilling has commenced on the expiration date of the primary term of the lease and is continued with reasonable diligence, such operations to include redrilling, sidetracking or other means necessary to reach the originally proposed bottom hole location, the lease shall continue in effect until 90 days after drilling has ceased and for so long thereafter as oil or gas is produced in paying quantities. If all or part of the lands covered by the lease are lands that have been selected by the state under laws of the United States granting lands to the state and a patent has not been issued thereon, a conditional lease may be issued. However, no term extension may be granted for the period during which the lease was conditional.

• Sec. 2. This Act takes effect on the day after its passage and approval or on the day it becomes law without approval.

LAWS OF ALASKA

1969

Source: HB 233

Chapter No. 66

AN ACT

Relating to sale of timber and materials.

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

• Section 1. AS 38.05.115 is amended to read:

Sec. 38.05.1[illegible] LIMITATIONS AND CONDITIONS OF SALE. ([illegible]) The commissi[illegible] upon recommendation of the director, shall determine th[illegible]ber and other materials to be sold, and the limitations, conditions and terms of sale. The limitations, conditions and terms shall include the utilization, development and maintenance of the sustained yield principle, subject to preference among other beneficial uses. The director may negotiate sales of timber or materials without advertisement and on the limitations, conditions, and terms which he considers are in the best interests of the state, subject to the approval of the commissioner. However, not more than 500 M.B.M. of timber or more than $2,500 of materials may be sold by nonadvertised, negotiated sale to the same purchaser within a one-year period.

(b) Negotiated sales for timber or materials not exceeding a value of $250 are exempt from the provisions of AS 34.15.150.

Approved by governor: May 5, 1969
Actual effective date: August 3, 1969

INDEX

SENATE BILLS

No.	Author and Title	In the SENATE: First reading	Committee reports	Second reading	Third reading	Reconsideration; Sent to House	Other action	Action by governor	In the HOUSE: First reading	Committee reports	Second reading	Third reading	Reconsideration; Returned to Senate	Other action	SLA Chapter No.
73.	Engstrom: Relating to national forest income.	25	104 303	319	320	329	598 625	720	345	582	614	614	614 695		32
74.	Engstrom: Relating to foreign fish processing vessels.	25	484	532											
74.	Substitute: Resources Committee: Same title.			532	532 542 562										
75.	Begich: Relating to relocation assistance and authorizing payments to persons displaced by certain highway activities; effective date.	25	426 441												
76.	Thomas: Relating to judgments and orders of juvenile courts.	25	176 688	724	724	742			841	876 908					
77.	B. Phillips, Ziegler: Establishing the voting age at 18 years; effective date.	26	644	679 681	681	689	541		790						
78.	Josephson, Rader: Relating to state legal holidays.	26													
79.	Josephson: Relating to oil and gas lease provisions requiring reports of labor conditions.	26	687 785												
80.	B. Phillips: Relating to the state museum.	29	207	219	219	230	353	442	253	323	339	340 348	349	364	10
81.	Rules Committee by Request of the Governor: Relating to oil and gas leases; effective date.	29	139 304	320											
81.	Substitute: Commerce Committee: Same title.			320	321	329	764 782 851	943	346	573 717 794	820	821	837	778 899	65
82.	Rules Committee by Request of the Governor: Providing for a gubernatorial successor in the event that both the Governor and Secretary of State are temporarily absent from the office.	30	458 688	724	725	742			841	909 942					
83.	Sledgett: Relating to department of fish and game employees as guides.	30													
84.	Sledgett: Requiring nonresident big game hunters to be accompanied by a guide.	31													
85.	Hordes: Relating to the compilation of jury lists.	31	616	631											
85.	Substitute: Judiciary Committee: Same title.			631	631	652	798 816		715	809	872	872	877	885 899	
85.	Substitute: Free Conference Committee: Same title.						850 913	943					955	920	67
86.	Begich: Relating to the rights of initiative, referendum and recall reserved to the people of the organized boroughs.	32	160 254	291	291	306	720 759	943	313	686 746	795	796	796 800 836		70
87.	Begich: Amending the Teachers' Retirement System; effective date.	32	558												

The House was called to order at 11:25 a.m.

CSHB 332 am
Mr. Fink withdrew his objection. There being no further objection, amendment No. 3 was adopted.

amendment No. 4 by Beirne:

Page 2, line 5: Strike "period" and add "provided the applicant shall have complied with AS 08.80.110(5)"

Mrs. Beirne moved and asked unanimous consent that amendment No. 4 be adopted. Mr. Guess objected. Mr. Guess withdrew his objection. Mr. Sweet objected. Mr. Sweet withdrew his objection. There being no further objection, amendment No. 4 was adopted.

Mrs. Beirne moved and asked unanimous consent that COMMITTEE SUBSTITUTE FOR HOUSE BILL NO. 332 amended be considered engrossed, advanced to third reading and placed on final passage. There being no objection, it was so ordered.

COMMITTEE SUBSTITUTE FOR HOUSE BILL NO. 332 amended was read the third time.

The question being: "Shall COMMITTEE SUBSTITUTE FOR HOUSE BILL NO. 332 amended pass the House?" The roll was called with the following result:

Yeas: 32 - Anderson, Banfield, Beirne, Boardman, Borer, Bradner, Bronson, Cornelius, Croft, Deveau, Eliason, Guess, Harris, Haugen, Hensley, Hillstrand, Hohman, Holm, Jackson, Kay, McGill, McVeigh, Miller, Orbeck, Paukan, Reeves, Rettig, Sackett, Schwamm, Sweet, Tillion, Young.

Nays: 5 - Fink, Kerttula, Metcalf, Ray, Sassara.

Excused: 3 - Chance, Moses, Peratrovich.

And so, COMMITTEE SUBSTITUTE FOR HOUSE BILL NO. 332 amended passed the House and was referred to the Chief Clerk for engrossment.

Mr. Guess moved and asked unanimous consent that the House revert to Reports of Standing Committees. There being no objection, the House reverted to

REPORTS OF STANDING COMMITTEES

CSSB 81
The Finance Committee has had COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 (relating to oil and gas leases) under consideration and a majority of the members of the committee recommends it do pass with the following amendment:

amendment No. 1 by the Finance Committee:

Page 3, lines 1 through 4: Restore deleted material on lines 1 through 4 ending with the word AND.

Page 3, line 4: Insert following material after AND: "patent has not been issued thereon, a conditional lease may be issued.

However, no term extension may be granted for the period during which the lease was conditional." CSSB 81

The report was signed by Mr. Ray, Chairman, and concurred in by Ray, Croft, Bradner, Sackett, Haugen and Borer.

COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 was referred to the Rules Committee for placement on the calendar.

CONSIDERATION OF DAILY CALENDAR (continued)

SECOND READING OF SENATE BILLS

COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 191 (relating to property exempt from execution) was read the second time with the Judiciary Committee report (pages 718 - 719 of the Journal). CSSB 191

amendment No. 1 by the Judiciary Committee:

Page 1, lines 14, 17 and 18: Delete "a single person" and insert in its place "he is not the head of a family."

Mr. Cornelius moved and asked unanimous consent that amendment No. 1 be adopted. There being no objection, amendment No. 1 was adopted. CSSB 191 am H

Mr. Cornelius moved and asked unanimous consent that COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 191 amended by the House be considered engrossed, advanced to third reading and placed on final passage. There being no objection, it was so ordered.

COMMITTEE SUBSTITUTE FOR HOUSE BILL NO. 191 amended by the House was read the third time.

The question being: "Shall COMMITTEE SUBSTITUTE FOR HOUSE BILL NO. 191 amended by the House pass the House?" The roll was called with the following result:

Yeas: 29 - Anderson, Banfield, Beirne, Boardman, Bronson, Cornelius, Croft, Deveau, Fink, Guess, Haugen, Hensley, Hohman, Holm, Jackson, Kay, Kerttula, Metcalf, Miller, Moses, Orbeck, Paukan, Reeves, Rettig, Sackett, Sassara, Schwamm, Sweet, Young.

Nays: 6 - Borer, Bradner, Eliason, Harris, Hillstrand, Tillion.

Excused: 5 - Chance, McGill, McVeigh, Peratrovich, Ray.

Mr. Eliason changed his vote from yea to nay.

And so, COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 191 amended by the House passed the House and was referred to the Chief Clerk for engrossment.

SENATE BILL NO. 86 (relating to the rights of initiative, referendum and recall reserved to the people of the SB 86

HB 341 And so, HOUSE BILL NO. 341 passed the House.

Mr. Ray moved and asked unanimous consent that the roll call on the passage of HOUSE BILL NO. 341 be considered the roll call on the effective date clause. There being no objection, it was so ordered.

HOUSE BILL NO. 341 was referred to the Chief Clerk for engrossment.

HB 273 HOUSE BILL NO. 273 (relating to the examination for communicable diseases of persons in custody) was read the second time with the Health, Welfare and Education Committee report (page 333 of the Journal) and the Judiciary Committee report (pages 745 - 746 of the Journal).

CSHB 273 Mr. Cornelius moved and asked unanimous consent that COMMITTEE SUBSTITUTE FOR HOUSE BILL NO. 273 be adopted in lieu of HOUSE BILL NO. 273. Mr. Guess objected. Mr. Guess withdrew his objection. There being no further objection, COMMITTEE SUBSTITUTE FOR HOUSE BILL NO. 273 was adopted.

Mr. Cornelius moved and asked unanimous consent that COMMITTEE SUBSTITUTE FOR HOUSE BILL NO. 273 be considered engrossed, advanced to third reading and placed on final passage. There being no objection, it was so ordered.

COMMITTEE SUBSTITUTE FOR HOUSE BILL NO. 273 was read the third time.

The question being: "Shall COMMITTEE SUBSTITUTE FOR HOUSE BILL NO. 273 pass the House?" The roll was called with the following result:

Yeas: 29 - Anderson, Banfield, Beirne, Boardman, Bronson, Cornelius, Deveau, Fink, Guess, Harris, Haugen, Hillstrand, Hohman, Holm, Kay, Kerttula, McGill, Metcalf, Miller, Moses, Orbeck, Peratrovich, Ray, Rettig, Sackett, Schwamm, Sweet, Tillion, Young.

Nays: 5 - Borer, Bradner, Croft, Eliason, Reeves.

Excused: 6 - Chance, Hensley, Jackson, McVeigh, Paukan, Sassara.

And so, COMMITTEE SUBSTITUTE FOR HOUSE BILL NO. 273 passed the House and was referred to the Chief Clerk for engrossment.

SECOND READING OF SENATE BILLS

CSSB 81 COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 (relating to oil and gas leases; and providing for an effective date) was read the second time with the Resources Committee report (page 573 of the Journal) and the Finance Committee report (pages 794 - 795 of the Journal).

amendment No. 1 by the Finance Committee:

Page 3, lines 1 through 4: Restore deleted material on lines 1 through 3 ending with the word AND.

Page 3, line 4: Insert the following material after AND: "patent has not been issued thereon, a conditional lease may be issued. However, no term extension may be granted for the period during which the lease was conditional." CSSB 81

Mr. Croft moved and asked unanimous consent that amendment No. 1 be adopted. Mr. Kay objected. Mr. Kay withdrew his objection. There being no further objection, amendment No. 1 was adopted. CSSB 81 am H

Mr. Croft moved and asked unanimous consent that COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 amended by the House be considered engrossed, advanced to third reading and placed on final passage. Mr. Fink objected. Mr. Fink withdrew his objection. Mr. McGill objected. Mr. McGill withdrew his objection. There being no further objection, it was so ordered.

COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 amended by the House was read the third time.

The question being: "Shall COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 amended by the House pass the House?" The roll was called with the following result:

Yeas: 32 - Anderson, Banfield, Beirne, Boardman, Borer, Bradner, Bronson, Cornelius, Croft, Deveau, Eliason, Fink, Guess, Harris, Haugen, Hillstrand, Holm, Kay, Kerttula, McGill, Metcalf, Moses, Orbeck, Peratrovich, Ray, Reeves, Rettig, Sackett, Schwamm, Sweet, Tillion, Young.

Nays: 1 - Miller.

Excused: 7 - Chance, Hensley, Hohman, Jackson, McVeigh, Paukan, Sassara.

And so, COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 amended by the House passed the House.

Mr. Guess moved and asked unanimous consent that the roll call on the passage of COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 amended by the House be considered the roll call on the effective date clause. There being no objection, it was so ordered.

COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 amended by the House was referred to the Chief Clerk for engrossment.

Mr. McGill gave notice of reconsideration of his vote on COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 amended by the House.

Mr. Cornelius gave notice of reconsideration of his vote on COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 amended by the House.

SENATE BILL NO. 182 amended (relating to physical therapists; and providing for an effective date) was read the second time with the Health, Welfare and Education Committee report (page [illegible] of the Journal) and the Commerce Committee report SB 182 am

January 30.

Also, if it is agreeable with the members of the House and Senate, I would suggest 3 p.m., this same date, as the time for presentation of the budget message and 1969-1970 budget appropriation bill to a joint session of the Legislature.

I join with all Alaskans in wishing the members of the First Session of the Sixth State Legislature a productive and rewarding session.

Best personal regards.

Sincerely yours,

s/ Keith H. Miller
Keith H. Miller
Governor"

MESSAGES FROM THE HOUSE

A message dated January 30, 1969, was read requesting the Senate meet in joint session January 30, 1969, at 11:00 a.m. to hear the Governor's State of Affairs message, and at 3:00 p.m. to receive the Governor's budget message.

Senator Hammond moved and asked unanimous consent that a message be transmitted to the House accepting their invitation. There being no objection, it was so ordered.

Senator Hammond moved and asked unanimous consent that a message be sent to the House asking it to join with the Senate in inviting Congressman Howard W. Pollock to address a joint session of the Legislature February 10, 1969. There being no objection, it was so ordered.

• • •

Senator Blodgett requested permission to be excused from a call of the Senate from today until Monday, February 3. There being no objection, it was so ordered.

ENGROSSMENT

SCR 2 The Secretary reported that SENATE CONCURRENT RESOLUTION NO. 2 (Honoring the late E. L. "Bob" Bartlett) had been correctly engrossed, signed by the President and Secretary and transmitted to the House for their consideration.

INTRODUCTION AND REFERENCE OF SENATE RESOLUTIONS

SCR 3 SENATE CONCURRENT RESOLUTION NO. 3 by Senator Begich,

expressing concern of the Legislature for sound oil and gas conservation practices in Alaska and directing that a study be made, was read the first time and referred to the Resources Committee. SCR 3

INTRODUCTION AND REFERENCE OF SENATE BILLS

SENATE BILL NO. 80 by Senator B. Phillips, entitled: SB 80

"An Act relating to the state museum."

was read the first time and referred to the State Affairs Committee.

SENATE BILL NO. 81 by the Rules Committee by request of the Governor, entitled: SB 81

"An Act relating to oil and gas leases; and providing for an effective date."

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

The Governor's transmittal letter covering SENATE BILL NO. 81 is as follows:

"January 29, 1969

The Honorable Jay S. Hammond
Chairman, Senate Rules Committee
Alaska State Legislature
Juneau, Alaska 99801

Dear Mr. Chairman:

Pursuant to State Law and the Uniform Rules of the Legislature, I am transmitting herewith a bill entitled 'An Act relating to oil and gas leases; and providing for an effective date.'

This amendment eliminates the extension of term on the lease for lands on which the State has only tentative approval at the time of leasing. A conditional lease has often been considered by most companies as drillable title and the fact of conditionality is no detriment to development of the leases. Some leases have extended to 15 years. I feel that the State did not contemplate nor intend for a leasee to be entitled to hold a lease beyond a ten year primary term. This bill also reverts to a minimum five year term oil and gas lease, at the discretion of the Department. The shorter term will hasten development and drilling activities in many areas and will open up more opportunities for smaller companies and independents not presently active in Alaska, by causing the land to be released at an earlier date.

Sincerely yours

SCR 8 SCR 6 The above two resolutions were referred to the Rules Committee for placement on the calendar.

SCR 7 The State Affairs Committee has had SENATE CONCURRENT RESOLUTION NO. 7 (study of Alaskan natives' employment) under consideration and the committee recommends it do pass. The report was signed by Senator Engstrom, Chairman, and concurred in by Senators Koslosky, Merdes, Butrovich and Blodgett.

SENATE CONCURRENT RESOLUTION NO. 7 was referred to the Rules Committee for placement on the calendar.

Senator Blodgett moved and asked unanimous consent that his name be added as a sponsor on SENATE CONCURRENT RESOLUTION NO. 7. There being no objection, it was so ordered.

SB 105 The State Affairs Committee has had SENATE BILL NO. 105 (statue of E.L. Bartlett) under consideration and the committee recommends it do pass. The report was signed by Senator Engstrom, Chairman, and concurred in by Senators Merdes, Butrovich, Koslosky and Blodgett.

SENATE BILL NO. 105 was referred to the Rules Committee for placement on the calendar.

SB 133 The State Affairs Committee has had SENATE BILL NO. 133 (Human Rights Commission) under consideration and the committee recommends it do pass. The report was signed by Senator Engstrom, Chairman, and concurred in by Senators Butrovich, Merdes and Blodgett. Not concurring was Senator Koslosky who recommends: "Do not pass."

SENATE BILL NO. 133 was referred to the Rules Committee for placement on the calendar.

CS HJR 1 am The State Affairs Committee has had COMMITTEE SUBSTITUTE FOR HOUSE JOINT RESOLUTION NO. 1, am (National Cemetery [illegible]) under consideration and the committee recommends it do pass. The report was signed by Senator Engstrom, Chairman, and concurred in by Senators Butrovich, Merdes, Blodgett and Koslosky.

COMMITTEE SUBSTITUTE FOR HOUSE JOINT RESOLUTION NO. 1, am, was referred to the Rules Committee for placement on the calendar.

HJR 14 The State Affairs Committee has had HOUSE JOINT RESOLUTION NO. 14 (commemorative stamp, the late Sen. E. L. "Bob" Bartlett) under consideration and the committee recommends it do pass. The report was signed by Senator Engstrom, Chairman, and concurred in by Senators Merdes, Butrovich, Koslosky and Blodgett.

HOUSE JOINT RESOLUTION NO. 14 was referred to the Rules Committee for placement on the calendar. HJR 14

The State Affairs Committee has had HOUSE CONCURRENT RESOLUTION NO. 6 (commending Senator Gruening) under consideration and the committee recommends it do pass. The report was signed by Senator Engstrom, Chairman, and concurred in by Senators Koslosky, Merdes and Butrovich. Not concurring was Senator Blodgett, who had no recommendation. HCR 6

HOUSE CONCURRENT RESOLUTION NO. 6 was referred to the Rules Committee for placement on the calendar.

The Finance Committee has had SENATE BILL NO. 70 (appropriating for Legislative Affairs Agency) under consideration and the committee recommends it be replaced with COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 70, with the same title, and that the Committee Substitute do pass. The report was signed by Senator V. Phillips, Chairman, and concurred in by Senators Lewis, Bradshaw and Haggland. Not concurring was Senator Miller who had no recommendation. SB 70

SENATE BILL NO. 70 was referred to the Rules Committee for placement on the calendar.

The Resources Committee has had SENATE BILL NO. 81 (oil and gas leases) under consideration and the committee recommends it do pass with the following amendment: SB 81

Page 2, line 4: "and the area north of the crest of the Brooks Range between the Arctic Ocean and the Alaska-Canada border, and all state-owned lands seaward of this area."

Page 2, line 5: Place period after "12 1/2 per cent," and delete remainder of sentence which ends on line 8 with the words, "less than five per cent."

Page 2, line 11: after word "leases," insert "in the Cook Inlet Basin"

The report was signed by Senator Palmer, Chairman, and concurred in by Senators Thomas, Butrovich, Koslosky, Hammond and Poland. Not concurring was Senator Christiansen, who had no recommendation.

SENATE BILL NO. 81 was referred to the Commerce Committee.

Senator Engstrom moved and asked unanimous consent that the Judiciary Committee report be adopted. There being no objection, the report was adopted thus adopting the amendment offered by the Judiciary Committee (page 303 of the Journal). SB 73 am

There being no further amendments, Senator Hammond moved and asked unanimous consent that SENATE BILL NO. 73, am, be considered engrossed, advanced to third reading and placed on final passage. There being no objection, it was so ordered.

SENATE BILL NO. 73, am, was read the third time.

The question being: "Shall SENATE BILL NO. 73, am, (national forest income) pass the Senate?" The roll was taken with the following result:

Yeas:	18	Begich, Blodgett, Butrovich, Christiansen, Engstrom, Haggland, Hammond, Josephson, Koslosky, Merdes, Miller, Palmer, V. Phillips, Poland, Rader, Thomas, Ziegler and B. Phillips.
Nays:	1	Bradshaw.
Absent:	1	Lewis.

And so, SENATE BILL NO. 73, am, passed the Senate.

SENATE BILL NO. 73, am, was referred to the Secretary for engrossment.

SB 81 SENATE BILL NO. 81 (oil and gas leases) was read the second time.

Senator Haggland moved and asked unanimous consent that the Commerce Committee report be adopted, thus adopting COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81. Senator Miller objected. Senator Miller withdrew his objection. There being no further objection, the Commerce Committee report was adopted, thus adopting COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81. CS SB 81

There being no amendments, Senator Hammond moved and asked unanimous consent that COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 be considered engrossed, advanced to third reading and placed on final passage. Without objection, it was so ordered.

COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 was read the third time.

The question being: "Shall COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 (oil and gas leases) pass the Senate?" The roll was taken with the following result:

Yeas:	19	Begich, Blodgett, Bradshaw, Butrovich, Christiansen, Engstrom, Haggland, Hammond, Josephson, Koslosky, Merdes, Miller, Palmer, V. Phillips, Poland, Rader, Thomas, Ziegler [illegible] Phillips.

Nays:	0		CS SB 81
Absent:	1	Lewis.	

And so, COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 passed the Senate.

Senator Hammond moved and asked unanimous consent that the roll call on the passage of COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 be considered the roll call on the effective date clause. Without objection, it was so ordered.

COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 was referred to the Secretary for engrossment.

SENATE BILL NO. 208 (search warrants) was read the second time. SB 208

There being no amendments, Senator Hammond moved and asked unanimous consent that SENATE BILL NO. 208 be considered engrossed, advanced to third reading and placed on final passage. Without objection, it was so ordered.

SENATE BILL NO. 208 was read the third time.

The question being: "Shall SENATE BILL NO. 208 (search warrants) pass the Senate?" The roll was taken with the following result:

Yeas:	19	Begich, Blodgett, Bradshaw, Butrovich, Christiansen, Engstrom, Haggland, Hammond, Josephson, Koslosky, Merdes, Miller, Palmer, V. Phillips, Poland, Rader, Thomas, Ziegler and B. Phillips.
Nays:	0	
Absent:	1	Lewis.

And so, SENATE BILL NO. 208 passed the Senate.

SENATE BILL NO. 208 was referred to the Secretary for engrossment.

SENATE BILL NO. 218 (single judicial ballot in each judicial district) was read the second time. SB 218

There being no amendments, Senator Hammond moved and asked unanimous consent that SENATE BILL NO. 218 be considered engrossed, advanced to third reading and placed on final passage. Without objection, it was so ordered.

SENATE BILL NO. 218 was read the third time.

The question being: "Shall SENATE BILL NO. 218 (single judicial ballot in each judicial district) pass the Senate?" The roll was taken with the following result:

SB 275 A message dated April 19, 1969, was read, stating the House has passed SENATE BILL NO. 275, SENATE JOINT RESOLUTION NO. 36 and SENATE CONCURRENT
SJR 36 RESOLUTION NO. 38 and returning same.

SCR 38 SENATE BILL NO. 275, SENATE JOINT RESOLUTION NO. 36 and SENATE CONCURRENT RESOLUTION NO. 38 were referred to the Secretary for enrollment.

CSSB 81 A message dated April 19, 1969, was read, stating the House has passed COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 (relating to oil and gas leases) with the following amendment and returning same.

> Page 3, lines 1 through 4: Restore deleted material on lines 1 through 4 ending with AND.
>
> Page 3, line 4: Insert the following material after AND: "patent has not been issued thereon, a conditional lease may be issued. However, no term extension may be granted for the period during which the lease was conditional."

Senator Palmer moved that the Senate concur in the House amendment to COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81. Senator Engstrom objected.

Senator Butrovich moved and asked unanimous consent that the House message relating to COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 be held one legislative day for action by the Senate. There being no objection, it was so ordered and the Secretary was instructed to reproduce the amendments for distribution to all Senators.

* * *

CSSB 136 (Rules) A message dated April 19, 1969, stating the House had passed COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 136 (Rules) (interest allowed on judgments) with the following amendment and returning same, was read:

> HOUSE COMMITTEE SUBSTITUTE FOR COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 136.

Senator Hammond moved and asked unanimous consent that the Senate concur in the House amendment to COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 136 (Rules). Senator V. Phillips objected, and then withdrew his objection. Senator Engstrom objected.

The question being: "Shall the Senate concur in the House amendment to COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 136 (Rules)?" On voice vote, the Senate concurred, and the Secretary was instructed to so inform the House.

HCS CSSB 136 HOUSE COMMITTEE SUBSTITUTE FOR COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 136 was referred to the Secretary for enrollment.

* * *

A message dated April 19, 1969, was read, stating the House has passed COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 14, amended, (electrical safety) withthe following amendment and returning same: CSSB 14

> HOUSE COMMITTEE SUBSTITUTE FOR COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 14

Senator Thomas moved that the Senate concur in the House amendment.

The question being: "Shall the Senate concur in the House amendment to COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 14, am?" On voice vote, the Senate failed to concur in the House amendments.

The Secretary was instructed to so inform the House and request that the House recede from its amendment.

* * *

A message dated April 19, 1969, was read, stating the House has passed COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 174 (state manpower training program) with the following amendment, and returning same: CSSB 174

> Page 2, line 9: Change <u>one</u> to <u>three</u>
>
> Page 2, line 10: Change <u>one</u> to <u>three</u>
>
> Page 2, line 11: Add <u>s</u> to <u>member</u> (twice in line)
>
> Page 2, line 12: Change <u>one</u> to <u>three</u>

Senator Hammond moved that the Senate concur in the House amendments to COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 174.

The question being: "Shall the Senate concur in the House amendments to COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 174?" On voice vote, the Senate concurred, and the Secretary was instructed to so notify the House.

COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 174, am H, was referred to the Secretary for enrollment. CSSB 174 am H

* * *

A message dated April 19, 1969, was read, stating the House has passed the following resolutions, and they are herewith transmitted for consideration:

> HOUSE CONCURRENT RESOLUTION NO. 52
>
> HOUSE JOINT RESOLUTION NO. 53
>
> HOUSE CONCURRENT RESOLUTION NO. 56 amended

<u>FIRST READING AND REFERENCE OF HOUSE RESOLUTIONS</u>

HOUSE CONCURRENT RESOLUTION NO. 52 by Messrs. Kerttula and Paukan, directing the Legislative Council to conduct a study on the reindeer industry, was read the first time and referred to the Resources Committee. HCR 52

SENATE JOURNAL

ALASKA STATE LEGISLATURE

SIXTH LEGISLATURE - FIRST SESSION

Juneau, Alaska April 22, 1969

Eighty-Sixth Day

Pursuant to adjournment the Senate was called to order by President Phillips at 2:15 p.m.

Roll call showed all members present.

The prayer, offered by the Chaplain, the Reverend Ralph Wegener, follows:

> "Our heavenly Father, the Author of all freedom, we in this hour do thank Thee for the Great Land in which we live and for all its basic freedoms. May this freedom mean for us that we are a responsible people, each having special interests, and yet living in the hope that a better tomorrow is actually possible. May it mean that varying opinions may grow and live side by side and also flow freely.
>
> We ask Thy divine blessings on this Senate. Cause the members of this body to deliberate, to debate, and to decide as individualistic, self-reliant, property-owning citizens . . . who are enlightened and aroused as they live in this atmosphere of freedom to seek to solve our common problems and to provide for our common good.
>
> We ask this, humbly grateful for Thy many blessings we do even now enjoy, in the blessed Savior's precious name. Amen."

The Secretary certified as to the correctness of the journal for the eighty-fifth legislative day in accordance with the rules. Senator Hammond moved and asked unanimous consent that the journal be approved as submitted. Without objection, it was so ordered.

MESSAGES FROM THE HOUSE

The message dated April 19, 1969 relating to COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81 (page 764 of the journal) was read again with the House amendments. This message had been held one legislative day for study. CSSB 81

Senator Palmer moved and asked unanimous consent that the Senate concur in the House amendments to COMMITTEE

CSSB 81 am H SUBSTITUTE FOR SENATE BILL NO. 81 (relating to oil and gas leases). There being no objection, it was so ordered; and the Secretary was instructed to so inform the House.

COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 81, am H, was referred to the Secretary for enrollment.

SJR 45 SB 235 A message dated April 21, 1969, was read, stating the House has passed SENATE JOINT RESOLUTION NO. 45 and SENATE BILL NO. 235 and returning same.

SENATE JOINT RESOLUTION NO. 45 and SENATE BILL NO. 235 were referred to the Secretary for enrollment.

A message, dated April 21, 1969, was read, transmitting the enrolled copies of the following resolutions for the signatures of the President and Secretary:

HOUSE JOINT RESOLUTION NO. 5

HOUSE JOINT RESOLUTION NO. 6

HOUSE JOINT RESOLUTION NO. 54 am

HOUSE JOINT RESOLUTION NO. 44

HOUSE JOINT RESOLUTION NO. 45

HOUSE JOINT RESOLUTION NO. 3.

The enrolled copies of the above resolutions were signed by the President and Secretary and returned to the House.

CSSB 23 (Jud.) am A message dated April 21, 1969, was read, stating the House has passed COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 23 (Judiciary), amended, with the following amendment, and returning same:

HOUSE COMMITTEE SUBSTITUTE FOR COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 23 as amended by the House: the amendments follow:

Page 1, line 11: Insert after "operates", the words: "or drives".

Page 1, lines 16, 19 and 20: Insert "operating or" before the word "driving". Delete "or in actual physical control of".

Senator Thomas moved that the Senate concur in the House amendments to COMMITTEE SUBSTITUTE FOR SENATE BILL NO. 23 (Judiciary). On voice vote, the Senate did not concur in the House amendments. The Secretary was instructed to so inform the House and ask it to recede from its amendment.

A message dated April 21, 1969, was read, stating the House has passed HOUSE JOINT RESOLUTION NO. 57, am, and transmitting same.

FIRST READING AND REFERENCE OF HOUSE RESOLUTIONS

HOUSE JOINT RESOLUTION NO. 57, am, by Messrs. Metcalf and Rettig requesting the construction of two additional sea-train slip facilities at the Port of Seward, was read the first time and referred to the State Affairs Committee. HJR 57 am

COMMUNICATIONS

"April 19, 1969

The Honorable Brad Phillips
President of the Senate
Alaska State Senate
Juneau, Alaska

Dear Brad:

I wish to express my appreciation and thanks to you and all my friends in the Senate. I have spent many happy birthdays, but the Senate birthday party on Tuesday topped them all.

Again, many thanks to you, the other senators and the Senate staff memebers who made the celebration possible.

Sincerely,

s/ Mark Jacobs, Sr.
Mark Jacobs, Sr."

• • •

Senator Hammond moved and asked unanimous consent that the Secretary send a message to the House requesting the members to meet in joint session with the Senate members at 3:00 p.m. Thursday, April 24, 1969, to consider the confirmation of recent appointments by the Governor. There being no objection, it was so ordered; the Secretary was instructed to transmit the message.

REPORTS OF STANDING COMMITTEES

ENCLOSURE 24

COOK INLET DISCOVERY ROYALTY APPLICATIONS

Name of Well	Lessee (present names)	ADL Number	Date of Discovery	First Affidavit or claim of discovery	Date of written decision granting discovery royalty	Effective date of the 10-year discovery royalty	Commencement of commercial production	Date 12 1/2% royalty replaced 5% 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	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	6/10/72	6 years 1 month
Cook Inlet State No. 1	Phillips	17589	8/21/62	11/12/62	11/24/64	9/1/62	3/69	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	1/73	4 years 10 months
Granite Point No. 1	Mobil Union	18761	5/16/65	5/21/65	9/14/65	6/1/65	5/67	6/75	8 years 1 month
Trading Bay No. 1-A	Union Marathon	18731	5/23/65	6/18/65	8/27/65	6/1/65	1/67	6/75	8 years 5 months
Grayling No. 1-A	Union Marathon	17594	9/29/65	10/28/65	1/19/82	10/1/65	10/67	10/75	8 years 1 month
Nicholai Creek State No. 1	Texaco Superior	17598	4/28/66	5/23/66	8/19/66	5/1/66	10/68	No production after 1972	About 4 years

APPLICATIONS DENIED

Name of Well	ADL Number
Trading Bay No. 1 and No. 2	17597
Shell Middle Ground Shoal	18754
W. Foreland Unit No. 3	18777
Redoubt Shoal No. 2	29690
Trading Bay State No. 1	35431

ENCLOSURE 25

NORTH SLOPE
DISCOVERY ROYALTY APPLICATIONS

Lease ADL	Well Name	Field Name	Applicant	Date of Application	Status of Application
28303	Prudhoe Bay State #1	Prudhoe Bay	ARCO	3/12/68	Granted
25633	Ugnu #1	Kuparuk	ARCO-BP	4/7/69	Granted
34633	Sag Delta #4	Endicott	BP	2/14/78	Granted
34635	Niakuk #5	Niakuk	BP	4/7/85	Granted
28297	Pt. McIntyre #3	Pt. McIntyre	ARCO	5/12/89	Granted
25906	Milne Point G-1	Milne Point	Conoco	12/7/89	Denied

Note:

Between 1968 and 1977 nine additional notice of discovery applications were filed, but the applicants never completed the full application procedure. Those nine applications are now expired.

Enclosure 25

ENCLOSURE 26

Tom Painter
Division Manager

Conoco Inc.
3201 C Street
Suite 200
Anchorage, AK 99503

September 7, 1989

RECEIVED
SEP 08 1989
DIV. OF OIL & GAS
DIRECTOR'S OFFICE

Mr. James Eason
Director, Division of Oil and Gas
Department of Natural Resources
P. O. Box 7034
Anchorage, AK 99510-7034

Dear Mr. Eason:

Pursuant to paragraph 12 of lease ADL 25906 and 11 AAC 83.210(a), Conoco Inc. is submitting the attached Statement of First Discovery of Oil and Gas in Commercial Quantities in a Geologic Structure precedent to filing an application for discovery royalty for ADL 25906.

As indicated in the attached Statement and Exhibits, oil and gas has been encountered in sufficient showing in well no. G-1 to cause Conoco, a reasonable and prudent operator, to conduct further operations to complete said well in the discovery zone so that the well can be tested for potential oil or gas production in commercial quantities.

As required in 11 AAC 83.210(b), Conoco will undertake production tests in well no G-1 to establish that oil and gas has been discovered in commercial quantities. This testing will take place in the latter half of September, 1989, and we will furnish you sufficient notice and transportation (if requested) for a representative of your department to witness the testing. The geologic data required in 11 AAC 83.210(c) will be furnished in a timely manner.

If you need additional information concerning this Statement, please contact Al Hastings at 564-7650. Conoco respectfully requests that the information contained in the Statement and attached Exhibits remain confidential until the conclusion of the application and certification process.

Very truly yours,

T. R. Painter
Division Manager

AEH(jr)
File 500.58.08

Enclosure 26

CONOCO

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

December 7, 1989

Mr. James Eason
Director, Division of Oil and Gas
Department of Natural Resources
P. O. Box 7034
Anchorage, Alaska 99510-7034

Dear Mr. Eason:

Pursuant to 11 AAC 83.215, Conoco Inc., as Operator of the Milne Point Unit and the sole Working Interest Owner of ADL 25906, requests discovery well certification for Well No. G-1. Conoco is in compliance with the filing provisions of 11 AAC 83.210.

It is my understanding that the Division of Oil and Gas will publish the appropriate notice of this application for discovery royalty. If you need additional information concerning this discovery royalty application, please contact me at 564-7601.

Attached to this application is a brief discussion of the Pre-Drilling Expectation and the Post-Drilling Verification for Well No. G-1. This discussion summarizes the other criteria that have been used in the more recent discovery royalty decisions.

Very truly yours,

David L. Bowler
Division Manager

AEH(jr)
Attachment
File 500.58.08

ENCLOSURE 27

WALTER J. HICKEL, GOVERNOR

DEPARTMENT OF NATURAL RESOURCES

PO BOX 7034
ANCHORAGE, ALASKA 99510-7034
PHONE: (907) 762-2553

DIVISION OF OIL AND GAS

CERTIFIED MAIL
RETURN RECEIPT REQUESTED

April 4, 1991

DECISION

Conoco, Inc.	:	Oil and Gas Lease
Suite 200	:	ADL 28297
3201 C Street	:	Milne Point Unit
Anchorage, Alaska 99503	:	

MILNE POINT UNIT G-1 WELL DENIED CERTIFICATION AS A DISCOVERY WELL

The Division of Oil and Gas (division) hereby denies certification of the Milne Point Unit G-1 well (G-1) as a discovery well. As discussed in greater detail below, this denial is based on the determination that overwhelming evidence, including that submitted by Conoco, Inc. (Conoco), clearly establishes that the G-1 well fails the essential "first discovery" requirement. The Shallow Oil Sands (SOS) and the larger structure of which it is a part was clearly discovered by previous exploration, and was publicly known.

Previous discovery is evidenced by: (1) several hundred earlier exploratory, Kuparuk River Unit and Milne Point Unit well penetrations which yield substantial electric log and/or core data to recognize the accumulation, and (2) previous successful flow tests of the accumulation from at least five other wells in the Milne Point Unit, and a pilot project within the Kuparuk River Unit. The division's evaluation is supported by the geological, geophysical, and engineering information submitted by Conoco, as well as by in-house data.

THE HISTORICAL BACKGROUND

The legal basis for the discovery royalty

The statute that authorized the granting of a reduced royalty rate for a discovery of a separate geologic structure was the former AS 38.05.180(a), which stated in part:

> 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 ten years following the date of discovery and thereafter the royalty rate of twelve and one half percent.

Although this provision was subsequently repealed, it was in effect when ADL 25906 was issued. Paragraph 12 of the lease describes the discovery royalty provision as follows:

> If Lessee shall drill on said land and make the first discovery of oil or gas in commercial quantities in any geological structure, the royalty rate under this lease shall, instead of the rates prescribed in Paragraph 11, be five percent for a period of ten years following the date of such discovery, and thereafter the royalty rates shall be those prescribed in Paragraph 11. If this lease is committed to a unit agreement approved or prescribed by Lessor as provided in the regulations, the five percent royalty rate shall not apply to all, but only, the production allocated to this lease under such agreement.

Regulations implementing the discovery royalty statute were initially adopted in August 1963 and were published at 11 AAC 505.74 - 11 AAC 505.748. They were subsequently amended and renumbered as 11 AAC 83.200 - 11 AAC 83.230. In January 1980, these regulations were repealed. In adjudicating the Conoco request for discovery royalty, the department has used the repealed regulations as a reference only, and does not consider them to be controlling.

Lease History

Humble Oil and Refining Company and Richfield Oil Corporation, in a 50-50 partnership, purchased Oil and Gas Lease ADL 25906 on December 9, 1964 at Competitive Oil and Gas Lease Sale 13.

The lease was issued as a conditional lease effective March 1, 1965, with a ten-year primary term and a fixed royalty rate of twelve and one half percent. Humble later became Exxon Corporation (Exxon), and Richfield became ARCO Alaska Inc. (ARCO). ADL 25906 was added to the Milne Point Unit during the second expansion of the Unit, effective June 1, 1983. Conoco acquired Exxon's interest in the lease on July 28, 1987 and ARCO's interest on November 2, 1988. Conoco currently retains 100 percent working interest and ownership in ADL 25906.

Drilling History

Four wells have been drilled on ADL 25906. The first well drilled on the lease was the Milne Point Unit G-1, which was spudded on August 10, 1989 and completed on August 22, 1989. The well was drilled to a measured depth of 4745 feet. The operator logged, cored, and tested the Shallow Oil Sands (SOS), which were, as anticipated, productive. Subsequently, three additional development wells have been drilled on G pad and four well each on H, I, and J pads.

Discovery Royalty Application History

Conoco submitted a Statement of First Discovery on September 7, 1989. The statement claimed to have discovered oil in "Upper Cretaceous Formation sandstones" in the Milne Point Unit G-1 well, located on ADL 25906, on August 15, 1989. On December , 1989 Conoco tendered an application for discovery well certification for the G-1 well based upon well tests conducted on October 31, 1989. In the discussion attached to and made part of the application, Conoco characterized the claimed discovery in terms of the "Shallow Oil Sands." On December 14, 1989 Conoco submitted "geologic data to establish the geologic structure from which the G-1 well produced oil in commercial quantities." That document also directed itself to the Shallow Oil Sands, and expressly equated intervals within the sands with what ARCO Alaska, Inc. calls the "West Sak" and the "upper Ugnu."

Division staff met with Conoco representatives on January 24 and February 6, 1990 to discuss the application. On November 1990, Conoco submitted additional geological and geophysical data in support of its claim. On December 10, 1990, after division technical staff determined that the application was complete, the division published notice and separately mailed notice of the discovery royalty application to known potentially interested parties.

The division received no responses during the thirty day comment period. Therefore, the application stands unopposed by any third party. No one has requested a public hearing, and the division has not requested a hearing in light of the vast amount of available data and the fact that the applicant has had a full opportunity to make both formal and informal presentations of its technical and legal positions.

DISCUSSION

The G-1 well did not make a first discovery.

The fatal deficiency of the application, demonstrated unequivocally by materials submitted by Conoco itself, is the absence of any "first discovery." The location and distribution of the SOS have been known for almost two decades. Published maps of the geologic structure and the oil accumulation for the SOS existed prior to the drilling of the Milne Point G-1 well. The application itself makes clear that the operator of the G-1 well had a pre-drilling expectation that the well would in fact penetrate a productive pool within the same geologic structure and interval as had been penetrated by hundreds of other wells within the Milne Point and Kuparuk River Units. In light of the amount of available information prior to drilling, it is clear that the G-1 well can best be described as Conoco's first planned production well within the SOS. Below are listed a few of the facts demonstrating that the structure containing the SOS was discovered long before the G-1 well.

- The East Ugnu No. 1 Well

In 1969, twenty years before the G-1 well was drilled, the East Ugnu No. 1 well discovered[1] two structures containing hydrocarbons: the deeper Kuparuk Formation (which forms the basis of production from both the Kuparuk River Unit and the initial participating area of the Milne Point Unit), and a shallower structure (which contains the intervals Conoco refers to as the SOS). The shallower structure was tested and flowed heavy oil at a rate of 20 barrels per day.

The East Ugnu No. 1 well is located four and three-fourths miles to the southwest of the G-1 well. The geologic isopach and structure maps, cross sections and interpreted seismic data supplied by Conoco show that the SOS, present in both the

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[1] Based upon this discovery by the East Ugnu No. 1 Well, the owners of ADL 25633 were granted discovery royalty rights for any production of oil and gas and associated hydrocarbons attributed to that lease from any zone of production, including the shallow sands, during the first ten years after the date of discovery, i.e., for the period from May 1, 1969 through April 30, 1979.

G-1 and East Ugnu wells, are contained within the same geologic structure. Furthermore, the sands present within the Shallow Sands Interval in both the G-1 and East Ugnu No. 1 well are part of the same reservoir. These sands are part of a large Late Cretaceous and Paleogene deltaic system, and are interpreted as being deposited in shelf, delta front, delta plain and fluvial environments.

Reservoirs found in these environments typically contain multiple stacked and partially isolated sands. The individual sand bodies which make up the SOS clearly demonstrate this reservoir heterogeneity. However, geological, geophysical, and engineering data indicate that, disregarding localized reservoir discontinuities and small faults, the SOS reservoir is continuous between East Ugnu No. 1 and Milne Point G-1.

O <u>Conoco's discovery royalty certification application</u>

On December 7, 1989, Conoco filed its application for discovery royalty certification. Attached to and made part of that application was a discussion of pre-drilling expectations for the G-1 well. That documents admits

> The risk of geologic nonsuccess for the shallow sands at Milne Point is small. Sufficient regional data in existence before the drilling of M No. G-1 minimized the risk of not finding the geologic structure.

The next paragraph of the document generally discusses the SOS in the Milne Point Unit and the West Sak in the Kuparuk River Unit as the same structure, and estimates that in excess of $150 million had been expended in drilling, testing and pilot project work. The document bluntly characterizes the difficulty with establishing sustained production from the SOS prior to the G-1 well as a "completion and production problem, and not a question of finding sufficient in-place hydrocarbons."

The attachment to the application goes on to state that pre-drilling expectations were confirmed:

> The post drilling confirmed that the basic geologic structural definition before drilling commenced was correct. Minor changes in sand thickness and fluid content slightly altered oil in place values.

This proves beyond any doubt that Conoco did not discover the structure. It knew to a high degree of confidence and specificity what it would encounter.

O The application for a participating area for production from the SOS

On November 16, 1989, Conoco applied to the Division of Oil and Gas for establishment of a participating area within the Milne Point Unit for purposes of production of hydrocarbons from the SOS. That application states that "The Shallow Oil Sands have been tested by six wells within the Milne Point Unit." The G-1 well was drilled in 1989. Of the other five, one, the A-1 well, was drilled in 1980, and the four others were drilled in 1982.

Nothing suggests that the SOS tested in the Milne Point G-1 well contains oil or reservoir rock of significantly better quality or quantity than revealed in the five previously tested wells within the Milne Point Unit. Thus, even without any consideration of the many wells drilled into and testing the SOS in the Kuparuk River Unit, Conoco's own submissions reveal the fact that five prior wells within the Milne Point Unit drilled into and tested the SOS many years prior to Conoco's claimed "first discovery."

O Geologic analysis submitted on December 14, 1989 and in November 1990.

That the SOS was discovered well before the G-1 well is further proven by Conoco's geologic interpretations submitted on December 14, 1989 an in November 1990. The December 14, 1989 document, entitled "Geologic Evidence in Support of the Discovery Royalty for the Shallow Oil Sands" states:

> The Shallow Oil Sands (SOS) of Milne Point comprise 17 individual beds that are readily traced between 78 wells in and around the Milne Point Unit. The type log for the SOS at Milne Point is Conoco's A-1 well. ... Although these sands were originally found in 1969 by the SOCAL Kavearak 32-25 well, the nearby A-1 well was chosen as the type well because of its modern (1981) [sic] well log suite.

Emphasis added. This statement admits that the SOS was originally discovered in 1969, and that 78 wells predating the G-1 had explored it to the extent that it could be "readily traced." Indeed, Figure 3 to the document, entitled "SOS Regional Structure," includes a large area of the Kuparuk River Unit within its mapping of the SOS, and traces between four wells within the Milne Point Unit and five wells within the Kuparuk River Unit.

This quotation is also significant because of its use of the A-1 well as the type well. Although well logs from 1989 G-1 well (the claimed discovery well) were available, Conoco chose well logs from the nearby 1982 A-1 well for purposes of discussion of the geology.

The December 14, 1989 submission also corr lates the nomenclature used by Conoco in describing the SOS with the nomenclature used by ARCO in describing the West Sak and the upper Ugnu in the Kuparuk River Unit. See second paragraph of the first page, and Figure 2.

The November 1990 submission also correctly encompasses the entire SOS, including West Sak, in its discussion of the geologic structure for which the discovery is claimed. While both the December 14, 1989 and the November 1990 submissions lend support to the conclusion that the SOS is separate from the Kuparuk Formation and the Prudhoe Bay field, they do not support the conclusion that the SOS in the Milne Point Unit are part of a geologic structure that is separate from the previously drilled and tested West Sak or the other SOS intervals previously drilled and tested within the Milne Point Unit.

- Information submitted in support of royalty reduction

In support of its efforts to obtain a royalty reduction for production from the Milne Point Unit (separate from this discovery royalty application), Conoco previously submitted to the Division a copy of a Conoco document entitled "Initial Development Plan for the Shallow Oil Sands in the Milne Point Unit." This document, prepared in 1985 (four years before the G-1 well was drilled), described the "wealth of information" that had been compiled and analyzed about the SOS. Page IV-1. While the document concluded that there was a need for further delineation, it nonetheless described the geology, made estimates of oil in place, and described production methods and scenarios. See, e.g., pages II-1 and II-2.

Tellingly, four years before the G-1 well made what Conoco claims is the "first discovery" of the Shallow Oil Sands, Conoco had developed a "Shallow Oil Sands Development Philosophy":

> The shallow oil sands have always been targeted for development after the Kuparuk zone was fully developed and excess facility capacity became available.

Page IV-6.

Conoco misapprehends the "commerciality" issue.

In the "Pre-drilling Expectation and Post-drilling Verification" discussion submitted with the December 7, 1989 application for discovery royalty certification, Conoco appears to suggest that risks relating to "completion and producing techniques, and crude price and perceived price stability" are somehow pertinent to the issue of whether Conoco's G-1 well made the "first discovery of oil or gas in commercial quantities in a geologic structure." I disagree for the following reasons.

First, the statute and lease term speak in terms of commercial quantities. The basic information about the quantity and quality of hydrocarbons was known before the G-1 well was drilled. As noted above, the well only resulted in "minor" or "slight" adjustments to Conoco's pre-drilling estimates. In short, there is nothing about the drilling of the asserted discovery well that could be characterized as a discovery of a heretofore unknown quantity of oil.

Second, Conoco argues that no well has been certified as capable of producing in "paying quantities" prior to the G-1 well. This argument is irrelevant. There is no evidence that any other party has ever sought a "paying quantities" determination for a well targeted for the SOS. Moreover, the "paying quantities" determination is made only for particular purposes, unrelated to the discovery royalty issue. See, e.g., Pan American Petroleum Corp. v. Shell Oil Co., 455 P.2d 12, 23-24 (Alaska 1969).

Third, the risks Conoco faces in putting the SOS into production are production related, not discovery-related risks. Conoco stresses the "costs of continued experimentation with completions, the risks concerning oil prices and transportation costs." While these are genuine risks, they are not discovery risks, were not unique to this well, and the G-1 well did not resolve those risks.[2] These

[2] Conoco explicitly states that the "[p]roduction history also verified that the completion technique utilized in G-1 will not provide the long term completion needed for full scale development. Additional experimentation with completions will be required before economic development is a reality." Thus the G-1 well, besides not being the discovery well for the SOS, did not resolve all production-related impediments either. It is just as clear that there is no nexus between the G-1 well and the resolution of other risks. Nothing about the drilling of the well could possibly affect future taxes, oil prices, and the like.

kinds of risks are common to all development projects. The discovery royalty was designed as a reward for undertaking discovery risks, not development risks. Conoco's 1985 "Initial Development Plan for the Shallow Oil Sands in the Milne Point Unit" and attachment to its December 7, 1989 discovery royalty application demonstrate that the development decision was a matter of timing (in relationship to the production from the Kuparuk Formation), oil prices, transportation prices, taxes, completion and production techniques and other such issues. In other words, actual development was determined by factors unrelated to any discovery efforts made by means of the G-1 well.

The statute was changed to explicitly focus on discovery rather than commercial production.

The Territorial Legislature enacted royalty provisions in 1955 that provided for issuance of oil and gas leases

> with a royalty fixed by the Commissioner, with the approval of the Attorney General and the Commissioner of Mines, at not less than five percentum (5%) the first ten years of new production, and twelve and one-half percentum (12%) each year thereafter ....

Sec.3, ch.189 SLA 1955. Emphasis added.

In 1957, the incentive was limited to the first producer in a new area. The statute provided, as a general rule, for a floor of 12 1/2%, with the following proviso:

> provided that a royalty of not less than five percentum (5%) for the first ten years will be allowed the first producer in a new area.

Art. IX, sec. 2, Ch 184 SLA 1957.

In 1959, the legislature rejected the earlier incentives triggered by commencement of production, and restricted the five percent royalty to the lease upon which a "first discovery of oil and gas in commercial quantities in a separate geologic structure" is made. Section 7, ch. 169 SLA 1959. This leaves no room to award a discovery royalty in this case. The risks and costs of commencing production (whether "new production" generally or as the "first producer in a new area") were rejected by the legislature as a basis for a reduced royalty. The legislature replaced an incentive tied to commencement of production with an incentive tied to "first discovery." The division has no authority to attempt to circumvent that clear intent.

CONCLUSION

The intent of the repealed statute was clearly to provide an incentive to discover and place on production new fields in previously untested structures. The statute foremost required the holder of the lease to "drill and make the first discovery" in a geologic structure (AS 38.05.180 repealed). Conoco exposed the fact that the G-1 well is not a discovery well in the attachment to its December 7, 1989 application by stating "The risk of geologic nonsuccess for the shallow oil sands at Milne Point is small."

Accordingly, the Milne Point G-1 well clearly does not meet the criteria for a discovery well. This well penetrated the Shallow Oil Sands in a geologic structure that had been discovered and determined to be productive over 20 years ago. Since 1969, the SOS has been penetrated and been found to be a hydrocarbon reservoir by hundreds of wells in the same geologic structure. Therefore, it is clear that the Milne Point G-1 fails to meet either the requirements or the intent of the repealed discovery royalty statute.

James E. Eason

James E. Eason
Director

WALTER J. HICKEL, GOVERNC

DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

P.O. BOX 107005
ANCHORAGE, ALASKA 99510-7005
PHONE: (907) 762-2483

CERTIFIED MAIL
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January 16, 1992

DECISION

Conoco, Inc.	:	Oil and Gas Lease
Suite 200	:	ADL 25906
3201 C Street	:	Milne Point Unit
Anchorage, Alaska 99503	:	

DECISION AFFIRMING DIRECTOR'S DENIAL OF DISCOVERY CERTIFICATION BASED ON MILNE POINT UNIT G-1 WELL

I have carefully reviewed the decision ("Decision") of the Director of the Division of Oil and Gas denying a "discovery royalty" to Conoco, Inc. ("Conoco"). The Decision concludes that Conoco's G-1 well in the Milne Point Unit did not qualify the lease for an award of the reduced "discovery royalty" rate because the well did not make a "first discovery of oil or gas in commercial quantities in any geologic structure." In essence, the Decision concludes that both the existence of the geologic structure (referred to variously as the "Schrader Bluff Formation" the "West Sak," and the "Shallow Oil Sands" ("SOS")) and the quantities of oil accumulated in the structure were known prior to the drilling of the well. The Decision determined that it was most accurate to describe the G-1 Well as "Conoco's first planned production well within the SOS" (Decision at 4, emphasis added), not as a "discovery well."

I have also carefully reviewed Conoco's appellate brief. Conoco does not deny that the structure had previously been discovered through the drilling of other wells, and that prior exploration had yielded confirmation that the structure contained a large accumulation of oil. Brief of Appellant ("Br.") at 1-2, and 3 at n.1. See also Affidavit of Alan Hastings, paragraph 10 ("Hastings Aff."), where it admitted that in 1985, four years before the G-1 Well was drilled, a study by the Milne Point Unit had estimated that there were "over 366 million barrels of oil in place" on the lease at issue alone. In light of this admission that the G-1 Well broke no new exploration ground, it is not surprising that Conoco tries to diminish the significance and common sense meaning of the "discovery" requirement. Thus, Conoco argues that the key requirement is not a discovery at all, but rather the mere drilling of the first well that establishes "commercial quantities." The term "commercial quantities" is, in turn, equated with actual "commerciality" (Br. at 4, 1.1) and "capability of commercial production" (Br. at 2, 11.14-15, emphasis added).

My review of the record of this appeal, and a common sense application of former AS 38.05.180(a) and the lease to the facts, compel me to affirm the Decision of the Director.

The former statute and regulations intended to encourage the discovery of new oil bearing structures and once a new discovery is made, to encourage rapid development of and production from the structure.

The plain language of AS 38.05.180(a) shows that the legislature intended to encourage drilling to discovery previously unknown oil bearing structures and once a discovery is made, to encourage rapid development of and production from the structure. "Discover" means to "be the first to find, learn of, or observe." Am. Her. Dictionary 376 (1970). In this instance, it means to find an oil bearing structure, not previously known. This requirement is emphasized by the term "first discovery." Importantly, the statute ties the finding with "drill(ing)". Thus, the statute obviously seeks to encourage exploratory drilling. The statute also plainly encourages rapid production by limiting the reduced rate to a ten year period following the date of discovery.

The Alaska Supreme Court has stated that the former regulations implementing the statute specified the three elements required by the statute for discovery well certification: date of discovery, commercial quantities, and geologic structure. See Union Oil Co. v. State, 574 P.2d 1266, 1269 (Alaska 1978). The regulations suggest that these elements are separate and distinct, and can be established at different times. When read as a whole these regulations foster the dual purposes of the statute--to encourage exploratory drilling and rapid production.

The regulations define the date of discovery element as the date that an operator first finds oil or, in the exact of language of the regulations, "first encounters sufficient evidence of oil or gas in a particular geologic structure". 11 AAC 83.200. This event starts the running of the ten year reduced rate period. 11 AAC 83.215. At this point, the operator is not required to show that the evidence is sufficient to prove production in commercial quantities, only that the evidence is enough to cause the reasonable operator to continue operations. In order to preserve his priority, he must provide a sworn statement of the first encounter within thirty days of the encounter.

The regulations do not require the operator to provide evidence of the second element, commerciality, until later. This is consistent with the reality that an operator first encounters or discovers oil, and then tests or evaluates a find to determine whether it is commercial. See Shoni Uranium Corp. v. Federal-Radrock Gas Hill Partners, 407 P.2d, 712 (Wyo. 1965) ("Upon the discovery . . . there was an implied obligation on the part of the lessee to do whatever was necessary under the circumstances (1) to ascertain whether the deposit existed in commercial quantities; and (2) thereafter to reasonably develop") (deletions in original). The regulations provide that the operator must continue to work diligently to "complete a well in the discovery zone . . . that can be tested for . . . commercial quantities." 11 AAC 83.210. The second event occurs when the operator establishes commercial quantities. 11 AAC 83.210(b)(1).

The third event occurs when the operator establishes that the discovery is in a separate geologic structure. This can occur up to ninety days after the date of the commercial quantities potential test.

Conoco's argument equating the "first to drill and discover oil" with the "first to produce oil" is inconsistent with the statute's plain language and would frustrate its purposes.

The director denied Conoco's application because he found that the G-1 well was not the first well to discover oil in the SOS structure. Both the East Ugnu No. 1 well and the A-1 well had encountered oil long before the G-1 well. Conoco argues that the discovery requirement and the commercial requirement should be collapsed into one test. It asserts that who discovered the oil is irrelevant. Br. 8. According to Conoco, in order to be the discovery well, the well itself must be shown to be "capable of production in commercial quantities." Br. 8.[1] Thus, discovery

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[1] I need not address whether the repealed regulations are binding or not Conoco's argument, which is premised on the regulations continued validity and on Conoco's interpretation of former 11 AAC 83.205(1) which defined "discovery," ignores the entire context of the regulations and is nonsensical. Under the regulations, the first or initial discovery of a discovery zone in a structure is the first encounter. 11 AAC 83.210. The commercial quantities test of the zone may be demonstrated in the first encounter well or a later well in the same structure. 11 AAC 83.200-.215. By misinterpreting 11 AAC 83.205(1), Conoco would (continued...)

depends not upon new knowledge of an oil-bearing structure acquired through drilling, but upon technological improvements, new tax benefits, projected oil price, and the operator's internal economics. See App. Br. 3; Affidavit of Harold D. Haley at 3, paragraph 6.

Conoco's interpretation would change the statutory language whoever "drills and makes the first discovery" to whoever "first completes a production well." The Decision pointed out, this would in essence make the statute read as it formerly did in the territorial days. It would reward purely production risks as opposed to discovery and production risks. As discussed in the preceding section, discovery royalty was intended to reward those who successfully undertook the geologic and economic risks associated with exploration tied to rapid development. While oil prices, cost of production, and efficiency of production influence when an accumulation of oil may be brought into production and what level

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[1](...continued)
require that both discovery and commercial quantities be proved in the same well. Br. 8-9.

Conoco's incorrect reading of 11 AAC 83.205 ignores the provisions of 11 AAC 83.200, .210, and .215, all of which contemplate that discovery and commercial quantities may be shown at different times and in different wells. Reading 11 AAC 83.205(1) consistently with these other provisions, "first acceptable evidence in a drilling well of the existence of oil or gas" refers to the first encounter while the modifying clause "which can be produced in commercial quantities after well completion" refers to the requirement that a well in the structure must meet the commercial quantities test. It is noteworthy that 11 AAC 83.205 does not require that the well which provides the first acceptable evidence be tested or produced. 11 AAC 83.205(1) refers to whether the structure can be produced in commercial quantities and refers to a future test in some well, not necessarily the well providing the first acceptable evidence of oil. The commercial quantities test only confirms that the first encounter has met the statutory requirement of a "discovery of oil or gas in any geologic structure." AS 38.05.180(a) (emphasis added). This is consistent with the division's and industry's twenty year history with discovery royalty that "discovery occurs upon the first encounterment of oil and gas, not upon the date of a drill stem test confirming the extent of the discovery of oil and gas." See Niakuk 34635 No. 5 Certified as Discovery Well ADL 34635 Conditionally Granted Five Percent Discovery Royalty (September 2, 1988) at 5.

of profits or loss the producer may enjoy, they do not determine when a "discovery" has taken place, or change the quantity of oil that has been discovered. Conoco's interpretation would frustrate the statute's dual purposes.

Conoco's interpretation would allow the operator to choose his discovery well and thereby manipulate the date of discovery to frustrate the rapid production intent of the statute. Since the ten year reduced rate commences on the date of discovery, an operator, who encountered a good show of oil, could delay the commencement of the period by delaying completion of testing of commerciality to coincide as closely as possible with the initiation of actual production.

Conoco's interpretation would also lead to absurd results as illustrated by a hypothetical example. Assume that lessees A and B purchased adjoining leases over the same prospect. However, only lessee A undertook the costs and risks of exploration, discovering a large accumulation. Assume, however, that the low quality of the oil and the high cost of production rendered it uneconomic to produce the accumulation at forecasted oil prices. Further, assume that after the results of lessee A's discovery efforts became public, a war in the mideast caused large price increases. Finally, assume this causes both lessee A and lessee B to commence drilling in order to produce oil from this known accumulation. Under Conoco's theory, lessee B would be credited with making the "first discovery of oil in commercial quantities in a geologic structure" if it were first in completing its well, despite the fact that lessee A had actually undertaken the discovery risks some years earlier, and lessee B did nothing except more quickly respond to a changed economic opportunity. This makes no sense.

The decision in Joseph I. O'Neill, Jr. 77 Interior Dec. 181, IBLA 70-39 (1970), supports my interpretation. In that case an argument similar to Conoco's argument that "discovery of oil and gas in commercial quantities" means "a well that is capable of production in commercial quantities" was rejected by the federal Board of Land Appeals. The Mineral Leasing Act provided that leases segregated from a primary lease would be extended for two years from the date of "discovery of oil or gas in paying quantities" upon any other segregated portion of the lease. The Board of Appeals rejected an argument that a well capable of producing oil or gas in paying quantities was required before an extension would be granted. After stating that "discovery" means "to find something not known before" the Board refused to read into the statute a predicate of a well capable of producing in paying quantities. Id. at 61. It stated that if Congress wanted to impose such a requirement, "it could have easily so provided. It did not." Id. at 62.

Likewise, had the legislature intended to reward only production, it could have easily awarded a reduced royalty to the first producer in the structure like the Territorial legislature did. But, it did not. I will not equate discovery with production.

As explained in detail in the Decision, the G-1 well did not make the first discovery of oil and gas in the SOS structure.[3] Conoco knew not only of the existence of oil bearing structure, but also the supergiant size of the accumulation, before it drilled. It did not bear any exploratory risk.

Even if Conoco's argument was correct, it would not be entitled to discovery royalty because previous wells demonstrated commercial quantities.

The G-1 well was hardly the first well into the SOS that yielded "acceptable evidence" of commercial quantities in the discovery zone. As explained in the Decision, many wells, including Conoco's own A-1, B-2, A-3, and N-1B wells, drilled and tested earlier in the SOS yielded that evidence. I find that the flow rates from potential tests in several of Conoco's earlier wells yielded acceptable evidence that oil could "be produced in commercial quantities." Furthermore, Arco's pilot program in the SOS structure demonstrated that the structure was currently commercial,

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[3] Conoco cites two other discovery royalty applications in support of its idea that "first discovery" is different from "first encounter." Neither of the cited cases assist Conoco. It is true that Point McIntyre No. 3 was certified despite the fact that earlier wells had penetrated the structure. However, it is clear that merely penetrating the structure does not constitute a first discovery. In the case of Point McIntyre, the operators of the wells making those earlier penetrations (the Point McIntyre No. 1 and No. 2 wells) failed to acquire sufficient evidence of a discovery before abandoning the wells as dry holes. Such corroborative data might have included open-hole logs, tests, or core data from the discovery intervals. This sharply contrasts with the circumstances extant with Conoco's knowledge regarding the SOS, where over a billion barrels of oil were known to exist from prior exploratory drilling.

In the case of the Sag Delta No. 3 well, it encountered no productive interval at all.

albeit only marginal. See DeRuiter, Nash & Wyrick, Solubility and Displacement Behavior of Carbon Dioxide and Hydrocarbon Gases with a Viscous Crude Oil, SPE 20523 (1990).[3]

Conoco argues the failure of any previous owner to undertake commercial development demonstrates that the previous wells did not discovery commercial quantities. First, the fact that no earlier lessee applied for certification is irrelevant. Br. at 7-8. The issue is not whether others could have qualified, but whether Conoco does. Second, the other's failure to develop in not surprising, given that the owners' decision to develop the underlying more economic Kuparuk structure first for their own internal reasons.

Even under Conoco's interpretation of "discovery" any benefit from discovery royalty would have expired before the drilling of the G-1 well.

I have previously stated my opinion that the first encounter well is the discovery well. Even if I accepted Conoco's argument that the first well to produce was the discovery well, the first encounter would nevertheless start the running of the ten year reduced royalty period.

Both regulations 11 AAC 83.200 & 210 refer to the first encounter of oil and gas. 11 AAC 83.210 states

> to establish priority as to the time and date of discovery, an operator must furnish the committee with a sworn statement and substantiating evidence acceptable to the committee that oil or gas has been encountered in sufficient showing to cause a reasonable and prudent operator to conduct further operations in an effort to complete a well in the discovery zone so that the well can be tested for potential oil or gas production in commercial quantities. The statement must include the time and date of first discovery . . .

[3] Conoco misunderstands the commerciality test as defined in the regulations. Conoco would require actual commercial development as the only method of satisfying the commercial quantities test. Br. 5. The regulations only require a potential test which would in the future lead to one additional well with a reasonable profit if a market existed. 11 AAC 83.205. No actual development is required.

It is clear that "first discovery" refers to first encounter in this regulation.

Regulation 11 AAC 83.215 states that "the date of commencement of the 10 year-5 percent discovery royalty term shall be the first of the next month after the established date of initial discovery." It is clear that "initial discovery" in this regulation refers to the same event referred to in 11 AAC 83.210 as "first discovery," namely first encounter of the discovery zone. 11 AAC 83.215 bases the date of initiation of the 10 year reduced royalty on this date, which is distinct from the date in which a well establishes oil in commercial quantities. Both the division and the industry have consistently accepted that the ten year period begins to run from the date of first encounter, not confirmation or establishment of commercial quantities. See Niakuk, supra at 5. Therefore, even if I were to accept Conoco's claim that the G-1 well established commercial quantities in the SOS structure (which I do not), the date of commencement of reduced royalty would be controlled by the date of first encounter. Indisputably the date of first encounter or initial discovery of the SOS occurred more than ten years prior to the drilling of the G-1 well and subsequent initiation of SOS production ADL 25906. Therefore, none of the production from this lease would be entitled to a reduced royalty.

Conclusion

The discovery royalty expressly rewards the one who makes a "first discovery," not the one who is "first into production." I know the difference between discovery and production. Conoco knew when it drilled the G-1 well what the structure was, and, to a high degree of precision, the quantity and quality of the oil accumulation that would be encountered. Conoco faced not the risks of a dry exploration hole, but the economic risks associated with taking someone else's discovery into production. It is not my role as lease manager on behalf of the citizens of the state to transform the discovery incentive into solely a production incentive. Therefore, I affirm the Decision of the director.

Harold C Heinze

Harold C. Heinze
Commissioner

ENCLOSURE 28

MONTHLY SAVINGS ATTRIBUTABLE TO THE DISCOVERY ROYALTY PROVISION

Example Month: JULY 1994

Field	Savings
Niakuk/Lisburne	$198,768.00
Point McIntyre	$534,118.00
North Prudhoe Bay	$ 51,587.00
TOTAL	$784,473.00

Enclosure 28