

**2/13/08**

**PT.**

**THOMPSON**

**POINT THOMSON LITIGATION FACT SHEET**

Updated January 31, 2008

1. The Point Thomson Unit included 45 leases and covered over 106,000 acres on the North Slope east of Prudhoe Bay, abutting the ANWR boundary. It was formed in 1977, and its boundaries have expanded and contracted several times. ExxonMobil is the unit operator.
  - a. No development has taken place during the 30 years this unit existed. There has been no drilling activity for more than ten years.
  - b. Commissioner Menge disapproved the 22<sup>nd</sup> Plan of Development and terminated the unit on November 27, 2006 because the unit owners failed to fulfill development commitments. Acting Commissioner Rutherford affirmed Menge's Decision on Reconsideration December 27, 2006.
2. ExxonMobil, BP, Chevron and ConocoPhillips appealed the Menge/Rutherford decision to Superior Court. Judge Gleason ruled December 26, 2007 that the state acted properly when it rejected the 22<sup>nd</sup> Plan of Development filed by ExxonMobil as unit operator. She ruled that DNR had the authority to terminate the unit administratively without a judicial proceeding.
  - a. The judge rejected several legal theories advocated by the leaseholders, ruling that;
    - i. DNR was correct in not applying the reasonably prudent operator standard in its decision to terminate the unit.
    - ii. DNR did not act in bad faith during the stranded gas contract negotiations.
    - iii. The unit agreement does not continue indefinitely because a commercial reservoir was discovered.
    - iv. DNR can terminate this unit without judicial proceedings even though it includes wells that were once certified as capable of production in paying quantities.
  - b. DNR was directed to hold a hearing on remand to allow the leaseholders to argue about the appropriate remedy after the 22<sup>nd</sup> POD was rejected. The hearing will begin March 3, 2008 with Commissioner Irwin hearing the arguments and evidence.
  - c. The leaseholders were invited to file briefs on the appropriate alternative remedy to unit termination, and any evidence they choose to offer in support by February 19, 2008.
  - d. Commissioner Irwin will issue a written decision on the remanded issue. The leaseholders will have the opportunity to ask for reconsideration. Commissioner Irwin's final decision will go back to Judge Gleason for review. She directed DNR to issue its decision by June 15, 2008.
  - e. Judge Gleason's ruling on the results of the remand, and her original decision could be appealed together to the Supreme Court. The estimated time for a Supreme Court decision is 12 to 24 months after the appeal is filed.
3. The leaseholders were sent notices that 43 of the 45 leases in the former Point Thomson Unit terminated when the unit terminated because they were beyond their primary term.
  - a. The leaseholders appealed, designated an extensive record and filed briefs.



IN THE SUPERIOR COURT FOR THE STATE OF ALASKA

THIRD JUDICIAL DISTRICT AT ANCHORAGE

EXXON MOBIL CORPORATION, )  
Operator of the Point Thomson Unit; )  
BP Exploration (Alaska) Inc.; )  
Chevron U.S.A., Inc.; and ) Case No. 3AN-06-13751 CI  
ConocoPhillips Alaska, Inc., ) (Consolidated)  
 ) Case No. 3AN-06-13760 CI  
 ) Case No. 3AN-06-13773 CI  
Appellants, ) Case No. 3AN-06-13799 CI  
 ) Case No. 3AN-07-04834 CI  
v. ) Case No. 3AN-07-04620 CI  
 ) Case No. 3AN-07-04621 CI  
STATE OF ALASKA, Department of )  
Natural Resources, )  
 )  
Appellee. )

**DECISION ON APPEAL**

This case is before the superior court in its capacity as an appellate court on appeal from administrative determinations by the Department of Natural Resources (DNR) with respect to the Point Thomson Unit Agreement. See AS 22.10.020(d).

***Factual and Procedural Background***

In 1977, the Point Thomson Unit Agreement (PTUA) was entered into between Exxon (now ExxonMobil) and the Commissioner of the Department of Natural Resources for the State of Alaska for the purpose of facilitating the production of oil and gas at Point Thomson. [R. 1253-1271] ExxonMobil, which holds the largest percentage of leasehold interests at Point Thomson, is

identified in the PTUA as the Unit Operator. The other appellants in this action all have leasehold interests within the unit.

The following paragraphs of the unit agreement are particularly relevant to this appeal:

1. **ENABLING ACT AND REGULATIONS.** The Alaska Land Act (AS 38.05.005--370) and all valid and pertinent oil and gas statutes and regulations including the oil and gas operating statutes and regulations in effect as of the effective date hereof or hereafter issued thereunder governing drilling and producing operations, not inconsistent with the terms hereof or the laws of the State of Alaska, are hereby accepted and made a part of this agreement.

10. **PLAN OF FURTHER DEVELOPMENT AND OPERATION.** Within six months after completion of a well capable of producing unitized substances in paying quantities, the Unit Operator shall submit for the approval of the Director an acceptable plan of development and operation for the unitized land which, when approved by the Director, shall constitute the further drilling and operating obligations of the Unit Operator under this agreement for the period specified therein. Thereafter, from time to time before the expiration of any existing plan, the Unit Operator shall submit for the approval of the Director a plan for an additional specified period for the development and operation of the unitized land. The Unit Operator expressly covenants to develop the unit area as a reasonably prudent operator in a reasonably prudent manner.

Any plan submitted pursuant to this section shall provide for the exploration of the unitized area and for the diligent drilling necessary for determination of the area or areas thereof capable of producing unitized substances in paying quantities in each and every productive formation and shall be as complete and adequate as the Director may determine to be necessary for timely development and proper conservation of the oil and gas resources of the unitized areas, and shall:

- (a) specify the number and location of any wells to be drilled and the proposed order and time for such drilling; and,
- (b) to the extent practicable, specify the operating practices regarded as necessary and advisable for the proper conservation of natural resources. ...

Said plan or plans shall be modified or supplemented when necessary to meet changed conditions, or to protect the interests of all parties to this agreement. Reasonable diligence shall be exercised in complying with the obligations of the approved plan of development. ...

**16. CONSERVATION.** Operations hereunder and production of unitized substances shall be conducted to provide for the most economical and efficient recovery of said substances without waste, as defined by or pursuant to state law or regulation.

**20. EFFECTIVE DATE AND TERM.** This agreement shall become effective upon approval by the Commissioner or his duly authorized representative as of the date of approval by the Commissioner and shall terminate five (5) years from said effective date unless:

- (a) such date of expiration is extended by the Commissioner, or
- (b) it is reasonably determined prior to the expiration of the fixed term or any extension thereof that the unitized land is incapable of production of unitized substances in paying quantities in the formations tested hereunder ... or
- (c) a valuable discovery of unitized substances has been made or accepted on unitized land during said initial term or any extension thereof, in which event the agreement shall remain in effect for such term and so long as unitized substances can be produced in quantities sufficient to pay for the cost of producing same from wells on unitized land ~~within any participating area established hereunder~~ and, should production cease, so long thereafter as diligent operations are in progress for the restoration of production or discovery of new production and so long thereafter as the unitized substances so discovered can be produced as aforesaid ...

**21. RATE OF PROSPECTING, DEVELOPMENT AND PRODUCTION.**

The Director is hereby vested with authority to alter or modify from time to time in his discretion the quantity and rate of production under this agreement when such quantity and rate is not fixed pursuant to state law or does not conform to any statewide voluntary conservation or allocation program which is established, recognized and generally adhered to by the majority of operators in such state, such authority being hereby limited to alternation [sic] or modification in the public interest, the purpose thereof and the public interest to be served thereby to be stated in the order of alternation or modification. Without regard to the foregoing, the Director is also hereby vested with

authority to alter or modify from time to time at his discretion the rate of prospecting and development and the quantity and rate of production under this agreement when such alternation or modification is in the interest of attaining the conservation objectives stated in this agreement and is not in violation of any applicable state law.

Powers in this section vested in the Director shall only be exercised after notice to Unit Operator and opportunity for hearing to be held not less than ~~fifteen~~ *thirty* (30) days from notice, and shall not be exercised in a manner that would (i) require any increase in the rate of prospecting, development or production in excess of that required under good faith and diligent oil and gas engineering and production practices; or (ii) alter or modify the rates of production from the rates provided in the approved plan of development and operations then in effect or, in any case, curtail rates of production to an unreasonable extent, considering unit productive capacity, transportation facilities available, and conservation objectives; or (iii) prevent this agreement from serving its purpose of adequately protecting all parties in interest hereunder, subject to applicable conservation laws and regulations.

The language that is struck out in Sections 20 and 21 above was deleted, and the italicized language in Section 21 was added in 1985 amendments to the PTUA. [R. 794, 1253-1268, 9448]

As set forth in Section 1 of the unit agreement, the regulations in effect at the time of the agreement's inception were "accepted and made a part of [the unit] agreement." See also *Exxon Corp. v. State*, 40 P.3d 786 (Alaska 2001).

Three of those regulations have particular bearing on this case.

Former 11 AAC.83.315 provided as follows:

**RATES OF PROSPECTING AND PRODUCTION.** The director [of the former State Division of Lands] may require that any unit agreement contain a provision vesting authority in the director or other person, committee, or agency as may be designated in the agreement and satisfactory to the director, to alter or modify from time to time the rate of prospecting and development and the quantity and rate of production under the agreement.

Former 11 AAC 83.340 provided in relevant part as follows:

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**APPROVAL OF UNIT AGREEMENT.** A unit agreement will be approved by the director if he determines that the agreement is necessary or advisable in the public interest, is for the purpose of more properly conserving natural resources, and adequately protects all parties in interest including Alaska ...

Former 11 AAC 83.345 provided as follows:

**MODIFICATION OF UNIT AGREEMENTS.** Any modification of an approved unit agreement is subject to the director's approval in the same manner and upon the same determination as the original agreement.

In addition to the above-quoted regulations, there was also a chapter of procedural regulations that were in effect in 1977 that applied to unit agreements. This chapter, entitled "Practice and Procedure," applied to several other chapters of the natural resources regulations, including the unitization chapter. It contained several provisions regarding administrative adjudications, including a provision for judicial appeals to the superior court of administrative decisions and actions.<sup>1</sup> But these former regulations did not contain any provision that required or authorized a unit termination or default action to be initiated by judicial proceedings. Former 11 AAC 88.100 – .185 (Eff. 9/20/74)

There are two subsections of the Alaska Land Act as it was in effect in 1977 that relate to unit agreements:

Former AS 38.05.180(m) provided as follows:

To conserve the natural resources of all or a part of an oil or gas pool, field, or like area, (whether or not the part is then subject to a cooperative or unit plan of development or operation), lessees and their representatives may unite with each other, or jointly or separately with others, in collectively adopting or operating under a

<sup>1</sup> Former 11 AAC 88.160 (Eff. 9/20/74).

cooperative or a unit plan of development or operation of the pool, field, or like area, or a part of it, whenever determined and certified by the commissioner to be necessary or advisable in the public interest. The commissioner may, with the consent of the holders of the leases involved, establish, alter, change, or revoke drilling, producing, rental minimum royalty, and royalty requirements of the leases and make regulations with reference to the leases, with like consent on the part of the lessees, in connection with the institution and operation of a cooperative or unit plan as he determines necessary or proper to secure the proper protection of the public interest. The commissioner may provide that oil and gas leases issued under this section shall contain a provision requiring the lessee to operate under a reasonable cooperative or unit plan, and he may prescribe a plan under which the lessee shall operate. The plan shall adequately protect all parties in interest, including the state.

Former AS 38.05.180(n) provided in relevant part as follows:

A plan authorized by (m) of this section, which includes lands owned by the state, may contain a provision vesting the commissioner, or a person, committee, or state agency with authority to alter or modify from time to time the rate of prospecting and development and the quantity and rate of production under the plan ...

The Alaska Land Act also accords broad authority to the Commissioner of the Department of Natural Resources. Specifically, AS 38.05.020 provides that "[t]he commissioner may establish reasonable procedures and adopt reasonable regulations necessary to carry out this chapter," and the commissioner may "exercise the powers and do the acts necessary to carry out the provisions and objectives of this chapter." These statutory provisions were in effect in 1977 and remain in effect today.

Overlying the entire statutory and regulatory construct is Article VIII, Section 2 of the Alaska Constitution, which provides, "[t]he legislature shall

provide for the utilization, development and conservation of all natural resources belonging to the State, including land and waters, for the maximum benefit of its people."

Several current regulations have been discussed by the parties extensively in this appeal, including 11 AAC 83.303; 11 AAC 83.336; 11 AAC 83.361; and 11 AAC 83.374. None of these regulations was in effect when the PTUA became effective in 1977. They were all originally adopted in 1981.

The history of the Point Thomson Unit has been thoroughly set out in the record before this court, including in the decisions issued at the administrative level. [See, e.g., R. 629-635] Since the unit's formation in 1977, eighteen exploration wells have been drilled within and around the PTU. At the request of the Unit Operator, the Division of Oil and Gas of the Department of Natural Resources (Division) certified seven wells within the PTU as capable of producing hydrocarbons in paying quantities. [R. 640] With one exception, all of those certifications were issued, and the wells all then abandoned, prior to 1987. [R. 5681] The last well was certified in 1994 and abandoned the following day. [Id.]<sup>2</sup>

The PTU Lessees are required to submit Plans of Development (PODs) at specified intervals to the Division that set out their development plans for the unit. The current controversy arises from the Department of Natural Resources'

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<sup>2</sup> However, the certification letter for the last well dated April 26, 1994 indicated, "It should be noted, however, that the well is not capable of producing in paying quantities as that phrase is defined in section 9 of the Point Thomson Unit Agreement." [R. 5681]

refusal to approve the Lessees' proposed 22<sup>nd</sup> Plan of Development for the Point Thomson Unit. [R. 1966-1976] The Division rejected the Lessees' first proposed 22<sup>nd</sup> Plan of Development in a decision dated September 30, 2005. [R. 12282] That proposed 22<sup>nd</sup> Plan, as described by the Division, conditioned PTU development on amending the State's existing tax and royalty structure and construction of a North Slope gas pipeline. [R. 12297] The Division found "the current PTU Owners have had the leases for far beyond their primary term, and their conclusion today is simply that they cannot make enough money to justify development. It is time for the PTU Owners to develop and produce or give new lessees ... a chance to develop the known hydrocarbon resources within the PTU." [R. 12303] That initial decision held that "[f]ailure to submit an acceptable plan of development is grounds for termination of the PTU." [R. 12305] The initial decision then referenced Section 21 of the PTUA, and held that "the PTU Operator shall commence development operations within the PTU by October 1, 2007. The PTU Owners shall have an opportunity for hearing regarding this notice to modify the rate of PTU development." [*Id.*] The initial decision also required that "the PTU Operator shall begin commercial production of unitized substances from the PTU by October 1, 2009." [R. 12304]

Shortly after the issuance of the September 2005 decision, the Division issued an Amended Decision on October 27, 2005. [R. 12282] The Amended Decision removed all references to Section 21 of the PTUA, because, according to the Amended Decision, that section does "not apply to the Division's

evaluation of the Unit Operator's proposed plans for development of the Point Thomson Unit." [Id.]<sup>3</sup> The Amended Decision of October 2005 accorded the Unit Operator 90 days within which to submit an acceptable POD. The Amended Decision also modified the initial decision to provide that the development and production deadlines previously specified in the initial decision were "an example of an acceptable PTU plan of development." [R. 12304; emphasis added] The Amended Decision eliminated the reference to the opportunity for a hearing regarding the proposed modification of the rate of PTU development. [R. 12305] But the Amended Decision retained the language from the initial decision that "[f]ailure to submit an acceptable plan of development is grounds for termination of the PTU." [R.12305]

The initial decision and the Division's Amended Decision of October 2005 both noted that the Division had certified seven wells on the unit as capable of producing hydrocarbons in paying quantities. [R. 12295] Nothing in either the initial decision or the Amended Decision of the Division purported to decertify those wells. To the contrary, the Division's Amended Decision stated, "the PTU contains wells certified as capable of production in paying quantities." [R. 12302]

The Division's October 2005 Amended Decision recognized that negotiations between State representatives and some of the PTU Lessees for

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<sup>3</sup> See also State's Br. at 49, n. 56. There, the State asserts that Section 21 "relates to the Director's authority to change the rate of prospecting and development once Lessees are operating under an approved POD," and is not applicable with respect to the approval of the POD itself, which the State asserts is governed solely by Section 10 of the PTUA. But see Section 21 as amended, paragraph 2, and the reference there excluding applicability of portions of that section to approved plans of development. [R. 794]

the construction of a gas pipeline were ongoing at that time, but clearly indicated that such negotiations would not serve as a basis to delay PTU development: "At this point in time, the PTU Owners do not control if or when a North Slope gas pipeline will ever be operational. Reliance on third parties, beyond the control of the PTU Owners, is not grounds for the delay of PTU development and production." [R. 642]

The ninety-day deadline for submission of an acceptable modified 22<sup>nd</sup> POD was extended by the Division until October 20, 2006, during which time negotiations continued with respect to the development of a gas pipeline. The resultant proposed Fiscal Contract for a gas pipeline included certain provisions dealing with the PTU. Specifically, the proposed Fiscal Contract provided that if certain PTU Lessees undertook designated actions with respect to the development of a gas pipeline, the State agreed not to terminate the PTU. [App. 125]

In May 2006, the proposed Fiscal Contract was submitted to the Alaska Legislature for its consideration as required by the Stranded Gas Development Act. [App. 125] On October 18, 2006, while the Fiscal Contract was still under legislative consideration, ExxonMobil submitted a modified 22<sup>nd</sup> POD to the Commissioner. [R. 3089-3105] The modified 22<sup>nd</sup> POD did not propose to put the unit into production by 2009, a commitment that had been delineated by the Division as a component of an acceptable plan of development in the Division's Amended Decision of October 2005. [R. 667] The Lessees have asserted that

the modified 22<sup>nd</sup> POD was consistent with the terms of the proposed Fiscal Contract. [App. 126] However, the Fiscal Contract had not been approved by the Legislature at that time, and indeed, has not ever been approved by the Legislature.

Oral argument before the Commissioner on the modified proposed 22<sup>nd</sup> POD was held on November 20, 2006. No participant requested an evidentiary hearing. However, approximately 5,000 pages of documents regarding the modified proposed POD were submitted to the Commissioner prior to the November 2006 hearing. [R. 5672]

The Commissioner issued a Decision on Appeal on November 27, 2006.

[R. 5670-5689] As summarized in the decision itself, the Decision on Appeal:

- (1) denies the request for modification of the 2001 Expansion Agreement, as amended, which affects only the expansion leases;
- (2) affirms the Director's Decision in all respects to the extent it is consistent with this Commissioner's Decision, but the Director's Decision is disapproved to the extent that it can be read to mean the PTU contains certified wells;
- (3) adopts and incorporates into the Commissioner's Decision the findings and rationale of the Director's Decision as modified by this Decision;
- (4) rejects the cure or revised 22<sup>nd</sup> PTU POD submitted by the Lessees on October 18, 2006; and
- (5) terminates the PTU.

[R. 5671]

The Commissioner rejected the Lessees' contention that the modified proposed 22<sup>nd</sup> POD should be evaluated pursuant to the Reasonably Prudent Operator Standard. He characterized the "lessees' appeal [as] based on the premise that they do not have to produce because a Reasonably Prudent Operator would not produce." [R. 5684] The Commissioner acknowledged that

Section 10 of the PTUA included a covenant by the Lessees to "develop the unit area as a reasonably prudent operator in a reasonably prudent manner." But he added, "Section 10 says much more." [*Id.*] He noted the PTU was not in production even though "massive PTU reserves were found in the early 1980s."

[R. 5686] Then he added,

I specifically find that the Reasonably Prudent Operator standard does not apply to this Commissioner's Decision involving a long standing unit with leases far beyond their primary term and Lessees which unambiguously refuse to adequately explore, delineate, or produce massive known hydrocarbon reserves. The Reasonably Prudent Operator language of section 10 of the unit agreement does not supersede the other provisions of that section, or the applicable statutes, regulations or leases. Section 10 contains significant detail on what an acceptable POD must contain and the Director's Decision asked the Lessees to comply. Instead, they ask for the protection of the RPO standard, but on these facts, it matters not what a Reasonably Prudent Operator would do, the state is entitled to terminate the PTU.

[R. 5686-87]

In his decision, the Commissioner noted that seven wells in the PTU had been previously certified by DNR as "capable of producing in paying quantities."

But he then held as follows:

Whatever the merits of the certifications when they were originally issued, the suggestions in the Director's Decision that certified wells exist today or that the prior certifications of now non-existent exploration wells indefinitely extend the term of the leases upon which they were drilled or that the PTU should be treated as a unit with certified wells is disapproved and reversed in this Commissioner's Decision. Those suggestions are not supported by the facts. There are no certified wells in the unit capable of producing in paying quantities. All wells which were certified have been plugged and abandoned. Inconsistent findings and statements in the Director's Decision on certified wells are hereby disapproved.

[R. 5682]

The Commissioner affirmed the Director's Amended Decision "in all respects to the extent it is consistent with this Commissioner's Decision, but it is disapproved to the extent it can be read to mean the PTU contains certified wells." [R. 5688] The Commissioner rejected the revised 22<sup>nd</sup> POD because it did "not commit to put the unit into production." He concluded that "[t]he PTU is terminated." [R. 5688, 5689]

Some of the PTU Lessees sought reconsideration of the Commissioner's Decision. The primary issue on reconsideration addressed the propriety of the Commissioner's determination that the PTU contains no wells certified as capable of producing in paying quantities. From there, the Lessees asserted that since the wells remained certified, the unit could only be terminated through judicial proceedings, citing 11 AAC 83.374(d). The Lessees also asserted that they did not receive fair notice that the certified well status of the PTU wells was at issue, and requested that DNR reopen the administrative proceedings for that reason. [R. 9287]

On December 27, 2006, Acting Commissioner Marty Rutherford issued an 11-page Decision on Reconsideration, which affirmed the Commissioner's Decision of November 27, 2006 in all respects. [R. 9286-9298] The Reconsideration Decision expressly distinguished between the well decertification component of the November 2006 decision and the termination component of that same decision. The Reconsideration Decision characterized

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the certified well status as a "collateral finding" to the termination decision. [R. 9288] Specifically, the Reconsideration Decision found:

The certified well finding is not the basis of the November 27, 2006 unit termination decision. The unit termination decision is based primarily on two independent grounds neither one of which regards certified wells.

One ground for unit termination is that DNR is entitled to terminate a unit which has been known to contain massive hydrocarbon reserves for more than 30 years, but which has never been put into production, when the lessees of the state oil and gas leases making up the unit unequivocally state that they still cannot find a way to put the unit into production. DNR is entitled to terminate a unit because the purpose of forming a unit is to effect production. Units are not formed for the purpose of simply holding properties until such time as the Lessees think production will be profitable enough to commence. On these facts, when the Lessees say they cannot put the unit into production, DNR can terminate the unit as a matter of law.

The second primary ground for unit termination is the failure to submit an acceptable Plan of Development. . . .

[R. 9289-90]

The Reconsideration Decision also addressed, but did not directly resolve, the Lessees' argument that 11 AAC 83.374(d) requires the agency to pursue unit termination through court proceedings, and not by administrative determination. In this regard, the decision notes, "[e]ven if the PTU contains certified wells, the November 27, 2006 Decision is an appropriate DNR action which facilitates court review." [R. 9292] The Reconsideration Decision acknowledges that it is undisputed that the decertification approach "reverses longstanding DNR Oil and Gas Director's Decisions that certify non-existent or non-production wells." [R.

9295] But the Acting Commissioner indicates that the longstanding policy was "poor policy" which it was incumbent on the Commissioner to correct. [R. 9296]

The Reconsideration Decision also held that the Lessees' own submissions to the Commissioner demonstrated that the Lessees had adequate notice that decertification was an issue before the Commissioner. [R. 9294-95]

The Acting Commissioner also found that the State was not estopped from decertifying the wells and that it had not breached the covenant of good faith and fair dealing under the Unit Agreement. [R. 9296-97]

Four of the PTU Lessees appealed the Commissioner's Decision and the Reconsideration Decision. The appeals were all consolidated to this court, sitting in its appellate capacity pursuant to AS 22.10.020(d).

In March 2007, the Appellants filed a motion with this court seeking to stay the administrative determinations pending appeal. They asserted that because the Division had certified wells in the unit as capable of producing hydrocarbons in paying quantities, subsection (d) of 11 AAC 83.374 applied such that the Division was required to "seek to terminate the unit agreement by judicial proceedings," and was precluded from administratively terminating the unit. By order dated May 1, 2007, this court denied the stay. While this court found that the Appellants had made a "clear showing of probable success on the merits" that the administrative termination of the unit did not comply with 11 AAC 83.374(d), this court also found that granting the stay would be contrary to the public interest, and particularly the benefit of according to DNR the opportunity to

appropriately address the related lease termination proceedings in the first instance. However, this court did query the parties at the end of those proceedings whether there was any significance to the fact that 11 AAC 83.374 was adopted in 1981 – after the PTUA was entered into in 1977 – an issue that was not the focus of the parties' briefing on the stay motion.

In a separate order issued on May 7, 2007, this court held that Alaska Gasline Port Authority and Jim Whitaker would not be considered parties to this appeal. However, they were permitted to, and did submit amicus curiae briefing to this court.

Oral argument on the appeal was held on October 5, 2007. At oral argument, the Appellants each indicated they were not pursuing an appeal with respect to the Commissioner's decision on the expansion leases. Thereafter, ExxonMobil and Chevron USA filed a motion to dismiss those claims on appeal. The State filed a limited objection, focused primarily on the language of the proposed order of dismissal of that portion of the appeal. That motion is addressed below.

### ***Standard of Review***

Four different standards apply to a court's review of the merits of an agency's rulings: "(1) the 'substantial evidence test' for questions of fact; (2) the 'reasonable basis test' for questions of law involving agency expertise; (3) the 'substitution of judgment test' for questions of law involving no agency expertise,

and (4) the 'reasonable and not arbitrary test' for review of administrative regulations." *ConocoPhillips v. DNR*, 109 P.3d 914, 919 (Alaska 2005)(footnote omitted).

While the issue of contract interpretation "generally presents a question of law,"<sup>4</sup> where a contract specifies that certain determinations are to be made through an administrative process, then the court's review of those determinations "would need to be appropriately deferential"<sup>5</sup> such that the reasonable basis test would apply. See also *Usibelli Coal Mine, Inc., v. State, Dept. of Natural Res.*, 921 P.2d 1134, 1146 (Alaska 1996). Under the reasonable basis standard of review for administrative decisions involving complex issues involving agency expertise, the court is to give deference to the agency's determination so long as it is reasonable, supported by evidence in the record as a whole, and there is no abuse of discretion. *Ellis v. State, Dept. of Natural Resources*, 944 P.2d 491, 493 (Alaska 1997).

In this case, the parties generally agree that the regulations that DNR adopted in 1981 are applicable to the PTUA to the extent those regulations are "not inconsistent with the ... unit agreement or regulations in effect on the effective date of the lease or unit agreement." 11 AAC 83.301(b). Section 1 of the PTUA expressly provides:

The Alaska Land Act (AS 38.05.005–370) and all valid and pertinent oil and gas statutes and regulations including the oil and gas operating statutes and regulations in effect as of the effective

<sup>4</sup> *ConocoPhillips*, 109 P.3d. at 920.

<sup>5</sup> *Id.*

date hereof or hereafter issued thereunder governing drilling and producing operations, not inconsistent with the terms hereof or the laws of the State of Alaska, are hereby accepted and made a part of this agreement.

See also Exxon Corp. v. State, 40 P. 3d 786, 796-797. Where the parties to this appeal disagree is as to which of the 1981 regulations are consistent with the PTUA and which are inconsistent.

In Exxon Corp. v. State, 40 P.3d 786 (Alaska 2001), the Alaska Supreme Court addressed the Prudhoe Bay Unit Agreement (PBUA), which, like the PTUA, became effective in 1977. Although the issue the court confronted in that case – whether the lessees had an absolute right to expansion of that unit – is dissimilar to that here, many of the legal principles discussed there by the Supreme Court are applicable when analyzing the legal issues presented in this case.

In the Prudhoe Bay case, Exxon asserted that the PBUA eliminated DNR's discretion to refuse to expand the Prudhoe Bay Unit (PBU). The Department argued that it had the authority to consider the State's best interests in making a decision on whether to expand the PBU. DNR relied not only on the contract language, but also on the regulations in effect at that time, and specifically former 11 AAC 83.340 and former 11 AAC 83.345 – regulations which the court held "required the director's approval, based on a determination of necessity or advisability in the public interest, for a modification of an approved unit agreement." 40 P.3d at 795 (footnote omitted). Exxon then asserted that DNR had agreed to contract terms that were binding upon the agency even if

those terms violated DNR's regulations. But the Supreme Court held that an agency does not have the authority to contract outside of its own regulations. "To allow such activity would be arbitrary; parties not contracting with the department would not be held to the same regulations that non-contracting parties were required to comply with." 40 P. 3d at 796.

The Prudhoe Bay *Exxon* case teaches that the interpretation of the PTUA contract in this case must be governed by the language of the contract itself, as well as the regulations and statutes that were in place when the contract was adopted. Thus, to the extent that Section 1 of the PTUA could be read to limit the applicability of regulations that were in effect at the time of the PTUA's adoption, that reading is contrary to Alaska law and must be rejected. All of the applicable regulations in effect at the time of the PTUA's adoption apply to the PTUA agreement. Secondly, the current regulations and statutes apply to the PTUA "where not inconsistent with the ... unit agreement or regulations in effect on the effective date of the ... unit agreement." 11 AAC 83.301(b).

### ***Discussion***

There are two primary administrative determinations that are before the court in this appeal – (1) the Department's rejection of the Lessees' proposed modified 22<sup>nd</sup> Plan of Development for the Point Thomson Unit, and (2) the Department's termination of the Point Thomson Unit.

**I. DNR's rejection of the proposed 22<sup>nd</sup> Plan of Development**

**A. DNR has the authority to administratively determine whether a proposed plan of development should be accepted or rejected.**

The PTUA, when read in conjunction with the regulations in effect in 1977, clearly accorded to DNR the ability to administratively determine whether the Unit Operator is in compliance with Section 10 of the Unit Agreement. That section provides, among other statements, that any development plan submitted by the Unit Operator "shall be as complete and adequate as the Director may determine to be necessary for timely development and proper conservation of the oil and gas resources of the unitized areas." [R. 1260, emphasis added] Moreover, former 11 AAC 88.160 accords to the Unit Operator the right to appeal to the superior court a "decision or other action" by DNR. To the extent that the Appellants are asserting that the more recently adopted regulation 11 AAC 83.374 requires that rejection or acceptance of a proposed POD must be made in the first instance in judicial proceedings, as opposed to by DNR, that regulation would be inconsistent with the PTUA and former regulation and is accordingly inapplicable to this agreement.

**B. What is the appropriate standard for the Department to apply when determining the adequacy of a plan of development?**

The Appellants' primary assertion with respect to DNR's rejection of the proposed modified 22<sup>nd</sup> Plan of Development is that the agency applied the wrong legal standard when reviewing the proposed POD. The Appellants assert that as a matter of law, DNR is required to apply a reasonably prudent operator

(RPO) standard. They assert this standard is mandated based on the following sentence in Section 10 of the PTUA: "The Unit Operator expressly covenants to develop the unit area as a reasonably prudent operator in a reasonably prudent manner." [R. 1260] The Appellants assert that this contractual language, in conjunction with applicable statutes, "makes clear that DNR may not require the Operator to carry out a plan that is not reasonable from the perspective of the Operator, because it does not adequately protect the lessees' interests."<sup>8</sup>

The State asserts that the PTUA's reference to the reasonably prudent operator "acts primarily as a covenant *by the lessee* to act as a RPO and does not alter how DNR is to administer the PTUA. It defines the Lessees' commitment rather than limiting DNR's authority." [State's Br. at 46, emphasis in original] Accordingly, the State asserts that this court should affirm DNR's determination which rejected the 22<sup>nd</sup> Plan of Development because, as found by the Commissioner, both the original plan and the revised plan "suffered from the same defects" as each proposal did not commit to put the unit into production but instead contained the "unequivocal statement that the lessees cannot find a way to put the unit into production." [R. 9290, 9291]

Generally, issues of contract interpretation are legal issues as to which a court is to apply its independent judgment. But here, the disputed section of the PTUA – Section 10 – expressly confers upon the Division the authority to require a plan from the Lessees that "shall be as complete and adequate as the Director

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<sup>8</sup> Jt. Br. at 54, citing AS 38.05.180.

may determine to be necessary for timely development and proper conservation of the oil and gas resources of the unitized area . . ." [R. 1260] Accordingly, this court's review of those determinations "would need to be appropriately deferential" such that the reasonable basis test should apply. *ConocoPhillips v. DNR*, 109 P.3d 914, 919 (Alaska 2005)(footnote omitted); *see also Usibelli Coal Mine, Inc., v. State, Dept. of Natural Res.*, 921 P.2d 1134, 1146 (Alaska 1996); *Pan American Petroleum Corp. v. Shell Oil Co.*, 455 P.2d 12, 22-23 (Alaska 1969).

Adoption of the Appellants' interpretation of the contract to mandate the RPO standard would run counter to the regulatory and statutory provisions that were in effect at the time of the contract's creation. The applicable effective regulation at the time of contracting in 1977 required a determination by the State "that the agreement is necessary or advisable in the public interest... and adequately protects all parties in interest including Alaska." Former 11 AAC 83.340. Likewise, former 11 AAC 83.345 provides that this same standard applied to modifications of approved unit agreements. To interpret Section 10 of the PTUA to focus on the Lessee's perspective, so as to preclude rejection of any plan of development that the Lessees asserted was unreasonable for them, irrespective of the public interest, would be inconsistent with this regulatory directive. *See also* former AS 38.05.180(m).

In this regard, the current regulation, 11 AAC 83.303, is not inconsistent with Section 10 of the PTUA or the former regulations. That regulation requires

the DNR Commissioner to approve a proposed plan of development upon a written finding that it will "(1) promote conservation of all natural resources ... (2) promote the prevention of economic and physical waste; and (3) provide for the protection of all parties of interest, including the state." 11 AAC 83.303(a), (c)(3). In evaluating these criteria, the regulation specifies that the Commissioner is to consider several factors, including "the geological and engineering characteristics of the potential hydrocarbon accumulation," "prior exploration activities in the proposed unit area," and "the applicant's plans for exploration or development of the unit area." 11 AAC 83.303(b). DNR thoroughly addressed these criteria when it rejected both of the Lessees' proposed 22<sup>nd</sup> Plans of Development. [See, e.g., R. 12297-12303] DNR consistently rejected the fundamental tenet of both of the 22<sup>nd</sup> PODs that the Lessees proposed – that unit development should be conditioned upon the construction of a North Slope gas pipeline. [R. 12299]

Accordingly, this court finds that DNR did not err when it declined to review the modified POD under a reasonably prudent operator standard. In evaluating the POD, DNR also considered whether the proposed POD provided adequate protection of the public interest in light of the history of limited development in the unit area over its 30-year history. DNR's approach was consistent with Section 10's grant of authority to the Director to require a plan of development "as complete and adequate as the Director may determine to be necessary for timely development and proper conservation of the oil and gas

resources of the unitized areas," and complies with the applicable statutes and regulations.<sup>7</sup>

**C. Substantial Evidence Supports DNR's Determination to Reject the 22<sup>nd</sup> POD**

The Appellants also assert that even if judged by a different standard that the RPO, the modified 22<sup>nd</sup> POD should have been approved. They note that their modified plan called for an appraisal well to be drilled for the winter of 2008-2009. [Jt. Br. at 61] But with regard to this proposed well, DNR responded that under the Appellants' modified POD, they would pay the State \$40 million if they did not drill the well as planned. [R. 3096] The Commissioner found "the value of the well to the state greatly exceeds \$40,000,000 because a well or wells are needed to adequately appraise the PTU." [R. 5678] DNR, looking at the history of the unit, determined that "[t]he proposed payment is no substitute for adequate delineation of the PTU hydrocarbon accumulations, now long overdue and repeatedly requested by DNR." [R. 5683]

Further, the 22<sup>nd</sup> modified plan indicated that production would require a gas pipeline. [R. 3093] In rejecting that plan, DNR concluded that "neither the oil nor the gas condensate [within Point Thomson] require a gas pipeline to produce" -- a finding that is not directly refuted by the Appellants. [R. 9296]

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<sup>7</sup> *But see* Section 21, second paragraph, of the PTUA as modified in 1985. [R. 794] That revision specifies that the Department may not require any increase in the rate of production or development "in excess of that required under good and diligent oil and gas engineering and production practices." This section may well have applicability when determining the appropriate remedy when DNR rejects a proposed plan of development. See discussion, *infra*.

In sum, there is substantial evidence in the record as a whole to support DNR's determination to reject the modified 22<sup>nd</sup> Plan of Development based on DNR's finding that the plan contained "no commitment to develop the unit and no firm commitment to adequately delineate the reservoirs." [R. 5677-78]

***D. The Impact of the Fiscal Contract Negotiations***

The Appellants that participated in the gas pipeline negotiations<sup>8</sup> have asserted that the DNR Commissioner acted in bad faith in rejecting the modified POD in light of the State's course of conduct during the negotiations for the Fiscal Contract for a gas pipeline. The Appellants also assert that the DNR Commissioner "breached the obligation of subjective good faith" based on the Commissioner's statements at a press conference that occurred the day he issued his November 2006 decision in this case. [App. 130-31] And these Appellants assert these same facts support a claim of estoppel against the State. Specifically, they assert that they relied on those provisions of the proposed Fiscal Contract that relieved the Lessees of submitting PODs for so long as the fiscal contract was in place. [R. 2247]

The State asserts that any reliance by the Appellants that is based on the proposed Fiscal Contract is unreasonable because that contract was never finalized when legislative approval was not forthcoming. The Appellants point to no assertion outside the context of the Fiscal Contract negotiations in which the State indicated that it would accept a modified POD that did not commit the unit

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<sup>8</sup> Chevron was not a participant in these negotiations. [Exxon Br. at 62, n. 122]

into production. For example, the Commissioner's letter to Exxon of August 31, 2006, which accorded to Exxon the final extension of the appeal period, made no reference at all to the Fiscal Contract. [R. 3081]

The parties agree that this court should consider these claims de novo, since technically there is no administrative determination on these issues for this court to review. See generally *Danco Exploration v. State*, 924 P.2d 432, 434 (Alaska 1996).

To the extent the Appellants relied upon the proposed Fiscal Contract when they presented the modified POD, such reliance was unreasonable. Although the Fiscal Contract, had it been accepted by the Legislature, would have permitted the PTU to be developed in conjunction with the construction of a gas pipeline, the Fiscal Contract was never approved. DNR made no definitive statements that the Appellants would be relieved of their obligations under the PTUA even if the Fiscal Contract was not approved. To the contrary, DNR advised the Appellants that the agency would not delay a drilling commitment for so long as the Fiscal Contract negotiations were occurring. [R. 1958] In these circumstances, DNR is not estopped from rejecting the 22<sup>nd</sup> POD based on its determination that the POD did not propose an adequate development plan for the unit. See, e.g., *Mortvedt v. State, Dept. of Natural Res.*, 941 P.2d 126, 130 (Alaska 1997).

Nor can the Appellants maintain their claim for breach of the covenant of good faith and fair dealing. This covenant is intended to effectuate the reasonable

expectations of the parties under an existing contract. It "cannot be interpreted to prohibit what is expressly permitted" in the contract. *Casey v. Semco Energy, Inc.*, 92 P.3d 379, 384-385 (Alaska 2004), quoting *Ramsey v. City of Sand Point*, 936 P.2d 126, 133 (Alaska 1997). Here, the covenant cannot be applied to preclude DNR's rejection of the modified 22<sup>nd</sup> Plan of Development, because the authority to insist on a plan of development that is "as complete and adequate as the Director may determine to be necessary" is expressly accorded to DNR under the PTUA. [R. 1260]

Based on the foregoing analysis, DNR's rejection of the modified proposed 22<sup>nd</sup> Plan of Development is affirmed.

**II. Did DNR have the authority to administratively terminate the PTUA?**

The Director's Amended Decision of October 27, 2005 rejected the 22<sup>nd</sup> POD, but it did not purport to terminate the unit agreement. Rather, it stated that "the PTU Agreement is in default," and listed certain commitments that represented "an example of an acceptable PTU plan of development" to cure the default. [R. 12304] The Director's Amended Decision also indicated that "[f]ailure to submit an acceptable plan of development is grounds for termination of the PTU." [R. 12305]

The Commissioner's Decision and Decision on Reconsideration, issued one year later and after a modified POD proposal had been submitted to DNR by the Lessees, not only rejected the modified 22<sup>nd</sup> POD proposal – it terminated

the unit. The Appellees have asserted that DNR does not have the authority to administratively terminate the unit, but must instead seek to terminate the agreement through judicial proceedings.

The State has asserted several bases to support its authority to administratively terminate the PTUA when it has rejected a proposed Plan of Development for the unit. Each of these bases is discussed below.

**A. Section 20(c) of the PTUA is not applicable.**

One potential basis for the PTUA's administrative termination is pursuant to Section 20 of the agreement itself. This section of the PTUA, termed a "habendum clause," specifies certain bases upon which the unit agreement automatically terminates. There is no reference to this specific clause of the PTUA in any of the agency determinations in this matter. Moreover, at oral argument before this court in October 2007, counsel for the State made clear that the State was not seeking to invoke this clause to support the agency's termination decision. [See Transcript of Oral Argument of 10/5/07 at 34] Accordingly, any authority to administratively terminate or cancel the unit agreement must derive either from other provisions within the PTU Agreement itself or the regulations and statutes that are applicable to this particular agreement.

**B. Other sections of the PTUA regarding termination**

Section 9 of the PTUA delineates the parties' obligations prior to the discovery of hydrocarbons at the unit. Since hydrocarbons were discovered at

the unit decades ago, it is inapplicable to the current controversy. But Section 9 of the agreement is noteworthy in that it expressly provides that if the Unit Operator fails to diligently drill until hydrocarbons are discovered, "the Commissioner may, after 15 days notice to the Unit Operator, declare this unit agreement terminated." [R. 1259] In contrast, Section 10 of the PTUA, which applies after a well capable of producing unitized substances in paying quantities has been completed, is silent on the rights of either party to terminate or cancel the contract. It does not expressly accord to the DNR a right to administratively terminate the unit – nor does it eliminate any such right.

Section 20, discussed above, specifies when the PTUA shall *automatically* terminate. This court does not interpret that habendum clause and Section 9 of the PTUA to preclude the cancellation or termination of the contract under any other circumstance apart from those listed there. *See generally Law of Federal Oil and Gas Leases*, Vol. 1 at §14.19[1](1992)(distinguishing cancellation through affirmative agency action from automatic termination by operation of law). Indeed, the parties in this action recognize that the State could seek to cancel the contract based on an alleged breach of Section 10 by the Lessees. [See, e.g., Jt. Reply at 9] At issue is whether that cancellation proceeding would need to be initiated in state court or if the agency could seek to cancel the contract in an administrative proceeding. This court does not read the PTUA to preclude an administrative cancellation proceeding when the Director has determined that a

proposed plan of development is incomplete or inadequate under Section 10 of the PTUA.

**C. *The Statutes and Regulations in Effect in 1977***

A fundamental question thus arises – did DNR have the implied authority to administratively terminate the PTUA under the statutes and regulations in effect when the PTUA was entered into in 1977? The Appellants assert that no such authority existed, such that the State “like parties to contracts generally, [must] seek relief by way of a claim of default in court.” [CPA at 21] The State and the Port Authority assert that when the PTUA is silent, the agency has the inherent authority to administratively terminate the unit unless judicial action is specifically required by statute or applicable regulation. [Port Auth. Supp. at 1]

“Administrative agencies rest their power on affirmative legislative acts. They are creatures of statute and therefore must find within the statute the authority for the exercise of any power they claim.” *McDaniel v. Cory*, 631 P.2d 82, 88 (Alaska 1981). The Alaska Land Act, as cited above, accorded broad authority to DNR’s Commissioner to “establish reasonable procedures” and “exercise the powers and do the acts necessary to carry out the provisions and objectives” of the Act. AS 38.05.020(b). Those powers included the ability to authorize and certify unit agreements “whenever determined and certified by the

Commissioner to be necessary or advisable in the public interest." Former AS 38.05.180(m).<sup>9</sup>

The State and the Port Authority both cite to the United States Supreme Court case of *Boesche v. Udall*, 373 U.S. 472, 478 (1963), which held that the Department of Interior had a "traditional administrative authority" to cancel a federal lease unless such authority had been specifically withdrawn by federal law. Similarly, in *White v. State, Dept. of Natural Resources*, 14 P.3d 956 (Alaska 2000)(*White II*), the Alaska Supreme Court held that a lessee's breach of contract claim against the State "fit[s] comfortably within the scope of an ordinary administrative claim" and should be pursued before the administrative agency. 14 P.3d at 960. See also *Danco Exploration v. State*, 924 P.2d 432, 434 (Alaska 1996) ("Oil and gas lessees and lease bidders which have grievances with the State must pursue the administrative procedures provided by [regulation].") Although there was no express statutory grant to DNR to terminate unit agreements in 1977, this court finds that this specified procedure falls "within the scope of an ordinary administrative claim" that is within the agency's broad statutory powers. *White v. State*, 14 P.3d at 960.

As discussed above, there were two chapters of regulations that were in effect in 1977 that applied to unitization agreements on state lands. One of these

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<sup>9</sup> When the unit agreement included lands owned by the state, the Alaska Land Act provided that the unit agreement "may contain a provision vesting the commissioner ... with authority to alter or modify from time to time the rate of prospecting and development and the quantity and rate of production under the plan." Former AS 38.05.180(n). Section 21 of the PTUA corresponds to this statutory grant of authority.

chapters addressed only unitization agreements. Former 11 AAC 83.300 et seq. (Eff. 9/20/74). The other chapter, entitled "Practice and Procedure," applied to several chapters of the natural resources regulations, including the unitization chapter. It contained several provisions regarding administrative adjudications, including a provision for judicial appeals to the superior court of administrative decisions and actions.<sup>10</sup> These former regulations neither required nor authorized that a unit termination be initiated by judicial proceedings. Former 11 AAC 88.100 – 145 (Eff. 9/20/74).

Under the regulatory scheme as it was in existence in 1977, the administrative authority to terminate the unit agreement had not been restricted or withdrawn. And the statutory regimen accorded broad powers to the commissioner to manage state land. As correctly noted by the Port Authority, "[a]t the time the PTUA was adopted, no statute or regulation abrogated the Department's authority to administratively cancel a unit ..." [Port Auth. Supp. at 2] Instead, the procedural regulations in effect at that time expressly contemplated agency determination and judicial review of all issues. This court finds that DNR possessed the authority to administratively terminate the Point Thomson Unit Agreement when that agreement was adopted in 1977 under the statutory and regulatory structure as it existed at that time.

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<sup>10</sup> Former 11 AAC 88.160 (Eff. 9/20/74).

**D. To what extent are the current regulations applicable to the Point Thomson Unit Agreement?**

In 1981, the State adopted several regulations that more comprehensively address unitization. With some modifications, most of these regulations remain in effect today. The parties in this action dispute both the interpretation of the current regulations and the extent to which those later-adopted regulations apply to the PTUA. Under Alaska law, the later-enacted regulations do not apply to the PTUA to the extent they conflict with either the terms of the PTU Agreement or with regulations that were in effect in 1977, when the PTUA was adopted. *Exxon v. State*, 40 P.3d 786 (Alaska 2001). While the parties to this appeal all generally agree with this principle, they have considerable disagreement as to which of the current regulations are consistent, and which are inconsistent, with the PTUA and former regulations.

1. **11 AAC 83.374 is not applicable when the basis for termination is the rejection of a plan of development, as opposed to failure to comply with an approved unit agreement.**

One regulation at issue that was adopted after the PTUA, 11 AAC 83.374(d), specifies that if the Division determines that a default has occurred with respect to a unit in which there is a certified well, "the commissioner will, in his discretion, seek to terminate the unit agreement by judicial proceedings." This regulation was the focus of the stay proceedings in this case earlier this year, although at that time the parties had not addressed the fact that this regulation was adopted in 1981, after the PTUA's effective date of 1977.

This regulation is cited in the agency's decisions in this case only in the Decision on Reconsideration. There, the Acting Commissioner referenced the regulation, but indicated that the unit termination "is an appropriate DNR action which facilitates court review" and could be undertaken "[r]egardless of whether the unit contains certified wells." [R. 9292] Although the parties have provided extensive analysis of this statute in their briefing to this court, it does not appear that DNR relied upon this regulation as the basis for its termination decision.

11 AAC 83.374(a) provides that the "failure to comply with ... any plans of exploration, development or operation which are a part of the unit agreement, is a default under the unit agreement," thereby making the balance of that regulation applicable. As Exxon noted in its briefing to the agency on appeal of the Director's Amended Decision in November 2006, "failure to receive DNR approval of a plan of development does not constitute default under DNR regulations. . . ." Instead, as noted by Exxon, "11 AAC 83.374(a) provides that failure to comply with the terms of an *approved* plan of development is a default under the unit agreement, not the failure to obtain approval." [R. 705, emphasis added]

Similarly, the Alaska Gasline Port Authority, in its amicus brief, has asserted that Section 374 should not apply in this case, where the issue is the agency's rejection of a proposed plan of development, as opposed to a lessee's failure to comply with an approved plan of development. [Amicus Br. at 29] In this court's view, upon close reading of the regulation, that position, espoused

both by Exxon in 2006 and by the Port Authority before this court, has merit. 11 AAC 83.374(a) does not apply to cases such as this in which DNR has rejected a proposed plan of development.

Moreover, even if the rejection of a modified plan of development were to constitute a "default" under Section 374, then that regulation would be inconsistent with the unit agreement, to the extent that this more recent regulation imposes a requirement of judicial termination proceedings that was not administratively or statutorily required in 1977.

The Appellants assert, however, that even if inconsistent with the PTUA, the 1981 regulation should nonetheless apply to the PTUA, because this later-enacted regulation impairs only DNR's rights, not the private parties to the PTUA, and is thus binding on the State so as to require judicial termination proceedings. In response to this court's request for supplemental briefing, the Appellants have asserted that under Alaska law, "[r]egulations that benefit those who are regulated are applied retroactively even if inconsistent with previous regulations." [CPA Supp. at 4] In support of this proposition, the Appellants cite to Atlantic Richfield Company v. State, 705 P. 2d 418, 424, n. 17 (1985). But in this court's view, the Appellants are reading the cited footnote in the *Arco* decision too broadly. In that case, the retroactive interpretation of a regulation was the only way in which that newly enacted regulation could be "meaningfully applied," such that the Supreme Court found an intent by the Department for that regulation to have retroactive effect. *Id.* Absent such unique circumstances, which are not

present here given the expected continuing creation of unit agreements throughout Alaska, neither the State nor the Appellants should be bound by subsequent regulations that are inconsistent with the State's prior contractual agreement or regulations in effect at the time of contracting.

Because this court finds that 11 AAC 83.374 is inapplicable to this case, this court will not issue a final determination with respect to DNR's purported "decertification" of the wells. As noted in the Commissioner's Decision on Reconsideration, [t]he certified well finding [was] not the basis of the November 27, 2006 unit termination decision." [R. 9289] In light of this court's rulings as set forth above, a decision on the decertification question is no longer essential to resolving the issues presented in this particular appeal. The Supreme Court instructs that an appellate court should generally not resolve legal issues when they are rendered moot. *Clark v. State, Dept. of Corrections*, 156 P.3d 384, 347 (Alaska 2007). Accordingly, apart from this court's statements on the decertification issue as set forth in the Order re Motion for Stay dated May 1, 2007, no further opinion on the propriety of the purported decertification of the seven wells is expressed by this court.

## **2. Does 11 AAC 83.336(a)(1) apply?**

The State and Port Authority have advanced a different current regulation to support DNR's termination decision -- 11 AAC 83.336(a)(1). This regulation, adopted in 1981, provides as follows:

A unit agreement becomes effective upon approval by the commissioner and automatically terminates five years from the

effective date unless (1) a unit well in the unit area has been certified as capable of producing hydrocarbons in paying quantities, in which case the unit agreement will remain in effect for so long as hydrocarbons are produced in paying quantities from the unit area, or for so long as hydrocarbons can be produced in paying quantities and unit operations are being conducted in accordance with an approved unit plan of exploration or development, or, should production cease, for so long after that as diligent operations are in progress to restore production and then so long after as unitized substances are produced in paying quantities...

This regulation is not referenced anywhere in the Commissioner's termination decision or in the Decision on Reconsideration. But the State asserts on appeal that although the specific reference to the regulation to support the unit termination was not made at the agency level, the requisite elements of the regulation to support termination are all "contained within the findings made by the Commissioner." [10/5/07 Oral Arg. Transcript at 36]

On appeal, the State and the Port Authority assert that Section 336 is "essentially a habendum clause," such that if a plan of development is not approved, "the failure means [the] Unit Agreement simply terminated." [State's Br. at 95] In response, the Appellants assert that Section 336(a) "is inconsistent with the PTU Agreement and the effective date regulations and thus cannot apply in this case." The inconsistency, in their view, is that Section 336 would "graft onto the PTU Agreement a new event of termination: DNR approval of a plan of development." [CPA Reply at 28; see also Jt. Reply at 25] The Appellants correctly note that Section 20(c) of the PTUA contains no reference to an agency-approved plan of development as a condition for the unit agreement to remain in effect.

DNR notes that Section 20(c) of the Agreement was modified in 1985, and asserts that "because the PTUA modification occurred after the promulgation of section 336, Article 20(c) [of the PTUA] must conform to the [1981] regulation" [State's Br. at 98, n. 172; see R. 787-795] But the Appellants note that Section 1 of the PTUA was not amended in 1985. That section precludes the application of inconsistent regulations enacted after the effective date of the PTUA. This court finds the Appellants' assertion on this point persuasive. [Jt. Reply at 26] The 1985 amendments did not graft onto the PTUA the provisions of 11 AAC 83.336(a).

Section 336, as interpreted by the parties in this case, would result in the *automatic* termination of the PTUA whenever a proposed unit plan was rejected by the DNR. As such, it is inconsistent with the PTUA and the regulations that were in effect when the PTUA was executed in 1977. For although, as discussed by this court in the preceding portion of this opinion, DNR may seek to administratively terminate the PTU, neither the PTUA nor the applicable regulations and statutes in effect in 1977 permitted an automatic termination whenever a POD was unacceptable to the State. At oral argument, counsel for the State asserted that Section 336 was not inconsistent with the PTUA, because "[a]n acceptable plan of development is an express condition contained with the Point Thomson Unit Agreement." [10/5/07 Oral Arg. at 48] The State noted that Section 10 of the PTUA accords to the Director the authority to specify a plan of development that "shall be as complete and adequate as the Director may

determine to be necessary for timely development and proper conservation of the oil and gas resources of the unitized area." [R. 1260] As discussed above, this court has found that this provision of the contract accords to DNR the administrative authority to reject proposed plans of development. But rejection of a proposed plan of development does not result in automatic termination under the PTUA. Rather, a separate administrative determination as to the appropriate remedy is required in such instance. To the extent Section 336 would permit the automatic termination of the PTUA whenever a POD was rejected by the State, it is inconsistent with the PTUA and inapplicable to this unit.

**E. The Appellants' Right to Due Process**

The right to due process, under both the state and federal constitutions, prohibits the State from depriving any person of "life, liberty, or property, without due process of law." U.S. Const. amend. XIV, § 1; Alaska Const. Art. I, §7. The State acknowledges that the Appellants are entitled to due process with respect to their interests at Point Thomson. [State's Br. at 99]

The Appellants assert that their due process rights were violated when the Commissioner terminated the PTU on appeal from the Director's Decision. They assert that the only issues over which the Commissioner had jurisdiction were whether the Director had properly rejected the 22<sup>nd</sup> POD and whether the modified POD should be approved. [Exxon Br. at 47] The Appellants maintain that the Director's Decision, which stated simply that "[f]ailure to submit an acceptable plan of development is grounds for termination of the PTU," was

inadequate to notify the Appellants that the Commissioner would terminate the PTU in the administrative appeal. [*Id.* at 50]

The State maintains that the Appellants were accorded adequate notice and an opportunity to be heard. It notes that the Commissioner indicated to the Lessees that his review would "cover both the appeal from the October 27, 2005 decision and the proposed cure." [R. 664; State's Br. at 101] It asserts that the Appellants "knew that a rejection of the POD and an affirmation of the default finding could lead to the determination of what remedy was appropriate as a result of the affirmation." [State's Br. at 101] And yet the State has also acknowledged that termination of the unit is only "one possible remedy" when a proposed POD is not acceptable to the Director. [*Id.* at 105]

The State also asserts that any alleged due process violations in connection with the unit termination decision were cured by the reconsideration process before the Commissioner that was pursued by two of the Appellants, ExxonMobil and ConocoPhillips. In support of this argument, the State cites to *State, Dept. of Natural Res. v. Greenpeace*, 98 P.3d 1056 (Alaska 2004), in which the Alaska Supreme Court held that any alleged procedural due process violations in that case were cured by according the objecting party an opportunity to be heard on reconsideration. Yet as Appellants note, BPXA and Chevron did not seek reconsideration before the Commissioner. [Jt. Reply at 19]. And, unlike the situation in *Greenpeace*, the Appellants here were not accorded an opportunity to fully contest the challenged decision on reconsideration. [*Id.* at 20]

Instead, the reconsideration motion and decision were primarily focused on the decertification issue, not the termination decision. [See R. 9288, 9291]

The Alaska Supreme Court's decision in *White v. State, Dept. of Natural Resources*, 984 P.2d 1122 (Alaska 1999) (*White I*) is instructive on these issues. In that case, White had requested a hearing before DNR on a disputed factual issue with respect to an oil and gas lease. DNR refused to grant him a hearing on the issue. The Supreme Court reversed and remanded, and held that the due process clause accorded to White the opportunity for a hearing on that issue before an agency determination was made that precluded the automatic extension of the lease. 984 P.2d at 1128.

Likewise, albeit in a quite different context, the Supreme Court found that a trial court had violated a parent's right to due process when the trial court entered a *permanent* child custody order after conducting a hearing that had been scheduled to determine *interim* custody. *Cushing v. Painter*, 666 P. 2d 1044, 1046 (Alaska 1983). Due process requires that parties are accorded "sufficient written notice, specifying the nature of the dispute and the relief requested." *Hickel v. Halford*, 872 P.2d 171,180 (Alaska 1994).

Here, the State did not seek termination under Section 20(c) of the PTUA. Rather, it sought to terminate the unit after it rejected the Appellants' proposed Plan of Development. Nothing in the PTUA nor the regulatory framework in place in 1977 mandated or authorized automatic termination of the unit when DNR rejected the proposed POD. And while this court has concluded that the

PTUA and then-existing regulations did not preclude DNR from pursuing termination at the administrative level, the Appellants were constitutionally entitled to a clear written notice that DNR was considering this remedy, when it rejected the POD, and should have been accorded the opportunity to be heard with respect to the appropriate remedy when the modified 22<sup>nd</sup> POD was rejected. *See generally* former 11 AAC 88.155. The Director's statement that "[f]ailure to submit an acceptable plan of development is grounds for termination of the PTU" is not constitutionally adequate notice that a termination would be administratively declared by the Commissioner on appeal of the Director's Decision rejecting the 22<sup>nd</sup> POD.

Accordingly, this matter is remanded to the DNR for the purpose of according to the Appellants a hearing on the appropriate remedy to the State upon DNR's rejection of the proposed 22<sup>nd</sup> Plan of Development. On remand, the agency should also consider the import of Section 21 of the PTUA, as amended in 1985, in determining the appropriate remedy.

### **III. The Expansion Leases**

A separate component of the administrative determinations focused on the Expansion Agreement entered into in 2001 between the Appellants and the State. That agreement expanded the PTU on the condition that the PTU Lessees performed certain work at the PTU and put the unit into production with at least seven development wells by 2008. [R. 5678] The agreement also provided that

if the Lessees failed to perform the work in a timely manner, the expansion leases would automatically contract out of the unit and the Lessees would owe DNR certain sums of money. [*Id.*]

The Appellants did not complete the work contemplated under the Expansion Agreement. Instead, in October 2006, ExxonMobil proposed a modification of the Expansion Agreement. DNR characterized the proposed modification as allowing it "to retain the most valuable portions of the Expansion Acreage without putting the unit into production." [R. 5680]

In the Commissioner's November 2006 decision, the Lessees' request to modify the Expansion Agreement was denied. The Commissioner's decision also stated that "the state is entitled to have the Expansion Leases back and to receive payment." [R. 5688-89]

The Appellants originally appealed this aspect of the Commissioner's decision, but later abandoned this particular claim and in June 2007 paid the State the \$20,000,000 payment plus interest then due as specified in the Expansion Agreement. On October 19, 2007, the Appellants filed a motion to dismiss the claims on appeal with respect to the Expansion Agreement. The State filed a partial opposition to the motion, disputing the language in the proposed order on these claims. Specifically, the Appellants' proposed order simply provided that all claims regarding the Expansion Agreement "are hereby dismissed as expressly abandoned by all Appellants and, in the alternative, as moot." The State's proposed order was broader, and sought to affirm a final

agency decision, effectively returning the expansion leases to the State. In reply, the Appellants asserted that the language from the Commissioner's decision that "the state is entitled to have the Expansion Leases back" should be considered dicta, and not a final agency determination with respect to the underlying leases in the expansion acreage. [R. 5689]

This court agrees with the Appellants that the validity of the leases encompassed within the expansion acreage was not directly before the Commissioner in this administrative proceeding, and thus is not properly before this court on appeal. With respect to mootness, this court agrees with the State's position that the claims related to the Expansion Agreement are more properly characterized as dismissed rather than moot.

Accordingly, with respect to the Expansion Agreement claims, all of the Appellants' claims concerning the Expansion Agreement are hereby dismissed as they have been expressly abandoned by all Appellants.

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**Conclusion**

DNR's rejection of the Lessees' proposed modified 22<sup>nd</sup> Plan of Development, including DNR's interpretation of Section 10 of the Point Thomson Unit Agreement, is affirmed.

DNR's determination as set forth in the Commissioner's Decision and the Decision on Reconsideration that terminated the Point Thomson Unit is reversed and remanded, so as to accord to the Appellants notice and an opportunity to be heard before the agency as to the appropriate remedy when the Department has rejected the proposed modified 22<sup>nd</sup> Plan of Development for the Point Thomson Unit.

All of the Appellants' claims concerning the Expansion Agreement are dismissed as they have been expressly abandoned by all Appellants.

Dated this 26<sup>th</sup> day of December, 2007.

Sharon Gleason  
Sharon Gleason  
Judge of the Superior Court

I certify that on 12-26-07 a copy  
of the above was mailed/faxed to each of the  
following at their addresses of record  
[Signature]  
Clerical Assistant

AG- Todd  
Ashburn / Crosby  
Oreansky  
Keithley  
Serdakely  
Royce

Dawn  
Ellis  
Ballew / Ashley  
Haynes / Phillips  
Sneed

IN THE SUPERIOR COURT FOR THE STATE OF ALASKA  
THIRD JUDICIAL DISTRICT AT ANCHORAGE

ExxonMobil Corporation, Operator )  
Of the Point Thomson Unit; BP )  
Exploration (Alaska) Inc.; Chevron U.S.A. )  
Inc; ConocoPhillips Alaska, Inc., )  
Appellants, ) Case No.: 3AN-06-13751 CI  
) (Consolidated Appeals)  
) Case No. 3AN-06-13760 CI  
vs. ) Case No. 3AN-06-13773 CI  
) Case No. 3AN-06-13799 CI  
State of Alaska, ) Case No. 3AN-07-04634 CI  
Department of Natural Resources, ) Case No. 3AN-07-04620 CI  
) Case No. 3AN-07-04621 CI  
Appellee. )

**BRIEF OF APPELLEE**

**APPEAL FROM THE DEPARTMENT OF NATURAL RESOURCES**

**FINAL DECISION OF THE COMMISSIONER  
DATED NOVEMBER 27, 2006**

**&**

**COMMISSIONER'S DECISION ON RECONSIDERATION  
DATED DECEMBER 27, 2006**

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## STATEMENT OF THE CASE

### I. INTRODUCTION

This appeal arises from the termination of the Point Thomson Unit (PTU or Unit). The termination is the nadir of a hotly-contested, decades-long struggle by the Appellee, the Alaska Department of Natural Resources (DNR), to achieve oil and gas production from this 30-year-old Unit. Appellants British Petroleum (BP), Chevron, ConocoPhillips (CPA) and ExxonMobil (Exxon), as the Unit Lessees, held the right to explore and produce the Unit. But for more than 20 years, they refused DNR's requests to adequately explore and develop the PTU and produce its known oil and gas deposits.

The dispute came to a head over Lessees' proposed 22nd Plan of Development (22nd POD). Lessees have long insisted that the only way to develop the Unit was to await construction of a gas pipeline, tap the main gas reservoir (the Thomson Sand), and then produce oil, gas condensate (gas liquids) and dry gas together with no effort to maintain reservoir pressure – this is known as a gas blow down project.<sup>1</sup> [R. 5674 n.2] In a high pressure gas reservoir, like the PTU's Thomson Sand, this approach poses a high risk that liquids suspended in the gas will fall out and become unrecoverable as pressure decreases. This means the potential loss of millions of barrels of liquid hydrocarbons.

<sup>1</sup> Citations to the record, indicated as “[R.],” refer to the record assembled by DNR for this appeal and labeled by DNR as “PTUREC\_.”

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By contrast, phased production starting with gas cycling avoids much of the waste inherent in a gas blow down project. In a gas cycling project, dry gas, gas liquids and oil are all produced together, liquids are stripped, and enough dry gas is re-injected into the reservoir to maintain sufficient pressure to keep the liquids producible. [R. 631]

In addition to the potential loss of liquids, Lessees' gas blow down approach meant an indefinite delay of unit production. There is no certainty about when a gas pipeline will be built, but the existing Trans Alaska Pipeline System (TAPS) can transport gas liquids and oil.

Both the Alaska Oil and Gas Conservation Commission (AOGCC) and DNR<sup>2</sup> are responsible for preventing wasteful oil and gas development.<sup>3</sup> Because Lessees wanted to pursue a gas blow down project, DNR asked them to apply to the AOGCC for approval of unit pool rules and a depletion plan. [R. 1960] The AOGCC asked for geologic and other data, but Lessees did not cooperate with the request for information. They did not provide sufficient information to enable the AOGCC to conclude that the PTU is primarily a gas unit or to conclude that a gas blow down project was an appropriate approach to PTU development. [R. 5606-08]

Early in the 22nd POD review process, the Lessees provided DNR with a draft POD for comment. They proposed more studies (not production or exploration) while

<sup>2</sup> AS 31.05.030; AS 38.05.020; 11 AAC 83.303(a)(2).

<sup>3</sup> Waste includes "the inefficient, excessive, or improper use of, or unnecessary dissipation of, reservoir energy . . . and the . . . operating or producing of any oil or gas well in a manner which results . . . in reducing the quantity of oil or gas to be recovered from a pool . . ." AS 31.05.170(15)(A).

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awaiting gas pipeline construction. [R. 207-14, 12217-25] In response, DNR asked the Lessees to drill an exploratory well to resolve reservoir uncertainties that Lessees were asserting precluded them from producing gas and oil liquids, neither one of which require a gas pipeline to produce. If Lessees had agreed to drill the well, DNR would have approved the POD and extended other drilling deadlines set out in a 2001 Unit expansion. DNR also stated that it would support a gas blow down project if new data generated by the exploratory well supported it. [R. 1958-60]

The Lessees refused to drill. [R. 12190] In the proposed 22nd POD, the Lessees stated that they could find no viable way to develop the PTU in the absence of a gas pipeline. [R. 628] The DNR Director of the Division of Oil and Gas (Director) issued a decision defaulting the PTU, provided an opportunity to cure by filing a POD that committed to development, and notified Lessees that Unit termination could result from their failure to cure the default. [R. 648]

The Lessees appealed to the Commissioner and continued to insist that development of the PTU must await a gas pipeline. Commissioner Menge upheld the default and terminated the unit. Commissioner Rutherford affirmed these decisions on reconsideration.

## II. UNIT HISTORY

Generally, an oil and gas unit is formed when DNR approves the joint development and operation of two or more oil and gas leases under a written

agreement.<sup>4</sup> The primary term of a lease is normally extended by production. Inclusion in a unit also extends the lease term.<sup>5</sup>

The PTU was formed in 1977. [R. 1253-72] It was located on the North Slope with a western boundary approximately three miles east of the Badami Unit, which is connected to TAPS, and 30 miles east of the Prudhoe Bay Unit. [R. 629]

In the early 1980s, exploration of the PTU confirmed the presence of significant oil and gas – at least eight trillion cubic feet of gas (TCF), 200 million barrels of gas liquids, an unknown quantity of oil in the Thomson Sand reservoir, and 200 million barrels of oil in Brookian reservoirs. Nearly 30 years later, the Lessees have not produced any oil or gas from the PTU. [R. 640]

#### A. Well Drilling, Certification, and Abandonment

The PTU Agreement (PTUA or Agreement) required Lessees to annually drill a well until the discovery of reserves capable of being produced in paying quantities. [R. 1259] By 1982, DNR had certified six Unit wells as capable of producing in paying quantities.<sup>6</sup> According to AOGCC records, Exxon petitioned the AOGCC to change the status of five of the wells from suspended to abandoned in 1986, thereby effectively

<sup>4</sup> “A unit agreement is a contract between the department and lessees that allows for the efficient development of a reservoir that underlies multiple leases owned by different lessees. The various lessees join together in exploration and drilling, and allocate costs and production.” *Exxon Corp. v. State*, 40 P.3d 786, 788 (Alaska 2001); AS 38.05.180(p).

<sup>5</sup> AS 38.05.180(m).

<sup>6</sup> Under 20 AAC 25.170, an operator abandoning a well must remove the wellhead equipment and some casing, install a well abandonment marker, and remove all materials, supplies, structures, and installations.

abandoning operations.<sup>7</sup> [R. 5047] These wells also received location clearances from the AOGCC.<sup>8</sup> [R. 5047] DNR certified a seventh well, Sourdough #2, on April 26, 1994 [R. 26200] and Lessees abandoned it the following day.<sup>9</sup> [R. 5759]

Lessees have admitted that the wells are no longer capable of production. In 1983, Lessees told DNR that the plugged and suspended wells were inappropriate for production. [R. 296-98] In 1988, Exxon stated “[w]ells drilled far in advance of commencement of sustained gas production would not be used for development purposes due to concerns over potential well bore degradation associated with prolonged shut-in.” [R. 11530] CPA has stated that “[s]everal of the ConocoPhillips certified wells were certified after the wells had been plugged and suspended or abandoned and are no longer physically capable of production.” [R. 5804-05]

<sup>7</sup> 20 AAC 25.105.

<sup>8</sup> AOGCC's website reflects abandonment of the sixth well in November 1986.

<sup>9</sup> (1) PTU Well No. 1 on ADL 47560 was certified under Article 9 of the PTUA. [R. 4078 – November 4, 1977, State decision]; (2) Alaska State Well No. F-1 on ADL 312862 was certified under the terms of the lease, but a lease POD was required by December 1982 to keep the lease in good standing. [R. 25366 – June 1982, State decision]; (3) Alaska State C-1 Well on ADL 38382 was certified under the lease and 11 AAC 83.105. [R. 20298 – July 22, 1981, State decision]; (4) Exxon No. 1 Alaska State “A” Well on ADL 47556 was certified. [R. 21012 – December 15, 1977, State decision]; (5) Point Thomson Unit No. 2 Well on ADL 47567 was certified under 11 AAC 83.105. [R. 23421 – January 5, 1979, State decision]; (6) Staines River State No. 1 Well on ADL 47573 was certified under the lease and 11 AAC 83.105. [R. 24521 – January 7, 1980, State decision]; and (7) Sourdough Well # 2 on ADL 343112 was certified under 11 AAC 83.361 and .395 and sections 4(d) and 30(6) of the lease. [R. 26200 – April 26, 1994, State decision; 629 – October 27, 2005, Director's Decision].

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Similarly, BP admitted it would take at least three to four years to put a production well into operation in the PTU. [R. 871-72]

**B. Amendment to the Unit Agreement Section 20(c)**

Section 20(c) of the Agreement provided that the PTU would automatically terminate five years from formation unless certain conditions were met, such as inclusion of a well capable of production in a participating area (PA). [R. 1267-8] A PA must be formed before production commences, and thus continuation past the primary five-year term required production in the PTU. [R. 9467, 9469] To avoid automatic termination, DNR agreed with Lessees' request to amend the Agreement to eliminate the PA requirement. [R. 9452] This amendment, allowing Lessees to avoid automatic Unit termination for lack of production was made effective in 1985. [R. 9448]

**C. Unit Expansions**

Lessees applied to expand the PTU three times. DNR approved an expansion application in March 1984, on the condition that Lessees drill two wells - one by 1985, and another by 1990. [R. 630] Lessees led DNR to believe that the approved expansion and promised drilling would lead to production by 1992. [R. 1172-73] Lessees did not comply with the drilling requirement. [R. 10025, 383-91, 630]

DNR denied a 1998 PTU expansion application partly due to lack of Unit development and exploration. [R. 630] It cautiously approved a 2001 application for expansion based on commitments to bring the unit into production. [R. 12757-66,

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12736-42, 26404-10, 1520-48] But Lessees did not perform the work commitments, which included an exploration well by 2003, a production well by 2006, and seven production wells by 2008. Specifically, when the Lessees failed to drill in 2003, two leases reverted to the State and Lessees paid \$950,000. [R. 377-78, 380 632, 26404-10] In 2005, DNR denied Lessees' request to substitute the Stranded Gas Development Act (SGDA) negotiations for the remaining drilling and other work commitments. [R. 200-03, 1958-60]

Despite this rejection, Lessees made the same request to substitute SGDA negotiations for the work commitments when they appealed the Director's decision in 2006. They also offered to pay \$20,000,000 and return 20,000 acres of PTU leases to the State. [R. 682-84] But Lessees proposed to return less and different acreage, i.e., acreage with no or marginal hydrocarbon prospects. [R. 5756-58, 5766] The Commissioner found that Lessees owed the State \$20,000,000 and the return of the remaining expansion leases. [R. 5756-58, 5766]

#### D. Plans of Development

##### 1. Requirement for Plans of Development

From the PTU's inception, Lessees have acknowledged that statute, regulation and the PTUA requires them to submit a POD for DNR's approval as a condition of unitization. At the time of PTU formation, AS 38.05.180(m) provided "that DNR may require the operator of an oil or gas unit to operate in accordance with a 'reasonable' unit plan of operation, and that the plan must 'adequately protect all parties in interest,

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including the state.” [R. 880] Lessees understood that “the regulations in effect at the time the Unit Agreement was signed required annual updates to Plans of Further Development and Operation.” [R. 11233]

In 1983, DNR amended its regulations to further define the requirements of a POD. Lessees have acknowledged that the PTU was subject to these amendments:

Exxon has received your letter dated October 14, 1985 requesting an update to the Seventh Plan of Further Development and Operation for the Point Thomson Unit. Your letter states that, pursuant to 11 AAC 83.343(c) and the terms of the Point Thomson Unit Agreement, an update to the 7th Plan was due in your office on October 1, 1985.

....

Exxon’s interpretation of the provisions of 11 AAC 83.343(c) and 11 AAC 83.343(d) as they relate to the 7th Plan is as follows. . . . Section 11 AAC 83.343(c) requires that a plan ‘be updated and submitted . . . for approval at least 90 days before the expiration date of the previously approved plan.’ Exxon, therefore, intends to submit an update for your approval on or before October 1, 1988.<sup>10</sup>

The unit regulations adopted in 1983 are consistent with PTUA Section 10, which requires Lessees to submit a POD for DNR’s approval. [R. 1259-60] Lessees’ PODs confirmed their understanding of the requirement that they submit a POD that is acceptable to DNR. For example, the 2004 21st POD included the following language:

ExxonMobil, as Point Thomson Unit (PTU) Operator and on behalf of the PTU Working Interest Owners (Owners), hereby submits the enclosed Twenty-first Plan of Further Development and Operation (POD 21) for your review and approval. POD 21 is submitted in accordance with

<sup>10</sup> [R. 11232 – October 31, 1985 7th POD Progress Report]. Another example of Lessees’ admission that the amended regulations apply to the PTU is Lessees’ 1991 9th POD, which states: “[t]his Ninth Plan of Development is submitted . . . pursuant to Article 10 of the . . . Unit Agreement and 11 AAC 83.343.” [R. 11453]

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Article 10 of the Point Thomson Unit Agreement (PTUA) and all other applicable regulations.<sup>11</sup>

2. PODs 1 Through 5 – 1978 to 1982 Exploration Period

PODs 1 through 5 focused on drilling PTU exploration wells. Lessees also conducted some unit studies and stated that if oil was discovered, it would be piped to Prudhoe Bay. [R. 11360-70, R. 11340-41, R. 11306-07, R. 11292-95, R. 11272-74]

3. PODs 6 Through 22 – 1983 to 2005 Study Period

Well drilling stopped with the 1982 6th POD, in which Lessees proposed environmental studies. [R. 296-98, 11261-68] DNR was concerned about the lack of drilling, inadequate reservoir delineation, and the need for production, but reluctantly approved the POD:

I have reviewed your request for approval of the Sixth Plan of Further Development and Operation . . . the Department feels that the activities proposed for the time period covered . . . do not significantly contribute to the further delineation and understanding of the reservoir(s) and unit area as required by 11 AAC 83.343(a)(1), and in the Unit Agreement.

The primary interests of the department in reviewing and approving unit plans of development and operation are to ensure that the engineering and geologic studies characterizing the underlying reservoir(s) are progressing, and that orderly and timely development of commercial hydrocarbon reservoirs occurs. [R. 11258]

<sup>11</sup> [R. 419-24 – August 31, 2004 21st POD Application]. For additional similar documents see [R. 206-14 – July 1, 2005 22nd POD Application, R. 316 – October 30, 1995, 13th POD Application, R. 383-91 – August 5, 2002 19th POD Application, R. 11340-01 – September 13, 1978 2nd POD Application, R. 11360-70 – November 18, 1977 1st POD Application, R. 11306-07 – October 18, 1979 3rd POD Application].

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The resulting studies indicated that the PTU had some oil and a large gas field, but Lessees did not propose to put the unit into production. Instead, in the 1983 7th POD, Lessees contended they were entitled to an additional five-year study period on the following grounds: (1) Lessees wanted credit for 700 million dollars they claimed to have already spent on PTU lease acquisition and drilling; (2) Exxon claimed credit for an alleged 15 years of diligent PTU development studies; (3) Lessees believed that development before construction of a gas pipeline would be waste; and (4) they did not think PTU wells were appropriate for production. [R. 296-98]

DNR approved the 7th POD for the period January 1984 through December 1988. However, the approval was made against the backdrop of ongoing negotiations between Lessees and DNR to expand the Unit, which involved a requirement to drill additional wells. The POD approval did not relieve Lessees of expansion drilling commitments. [R. 299]

Shortly after DNR approved the 7th POD, it also approved the expansion of the Unit based on Lessees' commitment to drill two unit wells. [R. 630, 1033] Lessees told DNR the commitments would lead to a gas cycling development by 1992:

To reiterate, Exxon as the Point Thomson Unit Operator, is making preparations to be in a position to commence a well in the 1985/1986 winter drilling season. The purpose of this well would be to confirm reserves sufficient to prove commerciality of the reservoir (additional delineation wells may be required) . . . .

Further, should the well satisfy the February 1, 1990 obligation, the lessees of these leases would be obligated to drill another well on lands covered by those leases prior to February 1, 1995. This second well

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should be drilled at a location to be determined jointly by the State and the lessees.

As discussed with you, current plans call for establishment of a participating area and start-up of production for a gas cycling / condensate recovery development as early as 1992. . . . A drilling obligation date of February 1, 1995 would provide owners the opportunity to gather additional data to better determine the need and location for further exploratory drilling outside of the established participating area. [R. 10023-24]

Because Lessees did not drill the first promised well, two expansion leases contracted out of the Unit in 1985. [R. 630, 10025]

In the 1988 8th POD, Lessees asked for three more years of study. [R. 11529-34] They committed to drilling the second 1984 expansion decision well by 1990, but after DNR approved the POD, Lessees refused to drill saying that "we have conducted further economic analysis and decided not to drill . . . Unit Well No. 5." [R. 11463]

In the 1991 9th POD [R. 11452-54a], Lessees proposed to finish the incomplete reservoir mapping project, which DNR had approved in the 8th POD. [R. 11469] DNR expressed the following concerns:

[T]he Eighth Plan of Development for the PTU, approved by the division on October 6, 1988 for a three year period, anticipated the preparation of unit consensus maps for each of the currently known reservoirs (Pre-Mississippian, Thomson, and Flaxman). The consensus maps were to be prepared during the period of the Eighth Plan and were to assist in the assessment of the unit's development potential and contribute to the further delineation and understanding of the reservoir(s) and unit area as required in 11 AAC 83.343(a)(1), and in the Unit Agreement.

The consensus mapping by the unit owners was not accomplished as proposed during the term of the Eighth Plan, and the division remains concerned with some of the rationale [sic] given for delaying consensus mapping program. (see September 25, 1991 correspondence). The

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division is further concerned with the length of time to accomplish the mapping program and the adverse impacts of this delay for making the detailed technical analysis for the orderly and timely development of the hydrocarbons in the Point Thomson Area.

[T]he division feels that it is essential that the working interest owners expedite the consensus mapping efforts in order to evaluate all Point Thomson development opportunities.

At the conclusion of the Ninth Plan period, Exxon should be prepared to convene a joint meeting of all working interest owners . . . to discuss . . . potential development options and schedules. [R. 11404-05]

But by 1992, the reservoir mapping was still incomplete and Lessees proposed to finish it as part of the 10th POD. [R. 11386-96] Lessees also proposed initiation of a multi-year "Consensus Reservoir Characterization Study" and a "Conceptual Planning Schedule." [R. 88, 11387]

The 1993 11th POD proposed to continue Reservoir Characterization and other studies. [R. 317, 11738-43] DNR reluctantly approved the POD, but expressed dissatisfaction with the lack of Unit exploration and development work; DNR also stated its intent to contract leases from the PTU:

I am informing Exxon, the PTU operator, of my intent to contract the unit boundary effective January 1, 1995 . . .

Little exploration work has been conducted on tracts within the unit boundary in the past few years. No explicit exploration work was conducted under the tenth plan nor is any contemplated under the eleventh plan. . . . Absent significant and actual on-the-ground exploratory activity on the tracts identified in Attachment # 1 on or before December 31, 1994, pursuant to 11 AAC 83.356(e) and 11 AAC

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83.343(b), I plan at this time to contract the unit boundary effective January 1, 1995. [R. 11735]

In the 1994 12th POD, the Lessees proposed to continue a reservoir description study (first proposed in the 10th POD) and other studies. [R. 1064] DNR requested the Lessees to report all efforts Lessees had made to market PTU hydrocarbons. [R. 336-37] Instead of providing the marketing information, Exxon asserted that no markets existed justifying production. [R. 339-40]

The 1995 13th POD reported that PTU development was uneconomic and proposed more studies. [R. 314-18] In its approval, DNR asked for Unit development:

The division remains concerned about the lack of exploration and development work that has been conducted in the PTU. The division has stepped back from its intent to contract the unit to allow the partners to find new opportunities, including farm-in agreements, to evaluate the area outside the known Pt. Thomson sands accumulation. The division wants the acreage within or immediate adjacent to the unit explored and evaluated. To that end, the division wants the working interest owners to share data pertaining to the acreage within or immediately adjacent to the unit. The division wants the unit to function as a unit rather than as separate leases. Most importantly the division wants a fair and honest attempt to get this acreage explored and to be appraised of efforts to develop and produce the Pt. Thomson sands accumulation itself. [R. 321]

In the 1996 14th POD, Lessees proposed yet more studies. [R. 11648-52] They also reported that BP and Chevron had drilled a well not previously proposed in a POD [R. 11650] In reporting on the 14th POD, Lessees stated that they were instrumental in passage of the SGDA. [R. 348-50]

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In 1997, Lessees filed the 15th POD. [R. 11633-38] Then-Division-Director Ken Boyd (who filed an affidavit in this appeal on the Lessees' behalf) rejected the 1997 15th POD as noncompliant with 11 AAC 83.343(a). [R. 323-25] DNR believed that the POD should include comprehensive plans for unit exploration, delineation and development:

... The 15th POD must also include an evaluation of the oil rim component... Exxon must estimate the volume of oil in place and the volume of recoverable oil and formulate a plan to further delineate and develop the oil component. ...

... BP and Chevron publicly announced a discovery with an estimated 100 mmb of recoverable oil from the Sourdough prospect within the ... unit ... Exxon's A-1 well discovered the Flaxman oil accumulation ... The proposed POD did not include plans for developing either of these known prospects or exploration for additional reservoirs within the unit ... The unit Plan of Development must include a schedule to evaluate the geology of the multiple reservoirs in the entire unit area and perform an integrated economic analysis of the unit. This evaluation should at a minimum incorporate the Thomson condensate, oil rim, Upper Cretaceous through Eocene turbidites, and fractured basement potential. [R. 324]

DNR requested that Lessees drill an exploration well in the Unit by 1999. Lessees responded that: (1) DNR should approve the POD as submitted; (2) they would not drill the well; and (3) they would not provide the studies. [R. 332-34] DNR threatened Unit default. [R. 327-30] Then-Director Boyd wrote: "[t]he division remains concerned about the lack of exploration and development work ... the division wants a fair and honest attempt to get this acreage explored and to be appraised of efforts to develop and produce ... ." [R. 321]

Despite these warnings, in the 16th and 17th PODs, Lessees only proposed additional studies – a reservoir consensus map project, continuation of engineering and geological studies, and data sharing. [R. 365–72, 640–41]

The 2001 18th POD proposed to drill the exploration well Lessees had committed to in the 2001 Unit expansion and to undertake related work for a gas cycling project. [R. 365–72, 641] But after DNR approved the 18th POD, Lessees refused to drill the well. [R. 374–75, 377–78]

In the 2002 19th POD, the Lessees proposed additional studies and permitting, and they refused to drill the well upon which the 18th POD was based. [R. 383–91] DNR nevertheless found that the proposed studies would facilitate development and approved the POD. [R. 393–94]

DNR approved the 2003 20th POD [R. 396–400] because it advanced the 2001 expansion development commitments. [R. 414-17] But after DNR approved the POD, Lessees stopped much of this work, including development permitting and investigation of the Pre-Mississippian formation reservoir. On December 18, 2003, Lessees notified DNR that, in their opinion, a gas cycling project was uneconomic and that they intended to change their development focus to a gas blow down project. [R. 632–33]

In the 2004 21st POD, Lessees continued to focus on a gas cycling project and the 2001 expansion work but conveyed that “the Owners have not been able to identify an economically viable Gas Injection Project under current fiscal terms.” [R. 419–24]

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DNR requested copies of reservoir data and the various PTU studies. It asked Lessees to work on all production options including liquids:

The Division must determine if the proposed 21st POD is in the public interest. The 21st POD focuses on gas sales, which may not be the best alternative, especially considering the unknown timing of a gas sales pipeline. A prudent unit operator should evaluate all alternatives to develop the unitized substances including: gas injection followed by gas sales, gas sales followed by gas injection, simultaneous gas sales and gas injection projects, and the combined economics of developing gas and oil from the Thomson Reservoir along with oil from the Pre-Mississippian and Brookian reservoirs within the PTU. The Division cannot adequately review the proposed plan without the technical data, assumptions, and interpretations that went into the PTU Owners' evaluation of the Gas Injection Project. Article 10 of the PTU Agreement, Plan of Further Development and Operations, supports the Division's data request as follows:

Any plan submitted pursuant to this section shall provide for the exploration of the unitized area and for the diligent drilling necessary for determination of the area or areas thereof capable of producing unitized substances in paying quantities in each and every productive formation and shall be as complete and adequate as the Director may determine to be necessary for timely development and proper conservation of the oil and gas resources of the unitized area . . . . [R. 427]

Lessees balked at providing the information, so the Director conditioned POD approval on disclosure of the information within 30 days or the Unit would default.

[R. 428] Lessees appealed, but the Commissioner affirmed the Director's decision. The Commissioner's decision also notified Lessees that the expansion drilling commitments were part of the POD and that the 22nd POD must address the expansion drilling commitments. [R. 12278-79] Ultimately Lessees provided enough information to avoid unit default. [R. 12268-80]

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The 2005 22nd POD proposed more studies and an extension of the 2001 expansion drilling commitments pending the SGDA negotiations. [R. 206-14] DNR offered to approve the POD and extend the drilling commitments if Lessees committed to drill an exploratory well and other delineation work. Moreover, if results indicated a gas blow down project was the best way to develop, DNR agreed to focus PTU development on a gas blow down project:

While first and foremost, the Division would like to see PTU development commence today, we would accept an extension of the existing development drilling commitments if the PTU Owners agree to acquire additional technical data to delineate the Thomson Reservoir. The Division believes there is considerable uncertainty in ExxonMobil's interpretation of the available PTU geological and geophysical data, which makes it difficult to assess the connectivity of the reservoir fluid contacts, and the hydrocarbon properties of the oil rim. An exploration/delineation well could provide significant information pertinent for appropriate development of the Thomson Reservoir.

ExxonMobil should begin development drilling within the PTU by June 15, 2006, as set forth in the Expansion Agreement, or if the PTU Owners concur that the geologic uncertainty is too great, ExxonMobil should drill a well to help resolve those uncertainties. The Division proposes modifications which, if accepted by the unit operator, would qualify the proposed 22nd POD for approval. [R. 1958-60]

Lessees refused to drill. [R. 636]

### III. THE OCTOBER 27, 2005, UNIT DEFAULT DECISION

The Director rejected the 22nd POD, defaulted the PTU, and gave Lessees 90 days to avoid Unit termination by submitting a POD that committed to develop the Unit - he warned Lessees that "[f]ailure to submit an acceptable plan of development is grounds for termination of the PTU." [R. 627-50]

Lessees' record of broken development promises, refusal to invest in needed exploration wells, refusal to commit to production of known commercial hydrocarbon deposits, and insistence on a gas blow down project, which risked the loss of millions of barrels of gas liquids and oil and indefinitely delayed PTU development, left the Director with no choice but to default the Unit:

The premise that the PTU can only be developed if a North Slope gas pipeline is built is inappropriate. In addition to dry gas, the unit contains 100s of millions of barrels of hydrocarbon liquids. These hydrocarbon liquids could be produced using mostly existing oil pipelines without construction of a North Slope gas pipeline. Therefore, potential PTU development is not, in fact, limited to dry gas production. In addition, the PTU Agreement, which requires timely exploration, delineation, development, and production of unitized substances, does not guarantee the lessees' commercial success or provide for indefinite extension of the leases. [R. 628]

The Director expressly rejected any linkage between the then pending SGDA negotiations and Lessees' PTU development obligations.

The Sponsor Group consists of only three of the Major PTU Owners: Exxon, BPXA, and CPAI, and does not officially represent the PTU lessees. The State is also negotiating with two other applicants that submitted proposals to build a North Slope gas pipeline. Depending on the progress of the negotiations, it is unlikely that a North Slope gas pipeline will be in operation before 2012, and the Sponsor Group has not yet made a public commitment to ever build a North Slope gas pipeline. However, regardless of the status of those negotiations, the PTU Owners have an obligation to diligently explore, delineate, and develop the hydrocarbon resources underlying the unit area.

The 22nd POD states that field activities associated with development drilling should begin three to three and one-half years before field startup, but it does not indicate when, if ever, an open season might occur or when, if ever, Exxon anticipates the commencement of development or production. At this point in time, the PTU Owners do not control if or when a North Slope gas pipeline will ever be operational. Reliance on

third parties, beyond the control of the PTU Owners, is not grounds for the delay of PTU development and production. [R. 642]

#### IV. THE NOVEMBER 27, 2006, TERMINATION DECISION

DNR granted Lessees' request to extend their time to appeal the Director's default decision so that the cure and appeal were ultimately due October 20, 2006, and November 3, 2006, respectively. [R. 651-65]

On October 18, 2006, Exxon submitted a revised 22nd POD as the cure. It was very similar to the initial 22nd POD, but it was for five years rather than one, and offered an exploratory well by 2010 and \$40 million if the well was not drilled due to circumstances not within Lessees' control.<sup>12</sup>

Lessees, and a number of other interested parties, submitted their November 3, 2006, filings amounting to approximately 5,500 pages.<sup>13</sup> They argued that the 22nd POD cure appropriately stayed development pending successful SGDA negotiations and construction of a gas pipeline because a reasonably prudent operator (RPO) would not develop until then. [R. 701-854, 873-77] Lessees never suggested that DNR had already approved this development delay. To the contrary, Lessees acknowledged the

<sup>12</sup> [R. 665-81] BP and Chevron supported the cure, and DNR staff opposed it. [R. 688-93, 700, 685-87]

<sup>13</sup> AOGCC [R. 5605], BP [R. 855-3715], Exxon [R. 701-854], Vic Fischer and Jack Coghill [R. 5614-17], Alaska Gasline Port Authority (Port) [R. 3716-5604], and Governor Hickel [R. 694-99]. Lessees were served with the Port and AOGCC filings. [R. 5654]

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Unit termination and contended that DNR did not have the power to terminate the PTU because it contained certified wells.<sup>14</sup> [R. 701-854]

The AOGCC supported the default decision, stating that Lessees had not cooperated with requests for information needed to establish PTU pool rules. AOGCC was concerned that a gas blow down project would cause waste of gas liquids. Lessees had also refused AOGCC requests for PTU gas cycling documents. [R. 5605-13]

The AOGCC explained that it needed significant additional information to decide pool rules:

This is a significant hydrocarbon reservoir, the largest proven accumulation of oil and gas in the State that is still undeveloped. The Commission's sole objective in providing these comments to the DNR is to ensure that we will receive, in a timely manner, the information we need to establish appropriate Pool Rules for the Thomson Sand Reservoir. Toward this end, there are several items in the proposed POD that we believe must be completed prior to submission of a Pool Rule application to the Commission. These include:

- (i) Completion of the revised geological, engineering, and economic models necessary to evaluate the gas sales and alternative development scenarios as outlined in section 3 of the POD.
- (ii) Completion of the evaluation of alternative development scenarios as described in section 3.2 of the POD.
- (iii) Completion of drilling of the well proposed in section 4 of the POD. Selection of the drilling location for this well should be done in consultation with the DNR and the Commission to help ensure that it will answer the questions that must be answered and, that can only be answered by drilling a well or wells.

<sup>14</sup> The SGDA findings also acknowledged that DNR had provided notice of the PTU termination. Specifically, the findings required DNR to "... suspend[] action to terminate the PTU." [R. 824]

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(iv) Resumption and timely completion of the process established between the Commission and the PTU owners that is described in section 5.1 of the POD.

In conclusion the Commission does not believe that the uncertainty that still exists about the potential development of the PTU can be used as justification for a decision that may promote waste of tens to hundreds of millions of barrels of oil and condensate. This is especially true in light of the fact that much of this uncertainty could have been eliminated already had the PTU owners adhered to the work commitments specified in previous PODs and agreements. [R. 5608-09]

In briefing to DNR, the Port argued that the PTU did not contain wells capable of producing in paying quantities because all the wells that DNR had certified were plugged and abandoned, and that DNR should terminate the Unit for failure to meet development and drilling obligations. [R. 3716-24]

On November 20, 2007, Commissioner Menge held a hearing. [R. 9299-409] AOGCC, BP, Chevron, Conoco, Exxon, the Port, Vic Fischer, and Governor Hickel made presentations. BP, Chevron and Exxon asked the Commissioner to approve the 22nd POD. The Port argued that the PTU did not contain wells capable of producing in paying quantities and that it should be terminated. [R. 33-37, 85, 9316-17,] The AOGCC criticized Lessees' gas blow down project and failure to adequately delineate the Unit. [R. 33-37, 85, 9314-17] After these presentations, and despite the Commissioner's express invitation, Lessees declined to respond. [R. 9385]

On November 27, 2006, the Commissioner issued his decision rejecting the proposed POD cure, declining to modify the 2001 expansion terms, and terminating the

PTU. The Commissioner affirmed the Director's default decision, except on certified wells. [R. 5759-60, 5765]

Lessees' contention that DNR had agreed to the gas blow down project is not supported by the record. [R. 5763] Instead, they repeatedly ignored DNR's requests to further explore and delineate the unit:<sup>15</sup>

DNR has repeatedly requested that Lessees drill an exploratory well to, among other things, better delineate the various hydrocarbon deposits and to firm up the potential of liquids production. A pure gas blow down project will result in the loss of millions of barrels of gas condensate. Neither DNR nor AOGCC are prepared to allow a pure gas blow down project in the face of such a potential hydrocarbon loss without more data indicating it is appropriate. Lessees contend the data indicate uncertainties which prevent them from engaging in liquids production, yet they refuse to obtain more data to reduce the uncertainties. [R. 5753]

The proposed cure did not meet the requirements of the Director's decision, DNR's unit regulations, or the PTUA. [R. 5765] Lessees made no commitment to develop or to adequately explore and delineate the Unit. [R. 5755-56] Instead, the Lessees wanted to further delay unit exploration, development and production until a gas pipeline was constructed and the State granted Lessees royalty and tax breaks.

<sup>15</sup> Lessees insisted that the contract negotiated under the SGDA provide for construction of a gas pipeline before PTU was developed. This was essentially the same position they had taken with DNR on PTU PODs. The Murkowski administration sponsored the resulting proposed contract and submitted it to the legislature for approval, but the legislature did not approve the contract. In the absence of legislative approval of the limited production obligations set out in the contract, DNR was bound to follow existing law regulations, and agreements which authorize the extension of lease terms by unitization only where Lessees comply with the POD requirements of Article 10 of the PTUA and 11 AAC 83.343, and DNR was also bound to follow the criteria for evaluating PODs set out in 11 AAC 82.303.

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[R. 5755-56]

Lessees' offer to drill a well by 2010 or pay \$40,000,000 was not a firm commitment to drill, and money was not an adequate substitute for the required exploratory well. Further, the five-year term did not protect the public interest. Lessees' profit concerns were simply not a valid basis for failing to develop the Unit.

[R. 61, 5756]

Commissioner Menge also rejected Lessees' request to modify the 2001 expansion commitments. Lessees' proposed modification relinquished fewer leases, less area, and less valuable acreage than the State was entitled to for breach of the 2001 expansion commitments. Thus, the Commissioner found Lessees were required to relinquish the expansion leases and pay the State \$20,000,000 for failure to drill the well due in 2006. [R. 66, 5757-58]

In his decision, the Commissioner addressed the unit wells previously certified as capable of producing in paying quantities. The Lessees had plugged and abandoned the wells many years ago, and they were incapable of production. [R. 5759-60] The Commissioner found that the policy of treating plugged and abandoned wells as capable of production was poor policy - it was inconsistent with the law, unit regulations and the PTUA. He revoked the certifications, and set a new policy that a well must actually be capable of production to be certified. [R. 65-66, 5759-60]

The Commissioner also rejected Lessees' contention that the acceptability of the 22nd POD turned on the RPO standard, noting:

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The Lessees' appeal is based on the premise that they do not have to produce because they contend a reasonably prudent operator (RPO) would not produce. This position comes from Section 10 of the unit agreement regarding PODs which states that the Lessees' covenant to develop the unit as a [RPO]. But section 10 says much more.

It requires the Lessees to submit PODs to DNR for approval. Section 10 includes specific requirements about the type and scope of work an acceptable POD must contain. The Director's Decision set out requirements for a PTU default cure which are consistent with the statutes, regulations, unit agreement and leases. The Lessees' proposed cure was not responsive. It did not include a commitment to produce any of the known PTU hydrocarbon reserves – oil, gas liquids or gas. The proposed POD did not make a firm commitment to further delineate the PTU hydrocarbon reservoirs notwithstanding DNR's repeated requests. [R. 5762]

Finally, the Commissioner specifically found that the decision did not turn on Lessees' economics:

Lessees' economics, adequate returns, and risk might be appropriate considerations in some situations. But they play no role here where the unit has been in existence since 1977, massive hydrocarbon deposits were discovered in the early 1980s, the unit has never been put into production, and the Lessees say it may never be put into production until a gas pipeline is constructed and the state compromises its taxes and royalties. Against this backdrop, the state oil and gas leasing system is not intended to require DNR to engage in a murky subjective contest about a Lessees' internal economics, development risk, or view of the difficulty of developing the unit. One of the state's primary interests is production. If production is not in the plan, the state's remedy is to terminate the unit and find another means to develop the unit. [R. 5763-64]

#### V. THE DECEMBER 27, 2006, RECONSIDERATION DECISION

The Lessees filed approximately 3,000 pages of material in their requests for reconsideration of the PTU termination decision. [R. 5819-9298] They did not assert

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that the wells that had been previously certified were still capable of production. In fact, CPA admitted they were not and argued that proper policy was to certify a reservoir rather than a well. [R. 5797-813] Exxon argued that DNR had not noticed the potential unit termination; lacked the authority to terminate because there were certified wells in the Unit; was estopped because requiring a certified well to actually be capable of production changed long-standing DNR policy of recognizing plugged and abandoned wells as capable of production; and had breached the covenant of good faith and fair dealing. [R. 5819-33]

Then-Acting Commissioner Rutherford affirmed Commissioner Menge's termination decision. [R. 9286-98] Lessees were not entitled to hold the Unit based on speculation that circumstances may eventually change enough to make development more profitable:

. . . [T]he PTU is among the largest oil reserves on the North Slope, and it also contains hundreds of millions of barrels of gas condensate. Neither the oil nor the gas condensate require a gas pipeline to produce. Lessees' statements that more tax and royalty concessions will be needed before production can occur and refusal to drill exploratory wells to further delineate the unit, also provide grounds for unit termination, but the primary basis of the decision is the unequivocal statement that the Lessees cannot find a way to put the unit into production and their refusal to submit and acceptable POD. [R. 9290-91]

She also affirmed Commissioner Menge's certified well findings. Lessees had not contended the plugged and abandoned wells were actually capable of production. Thus, she concluded, that Commissioner Menge's decision had conformed the status of the wells to the facts. [R. 9292-93]

Commissioner Rutherford declined to stay the decision and refused Lessees' requests to conduct discovery intended to show that DNR had a long-standing policy of treating plugged and abandoned wells as capable of production because DNR had already admitted as much. [R. 9295-96] She also found that Lessees had notice and an opportunity to be heard on the issues of Unit termination and certified wells because Lessees and the Port raised those issues on appeal. [R. 9286-98] Finally, she determined that even if the PTU contained certified wells, issuance of the termination decision was proper because in all unit terminations, the Commissioner needed to make default, cure and, termination findings. [R. 9291-92]

## STANDARD OF REVIEW

### I. Applicable Standard of Review

Below, the State identifies the standard of review that the court should apply to the issues in this appeal.

#### A. Rejection of the POD

To decide whether the circumstances justified DNR's rejection of the initial and modified PODs, the court should apply the reasonable basis test because the agency's decision is best characterized as a mixed question of fact and law. For example, in *Tarbox v. State, Alaska Transp. Com'n*,<sup>16</sup> the Alaska Supreme Court applied the

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<sup>16</sup> 687 P.2d 916, 919 (Alaska 1984).

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IN THE SUPERIOR COURT FOR THE STATE OF ALASKA

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EXXON MOBIL CORPORATION, )  
Operator of the Point Thomson Unit; BP )  
Exploration (Alaska) Inc.; Chevron U.S.A., Inc.; )  
ConocoPhillips Alaska, Inc., )  
 )  
Appellants, )  
v. )  
STATE OF ALASKA, Department of )  
Natural Resources, )  
 )  
Appellee. )

Case No. 3AN-06-13751 CI  
(Consolidated)  
Case No. 3AN-06-13760 CI  
Case No. 3AN-06-13773 CI  
Case No. 3AN-06-13799 CI  
Case No. 3AN-07-04634 CI  
Case No. 3AN-07-04620 CI  
Case No. 3AN-07-04621 CI

**ORDER RE MOTION FOR STAY PENDING APPEAL**

This case is before the superior court in its capacity as an appellate court upon appeal from administrative determinations by the Department of Natural Resources (DNR) which terminated the Point Thomson Unit Agreement. See AS 22.10.020(d). This Agreement was entered into between the Appellants and the State in 1977 for the purpose of facilitating the production of oil and gas at Point Thomson.

On March 15, 2007, Chevron U.S.A. Inc. (Chevron) filed a Motion to Stay the Commissioner's Decision on Appeal from the Director's October 27, 2005 Decision Denying the Proposed Plans for Development of the Point Thomson Unit (PTU) issued November 27, 2006, and the Commissioner's Decision on Reconsideration of the Point Thomson Unit Termination Decision issued December 27, 2006. Chevron asserts that pursuant to Appellate Rule 603(a)(2) and the Supreme Court's ruling in Keane v. Local Boundary Comm'n, 893 P.2d 1239 (Alaska 1995), this Court should stay these

administrative decisions pending the resolution of this appeal. Subsequently, all of the other Appellants have joined in Chevron's motion.

On April 5, 2007, the State filed its Opposition to Chevron's Motion to Stay. The State asserts that a stay of the Commissioner's unit termination decisions would impede the public's overriding interest in the development of the PTU oil and gas reserves. The State also asserts that a stay would adversely impact pending administrative proceedings with respect to leases within the PTU. And the State argues that the motion for stay should be denied because the Appellants have failed to meet the requirements of Appellate Rule 603. Finally, the State notes that the Appellants have not filed a supersedeas bond as required by the appellate rules with respect to the Commissioner's finding that the Appellants had breached the unit expansion agreement.

On April 5, 2007, the Alaska Gasline Port Authority (AGPA) and Jim Whitaker filed an Opposition to the Motion to Stay. They, too, assert that a stay of the Commissioner's unit termination decision would improperly impact pending administrative appeals of the Director's lease termination decisions. Further, AGPA and Mr. Whitaker argue that a stay would delay a gas pipeline and cause undue hardship to Alaska. Still pending before this court is the issue of whether AGPA and Mr. Whitaker should be permitted to participate as parties in this appeal (and the related motion to strike their opposition to the stay motion) which issue will be addressed by separate order of this Court.

Oral argument was heard on the motion on April 17, 2007. Thereafter, the parties designated additional portions of the administrative record that relate to this motion.

The legal standard for considering motions to stay administrative decisions pending appeal.

Appellate Rule 603(a)(2)(a) provides:

When an appeal is taken, the appellant may obtain a stay of proceedings to enforce the judgment by filing a supersedeas bond. The stay is effective when the supersedeas bond is approved. The filing of a supersedeas bond does not prohibit the court from considering the public interest in deciding whether to impose or continue a stay on that portion of an administrative or district court judgment which is not limited to monetary relief.

The Appellants seek primarily to stay the non-monetary portions of the administrative determinations. In Keane v. Local Boundary Comm'n, 893 P.2d 1239, 1249 (Alaska 1995), the Alaska Supreme Court discussed the appropriate legal analysis to apply when a party seeks to stay a non-monetary administrative decision pending appeal. Whether to grant such a stay is a discretionary determination for the court, which is to be "guided by the public interest." Id.

In addition to consideration of the public interest, the two alternative tests presented in A.J. Industries, Inc. v. Alaska Public Service Commission, 470 P.2d 537 (Alaska 1970) apply to motions for stays of non-monetary administrative decisions sought under Appellate Rule 603(a)(2). Keane v. Local Boundary Comm'n, 893 P.2d 1239, 1249-1250 (Alaska 1995). Under one approach, an appellant may be entitled to a stay upon a "clear showing of probable success on the merits." Id. Upon such a showing, a stay may be granted even where the party seeking the stay does not stand

to suffer irreparable harm in the absence of the stay, or where the party against whom the stay is sought would be harmed if the stay is issued. Id. Alternatively, if the appellant does not demonstrate a clear showing of probable success on the merits, but does raise "serious and substantial questions going to the merits of the case," a stay may be granted, but in such circumstances the moving party must also demonstrate that it is faced with irreparable harm in the absence of the stay and that the party opposing the stay can be adequately protected. Id. See also Keystone v. Alaska Transportation Comm'n, 568 P.2d 952, 954 (Alaska 1977). This second approach is termed the "balance of hardships" approach, as it requires weighing the moving party's potential injury in the absence of the stay against the harm that would be imposed on the non-moving party if the stay is granted. 568 P.2d at 954.

Discussion.

Of primary contention between the parties at this initial stage of the appeal is the appropriate interpretation to accord to two subparts of a DNR regulation, 11 AAC 83.374(c) and (d), and also the applicability of a separate regulation, 11 AAC 83.361.

11 AAC 83.374(c) and (d) provide:

(c) If a default occurs with respect to a unit in which there is no well capable of producing oil or gas in paying quantities and the default is not cured by the date indicated in the demand, the commissioner will, in his discretion, and after giving the unit operator and defaulting party (if other than the unit operator) reasonable notice and opportunity to be heard, terminate the unit agreement by mailing notice of the termination to the unit operator and the defaulting party. Termination is effective upon mailing the notice.

(d) If a default occurs with respect to a unit in which there is a well capable of producing oil or gas in paying quantities and the default is not

cured by the date indicated on the demand, the commissioner will, in his discretion, seek to terminate the unit agreement by judicial proceedings.

11 AAC 83.361 provides in pertinent part:

**Certification of well test results.** For the purposes of 11 AAC 83.301 – 11 AAC 83.395, a well will be considered capable of producing hydrocarbons in paying quantities, as defined in 11 AAC 83.395, when so certified by the commissioner following application by the lessee or unit operator. . .

The applicable portion of 11 AAC 83.395 cited above is subsection (4), which provides as follows:

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

It is undisputed that there are wells within the Point Thomson Unit that had been certified by DNR pursuant to 11 AAC 83.361 as “capable of producing hydrocarbons in paying quantities.” Because of those certifications, the Appellants assert that subsection (d) of 11 AAC 83.374 applies, which requires that the Commissioner must “seek to terminate the unit agreement by judicial proceedings” as opposed to what occurred in this case – termination of the unit agreement at the administrative level. The Appellants also assert that their constitutional rights to due process and equal protection were violated at the administrative level.<sup>1</sup> In the Appellants’ view, they have

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<sup>1</sup> One concern of the Appellants in this regard is their assertion that the AGPA had submitted extensive materials it delineated as “confidential” to DNR setting forth AGPA’s legal analysis of the State’s ability to terminate the PTU Agreement, which materials were not served on the Appellants during the course of the administrative proceedings. See also State’s Notice of Supplemental Record Citation at fn. 1.

demonstrated a clear probability of success on these issues such that this court should stay DNR's determinations during the pendency of this appeal. They also assert that the public interest warrants granting the stay, because the Appellants will be able to continue development of the PTU if the unit agreement is reinstated and because other potential lessees would discount their bids if leases were reoffered while this appeal is pending.

The State asserts that "what appellants actually want is a stay of the lease termination appeal proceedings now pending before the DNR Commissioner." State Opp. at 2. It asserts that staying the agency's PTU termination decisions would preclude DNR from concluding the related lease termination proceedings at the administrative level, which would not result in an ordered determination of the legal issues associated with the Point Thomson reserves.

In the termination decision of November 2006, the DNR Commissioner found that:

DNR Oil and Gas Directors have certified seven exploration wells drilled into the PTU as capable of producing in paying quantities. With one exception, all of the certifications were issued in the 1970s and 1980s. All of the wells which were certified have been plugged and abandoned

There is no existing certified PTU well capable of producing in paying quantities. A PTU production well has never been drilled. No certified PTU well exists today.

[Ex. E to Chevron's Memo. at 12, 13.] In the December 2006 reconsideration decision, the Commissioner found that "the primary basis of the [unit termination] decision is the unequivocal statement that the Lessees cannot find a way to put the unit into production and their refusal to submit an acceptable POD." [Ex. F to Chevron's Memo at 6.]

Relying on 11 AAC 83.361, the Appellants assert that the plugged and abandoned wells in the unit that had been certified must still be "considered capable of producing hydrocarbons in paying quantities" pursuant to the Department's own regulations, such that judicial proceedings to seek unit termination are required under 11 AAC 83.374(d). The Appellants assert that the purported "decertification" of the wells at the administrative level was an invalid attempt to make subsection (d)'s requirement of judicial proceedings unnecessary. The Appellants have also submitted affidavits from a number of technical experts regarding well suspension practices that assert that the wells could be successfully reentered as production or injection wells.

Yet at the same time that the Appellants assert the wells should be considered as capable of producing hydrocarbons for purposes of default proceedings under 11 AAC 83.374, for purposes of actual production at Point Thomson, the Appellants appear to assert that the wells that were certified are in fact not currently capable of producing hydrocarbons in paying quantities. According to DNR's Director of the Division of Oil and Gas, the Appellants' proposed 22<sup>nd</sup> Plan of Development for the Unit "states that PTU development is not possible without modifying the laws regarding the State's right to taxes and royalties on oil and gas production and on construction of a North Slope gas pipeline." [Ex. C to Chevron's Memo. at 2].

But irrespective of the current actual ability of the plugged and abandoned wells to produce hydrocarbons in paying quantities, the undisputed fact remains that the Department certified these wells pursuant to 11 AAC 83.361 and that as a result of these certifications, the wells "will be considered capable of producing hydrocarbons in paying quantities" for purposes of 11 AAC 83.374. Although the State asserts that this

Court should look past the alleged procedural infirmities given the current actual status of the wells, parties appearing before an agency are entitled to relief when an agency has substantially failed to follow its own procedural regulations. Under the established precedent of the Alaska Supreme Court, "[an] agency is bound by the regulations it promulgates . . . An agency has not acted in the manner required by law if its actions are not in compliance with its own regulations." Trustees for Alaska v. Gorsuch, 835 P.2d 1239, 1244 (Alaska 1992)(citation omitted).

Upon review of the applicable regulations, this Court finds that the Appellants have made the requisite "clear showing of probable success on the merits" with respect to the procedures employed by DNR to terminate the Point Thomson Unit, and particularly whether 11 AAC 83.374(d) should have been applied to this unit termination proceeding. Of course, it is certainly possible that upon further briefing of the many complex and unprecedented legal issues presented in this case, this Court may be persuaded by the State that the Department's decisions should be affirmed. But upon consideration of the submissions of the parties to date and the representations of counsel at oral argument, this Court finds that at this initial stage of the appeal, the Appellants have made a clear showing of probable success with respect to the procedural challenges the Appellants have raised, and specifically with respect to DNR's apparent violation of its own procedural regulations.

But the determination of whether to grant a stay on appeal is to be "guided by the public interest." Keane, 893 P.2d at 1249. Fundamentally, the public interest with respect to the Point Thomson reserves is the production of oil and gas. "It is the policy of the State to encourage the . . . development of its resources by making them

available for maximum use consistent with the public interest." Ak. Const. Art. VIII, §1. See also §§ 11, 12. The Appellants assert that the public interest warrants the stay because if the decisions are stayed they will be able to continue development of the PTU. But this argument is not persuasive, as it is somewhat at odds with the Appellants' own proposed 22<sup>nd</sup> POD, which did not propose to put the unit into production. See, e.g., PTU REC 000871.

In addition, the State has persuasively demonstrated that it is in the public interest to accord to DNR a reasonable opportunity to address the related lease termination proceedings at the administrative level at this time. Over the course of the appeal, the public interest could be adversely affected by DNR's decertification action to the extent that that action generates uncertainty and instability among lessees or potential lessees throughout the state with respect to their rights in the state's oil and gas reserves. See, e.g., PTU REC 005743. But at this stage of the proceedings, the public interest warrants that DNR continue to be accorded a reasonable opportunity in the first instance to address the legal status of the Point Thomson leases. Allowing the agency that opportunity is consistent with the doctrine requiring exhaustion of administrative remedies. In explaining the reasons underlying that doctrine, the Alaska Supreme Court quoted the United States Supreme Court as follows:

Judicial review may be hindered by the failure of the litigant to allow the agency to make a factual record, or to exercise its discretion or apply its expertise. . . A complaining party may be successful in vindicating his rights in the administrative process. . . And notions of administrative autonomy require that the agency be given a chance to discover and correct its own errors. Finally, it is possible that frequent and deliberate flouting of the administrative processes could weaken the effectiveness of an agency by encouraging people to ignore its procedures.

Eldelson v. Archer, 645 P.2d 171, 176 (Alaska 1982) quoting McKart v. United States, 395 U.S. 185, 194-195 (1969). Cf. Matanuska Electric Association v. Chugach Electric Association, 99 P.3d 553, 559 (Alaska 2004)(discussion of primary jurisdiction doctrine).

This court does find merit in the Appellants' argument that the public interest could be adversely affected in the absence of a stay because potential lessees would discount their bids if leases were reoffered to the public while this appeal is pending. But should DNR seek to reoffer oil and gas leases to the public at Point Thomson during the pendency of this appeal, the State has acknowledged that it will accord at least 60 days notice. See AS 38.05.035(e). That timeframe accords to the Appellants sufficient time to renew their stay motion with this Court as warranted.

Accordingly, the Appellants' motion for a stay of the non-monetary components of the PTU termination decisions is denied at this time, without prejudice to the Appellants' right to renew the motion during the pendency of this appeal, and particularly if DNR seeks to reoffer oil and gas leases at Point Thomson to the public.

With respect to the Commissioner's finding that the Appellants owe the State \$20,000,000 for breach of the 2001 Expansion Agreement, the Appellants are entitled to a stay of that monetary portion of the Commissioner's Decision upon posting a supersedeas bond with this court in the amount of \$25,000,000.

Dated this 15<sup>th</sup> day of May, 2007.

Sharon Gleason  
Sharon Gleason  
Judge of the Superior Court

I certify that on 5-1-07 a copy  
of the above was mailed/mailed to each of the  
following at their addresses of record  
[Signature]  
Judicial Assistant

allis  
At-todd  
ashburn/crosby  
oreansby  
keithly  
serdahaley

rozell  
down  
ballew  
weck  
walker



**State wins ruling over Slope field - POINT THOMSON: Alaska had right to reject Exxon's plan.**

Anchorage Daily News (AK) - December 28, 2007

Author: WESLEY LOY wloy@adn.com ; Staff

The state has landed a sharp blow against oil titan Exxon Mobil with a judge's ruling that officials had the right to reject the company's noncommittal development plan for a giant North Slope oil and gas field. But whether the ruling is a knockout punch in the struggle for control of the Point Thomson field remains to be seen.

Exxon and other oil companies with a stake in the field still have legal options. And at a minimum, state Superior Court Judge Sharon Gleason ruled that the companies are entitled to a hearing before the state decides what to do next.

The ruling, which Gleason issued the day after Christmas, is a victory for Gov. Sarah Palin and her predecessor, Frank Murkowski, whose administration in 2005 made the first move to snub Exxon's development plan -- the 22nd offered by the company over the years -- for lack of a promise to start producing from the field, which has lain fallow for 30 years.

Weary of waiting, state officials since have suggested it's time to wrench the Point Thomson acreage away from Exxon and other leaseholders and offer it for sale to companies more eager to develop the field, which would create jobs and big tax dollars for the state.

Located just west of the Arctic National Wildlife Refuge, Point Thomson is believed to hold huge reserves of natural gas -- supplies considered critical for supporting a proposed natural gas pipeline.

Despite its riches, Exxon hasn't developed the field, citing technical challenges and the lack of a multibillion-dollar pipeline to carry the gas to the Lower 48 or Asian markets.

State officials counter Exxon has had plenty of time to exploit at least Point Thomson's considerable oil reserves plus its liquid gas, both of which could be shipped down the trans-Alaska oil pipeline.

The judge ruled state officials had the right, and substantial justification, to reject Exxon's development plan.

But Gleason also held the state was too hasty in breaking up the unit binding together Point Thomson leases covering 106,000 acres. Before state officials did that, the companies had a constitutional right to a written notice plus a hearing before the Department of Natural Resources, she ruled.

Exxon spokeswoman Kimberly Brasington said the ruling "confirms" that the state "was wrong" in dissolving the unit. Exxon and the other companies will keep working with the state to settle the conflict, she said.

Nan Thompson, a manager with the department, said Thursday state officials are "quite pleased" with Gleason's ruling overall.

She wouldn't say definitively, however, whether the state is hellbent on regaining control of the Point Thomson land and leasing it again.

"The state is eager to see this land developed," she said. "That's about as close as I can get to answering your question."

Exxon controls Point Thomson with a 53 percent stake. Other leaseholders include BP, Chevron and Conoco Phillips.

Outside of court, however, the state has moved to revoke the leases. The companies have appealed.

Find Wesley Loy online at [adn.com/contact/wloy](http://adn.com/contact/wloy) or call 257-4590.

**Caption:** Illustrated by Ron Engstrom ILLUSTRATION SHOWS MAP Photo by Bruce Webb, Alaska  
Department of Natural Resources

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