

SCOMM

#46:36

STATE OF ALASKA 1986 LEGISLATIVE SESSION FISCAL NOTE

Revision Date : 03-21-86

REQUEST

Bill/Resolution No. CSSSB 430 (R)
 Title : Revoke/Reduce Royalty Increase

Sponsor : Fahrenkamp
 Requestor : Senate Finance
 Date of Request : 03-21-86

FISCAL DETAIL

Agency Affected : Natural Resources
 BRU : Petroleum Management

Components : _____

EXPENDITURES/REVENUES : (Thousands of Dollars)

OPERATING	FY 86	FY 87	FY 88	FY 89	FY 90	FY 91
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	-0-	-0-	-0-	-0-	-0-	-0-

CAPITAL						
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REVENUE	(2260.0)	(2150.0)	(1900.0)	(1660.0)	(1460.0)	
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FUNDING : (Thousands of Dollars)

GENERAL FUND						
FEDERAL FUNDS						
OTHER						
TOTAL						

POSITIONS :

FULL-TIME						
PART-TIME						
TEMPORARY						

ANALYSIS : Attach a separate page if necessary

See Attached Explanation

Revenue reduction figures are based on a calendar year, not a fiscal year.

Prepared by : Kay Brown Phone : 762-4241
 Division : Oil and Gas Date : 03-21-86

Approved by Commissioner : Norm D. Ammel, Deputy Date : 03-21-86
 Agency : Natural Resources

Distribution (by Agency preparing fiscal note):

- Legislative Finance
- Legislative Sponsor
- Requestor
- Office of Management and Budget
- Impacted Agency(ies)

Attachment Fiscal Note for SSSB 430

This amended fiscal note is necessary because CONOCO last week revised downward their projected rate of production. This fiscal impact (Revenue) is estimated on the basis of several assumptions:

... The bill would affect only Milne Point unit production;

... Milne Point Unit production at:

1986	18,500 bpd
1987	17,600 bpd
1988	15,500 bpd
1989	13,600 bpd
1990	11,900 bpd

... Royalty reduction from 20% to 12.5% under SSSB 430;

... Wellhead price is assumed to be \$5.45/barrel

STATE OF ALASKA



POUCH V
JUNEAU, ALASKA 99811
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HOUSE SPECIAL COMMITTEE ON OIL AND GAS

CSSSSB 430 (Rules)

CSSSSB 430 (Rules) would allow the commissioner of the Department of Natural Resources to reduce or revoke a royalty increase that was made in connection with the institution or operation of a cooperative or unit plan. Such a reduction or revocation would also have to contain a mechanism to provide that if the profitability of a lessee's operation increases to a specified level after the reduction or revocation is made, the commissioner shall increase the royalty obligation to a level not exceeding the amount of the royalty increase that the commissioner reduced or revoked.

This legislation is directed specifically toward Conoco's Milne Point Unit. The renegotiation of lease terms in 1979 between Conoco and DNR occurred as a result of the unitization of the Milne Point field. One condition of unitization was a royalty increase from 12.5 to 20 percent. Milne Point is the only producing unit that has been subjected to a royalty increase. Non-producing units that have been subjected to similar royalty increases are Gwydyr Bay and Duck Island.

It is the view of DNR that present law prevents the commissioner from making the royalty reduction or revocation sought by the operator of the Milne Point Unit. DNR believes that the specific royalty reduction limitations stated in AS 38.05.180(j) control the general royalty reduction powers granted in AS 38.05.180(p).

AS 38.05.180(j) states that "To prolong the economic life of an oil and gas field, the commissioner shall adopt regulations for all bidding methods to allow reduction of royalty on leases within the field to compensate for increasing costs in the later stages of production decline. The commissioner may not grant a reduction of royalty until two years' initial production from the field has occurred and each lessee requesting the reduction has made a clear showing that the revenue from all hydrocarbons produced from the field is insufficient to produce a reasonable rate of return with respect to that lessee's total investment in the field."

SSSB 430 started to move actively through the Senate after Conoco and DNR failed to negotiate an agreement to alter the royalty obligation at Milne Point. The most hopeful attempt at resolving this issue was DNR's offer of a royalty reduction to 12.5 percent, in combination with a 12.5 percent royalty and a 35 percent net profit share from the Shallow Sands reservoirs at Milne Point. This would have provided the state with revenues equivalent to a 20 percent royalty, while allowing Conoco to defer payment of 7.5 percent of its royalty obligation. Negotiations broke down, however, when Conoco stated that the company must have a real reduction in its royalty obligation rather than simply the deferring of a share of this obligation.

Conoco's request for a royalty reduction derives from the company's unfortunate economic timing. The Milne Point Unit and the consequent royalty increase were established at a time when the price for crude oil was near its record high. Profitability projections at the time were sufficient to warrant the commencement of production activities, notwithstanding the 20 percent royalty.

Because of the lower current price for crude oil, however, Conoco claims that the life of the Milne Point field will be terminated prematurely unless the company is provided with some measure of royalty relief. Conoco further states that the reduction or revocation of its Milne Point royalty obligation will enhance the company's opportunity to develop the nearby Shallow Sands reservoir. However, the costs of field development are expected to far exceed the revenues retained by Conoco through a reduction in its royalty obligation.

STATE OF ALASKA

DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

BILL SHEFFIELD, GOVERNOR

POUCH M
JUNEAU, ALASKA 99811
PHONE: 907-465-2400

March 17, 1986

The Honorable Arliss Sturgulewski
Chair, Senate Resources Committee
P.O. Box V
Juneau, AK 99811

Dear Senator Sturgulewski:

The Department of Natural Resources supports SS SB 430, which is scheduled for a hearing today in the Senate Resources Committee. The bill would authorize the commissioner of the Department of Natural Resources under certain circumstances to reduce or revoke oil or gas royalty obligation increases made in connection with the institution or operation of a cooperative or unit plan.

The bill primarily would affect the Milne Point Unit, a small North Slope oil field which began production last fall.

Conoco, Inc., the Milne Point Unit operator, has been seeking for several years to roll back a 20% royalty on certain Milne Point leases. The royalty obligation on those leases was increased from 12.5% to 20% under an agreement required by the department in 1979 as a condition of approval of the Milne Point Unit.

As a result of an application for royalty relief filed last fall by Conoco and Milne Point Unit working interest owners Reading and Bates Petroleum Company, Champlin Petroleum Company and Cities Oil and Gas Corporation, the department has examined confidential economic, geological, geophysical and engineering data supplied by the companies. Based upon that review, the department believes that rescinding the royalty increase would encourage continued production and further development of oil reservoirs within the Milne Point Unit.

Under existing and forecasted economic conditions, there is a high likelihood that both the economic and physical recovery of oil and gas at Milne Point will not be maximized for either the companies or the state at a royalty rate of 20%. Production of oil and gas from the developed reservoir (i.e., the Kuparuk River formation) will not be maximized, and development and production of oil and gas from yet to be

developed reservoirs (i.e., the Shallow Sands - heavy oil and gas reservoirs, geologically equivalent to ARCO's West Sak-Ugnu reservoirs at Kuparuk Unit) likely will not occur at all. The companies have made a persuasive case that they cannot be reasonably assured an adequate rate of return on any future or incremental investment under the existing 20% royalty. Given the further erosion of crude oil prices since the application was filed with the state last October, it is possible that current production will be halted if the royalty rate on the leases remains at 20 percent.

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

A reduction in the royalty rate from 20% to 12.5% would result in a revenue decrease to the State of approximately \$4.5 million a year from the Milne Point Unit. (See attached fiscal note.)

The department has tried to address the need for royalty relief within the current statutory framework, and earlier this year proposed that the royalty obligation be changed (not reduced) to a 12.5% royalty and a 35% Net Profit Share in lieu of the current 20% royalty. The companies have not accepted this proposal, even though it would have the effect of an immediate reduction in the royalty obligation, and would leave open the opportunity for the companies to apply for further relief after two years of field production based on the facts and circumstances at that time.

The department has been constrained from considering an outright royalty reduction by AS 38.05.180(j), which precludes the commissioner from granting a reduction of a lease royalty "until two years' initial production from the field has occurred and each lessee requesting the reduction has made a clear showing that the revenue from all hydrocarbons produced from the field is insufficient to produce a reasonable rate of return with respect to that lessee's total investment in that field."

The department's proposal to change the existing royalty rate was based on the authority of AS 38.05.180(p), which authorizes the commissioner to change royalty requirements of unitized leases "as the commissioner determines necessary

or proper to secure the proper protection of the public interest." Under the department's proposal, the state likely would have been compensated for the near-term revenue losses resulting from a reduction to a 12.5% royalty rate by the further receipt of revenues from the development of the Shallow Sands reservoirs at Milne Point and the application of the 35% Net Profit Share and the 12.5% royalty to that production. Revenues to the state over time likely would have been equivalent or greater under the department's proposal, but the income would have been delayed.

The department believes that it is not authorized to reduce the royalty obligation under AS 38.05.180(p), because of the limitation AS 38.05.180(j) appears to place on the commissioner's powers. If AS 38.05.180(j) applied only to leases that had not yet been unitized, AS 38.05.180(j) would be a nullity because, as a practical matter, unitization always precedes production. Related statutes should not be construed to make one statute a nullity.

Further, the general rule of statutory construction is that specific provisions control general provisions. Under this rule, the specific royalty reduction provisions of AS 38.05.180(j) would control the general provisions of AS 38.05.180(p).

Further, the legislative history of AS 38.05.180(j) argues against using AS 38.05.180(p) to circumvent the royalty reduction limitations stated in AS 38.05.180(j).

Testimony before the Legislature in 1978 focused on royalty reductions in conjunction with the increased flexibility given to the commissioner to select bidding methods. A prime concern was to prevent royalty bid manipulation, where a bidder obtains a tract by bidding an unreasonably high royalty counting on a subsequent royalty reduction to make the lease profitable. Although the companies obtained their leases at a fixed royalty sale, the policy against royalty bidding is arguably still applicable. The companies' leases were about to expire, causing the companies to agree to increase royalties in order to keep from losing the leases which were about to expire.

The bill that created AS 38.05.180(j) went through several committee substitutes. One committee, the House Resources Committee, voted to place an express limit on the commissioner's powers under AS 38.05.180(p) by adding the language: "however, the commissioner may not reduce the state's royalty within any unit except as provided in [j] of this section." A subsequent committee reviewing the bill, the Senate Resources Committee, deleted that language, but its sole motive was that the language was unnecessary since that committee had already decided to delete AS 38.05.180(j) altogether.


March 17, 1986

Later in the Senate Resources hearing, DNR pointed out that AS 38.05.180(j) granted the commissioner less power to reduce royalties than existed at that time under AS 38.05.140. The committee then voted to amend AS 38.05.140 to delete the commissioner's royalty reduction powers for oil and gas, and voted to reinstate AS 38.05.180(j). The committee immediately adjourned, without taking up the question of whether the previous committee's limitation of AS 38.05.180(p) should be retained.

In view of this legislative history, the department concluded that the specific royalty reduction limitations stated in AS 38.05.180(j) control the general royalty reduction powers granted in AS 38.05.180(p).

Thank you for the opportunity to comment on SS SB 430.

Sincerely,


Esther C. Wunnicke
Commissioner

Attachment

cc: Senator Bettye Fahrenkamp



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

December 23, 1985

The Honorable Mike Davis
Representative, Alaska
315 Barnette Street
Suite 101
Fairbanks, Alaska 99701

Re: Enclosed Request for Unit
Agreement Amendment

Dear Representative Davis:

Enclosed is a copy of a request by Conoco Inc. and other Milne Point Unit working interest owners to amend the Milne Point Unit Agreement. The companies submitted the request to DNR on November 4, 1985. The amendment would remove a 7½% royalty surcharge that was imposed upon these companies by DNR Commissioner Robert LeResche in September, 1979.

Granting the companies' request for removal of the surcharge will have a negligible effect on current state revenues. Indeed, the surcharge will net the state only some \$8 million in additional royalties in 1986. However, if the surcharge results in premature field abandonment, the state will suffer a foreseeable \$1.1 billion net loss in taxes and royalties. Moreover, the subsequent production at Milne Point which is jeopardized by the surcharge is critical to the state. For example, if the surcharge is removed, and the unit is fully developed, the state's projected FY 1996 oil production decline will be reduced by 31%.

Either inaction by DNR, or DNR's refusal to acknowledge its authority to grant the companies' request, may necessitate a legislative response in order to prevent premature abandonment of the only currently-active marginal field on the North Slope, and the resultant loss in state revenue. As a result, we hope that you, and your staff, will have the opportunity to review the companies' papers.

This matter arose in 1979, when the Milne Point companies applied to Commissioner LeResche for approval of the Milne Point Unit. The commissioner refused to approve the unit unless the companies consented to pay a 20% royalty, rather than the 12½% that had been agreed to at the 1969 competitive sale. The companies, of course, had little choice but to accept the commissioner's demands, since a rejection of the unit

decision before your next session commences. And, we will certainly keep you advised of the progress of our request.

Thank you in advance for the attention which I know that you, and your staff, will give to this matter.

Sincerely,



John R. Kemp
Division Manager
Anchorage Division

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TESTIMONY OF AL HASTINGS
BEFORE THE HOUSE OIL & GAS COMMITTEE
REGARDING CS SS SB 430 (APRIL 16, 1986)

CONOCO IS THE OPERATOR OF THE MILNE POINT UNIT. BY ANY DEFINITION, MILNE POINT IS A MARGINAL UNIT. IT BEGAN PRODUCTION LAST FALL, AND IS CURRENTLY PRODUCING ONLY 18,000 BARRELS PER DAY--THIS IN COMPARISON TO PRUDHOE BAY'S 1.5 MILLION BARRELS PER DAY, AND 260,000 BARRELS PER DAY FROM THE KUPARUK UNIT.

DESPITE ITS MARGINAL NATURE, MILNE POINT, AND MILNE POINT ALONE, IS REQUIRED TO PAY A SPECIAL ROYALTY SURCHARGE. AT THE STATE'S 1969 COMPETITIVE SALE, THE SUCCESSFUL BIDDERS STRUCK AN AGREEMENT UNDER WHICH THEY AGREED TO PAY A 12.5% ROYALTY. IN 1979, HOWEVER, WHEN THE MILNE POINT COMPANIES SOUGHT APPROVAL OF THEIR UNIT, THE STATE REFUSED UNLESS THE COMPANIES AGREED TO PAY A ROYALTY SURCHARGE OF 7½%, THUS INCREASING THE ROYALTY TO 20%.

SINCE REJECTION OF THE UNIT WOULD CAUSE THE COMPANIES TO LOSE THEIR LEASES, WE HAD LITTLE CHOICE BUT TO ACCEPT.

IN 1979, THE STATE BELIEVED THAT THIS ROYALTY SURCHARGE WAS IN THE PUBLIC INTEREST, BECAUSE IT ALSO BELIEVED THAT WELLHEAD OIL PRICES IN 1985 WOULD BE NEARLY \$35 PER BARREL. AS EVENTS HAVE TRANSPIRED, ANS CRUDE IS SELLING ON THE WEST COAST SPOT MARKET AT \$12-\$14/BBL, AND TRANSPORTATION COSTS FROM MILNE POINT TO MARKET ARE \$11-\$12/BBL. AS A RESULT, INSTEAD OF INCREASING STATE REVENUES, THE ROYALTY SURCHARGE THREATENS TO FORCE PREMATURE ABANDONMENT OF THE UNIT.

LAST NOVEMBER, CONOCO SUBMITTED A FORMAL REQUEST TO RECONSIDER THE ROYALTY SURCHARGE IN THE MILNE POINT UNIT AGREEMENT. ON FEBRUARY 5th OF THIS YEAR, WE RECEIVED A LETTER FROM COMMISSIONER WUNNICKE, WHICH INDICATED THAT EXISTING LAW COULD PRECLUDE HER FROM REDUCING OR REVOKING THE ROYALTY SURCHARGE.

AT THAT POINT, AND IN LIGHT OF DNR'S CONCERNS OVER THE

STATUTE, IT BECAME OBVIOUS THAT LEGISLATION WAS NECESSARY IF DNR WAS ABLE TO CONSIDER REVOKING OR REDUCING THE SURCHARGE, AS OPPOSED TO SIMPLY CHANGING ITS FORM. THIS BILL WOULD ACCOMPLISH PRECISELY THAT.

THERE ARE A FEW POINTS THAT I WOULD LIKE TO BRIEFLY MAKE WITH RESPECT TO THE BILL, THE URGENCY BEHIND IT, AND THE ONGOING EFFORTS TO NEGOTIATE A SOLUTION TO THIS CONTROVERSY WITH DNR. FIRST, THE BILL IS VERY NARROWLY DRAFTED. IT WOULD AUTHORIZE, AND ONLY AUTHORIZE, THE COMMISSIONER TO REDUCE OR REVOKE ROYALTY SURCHARGES IMPOSED AT THE TIME OF UNIT FORMATION. IT ALSO REQUIRES THE COMMISSIONER TO PROVIDE A MECHANISM TO INCREASE THE ROYALTY IF THE COMPANIES' PROFITABILITY IMPROVES. FINALLY, THIS BILL GIVES THE COMMISSIONER NO AUTHORITY WHATSOEVER TO REDUCE ROYALTIES BID UPON OR AGREED TO AT A COMPETITIVE SALE.

NEXT, THE BILL DOES NOT GRANT CONOCO, OR ANYONE ELSE, ROYALTY RELIEF. IT MERELY AUTHORIZES THE COMMISSIONER TO RECONSIDER ROYALTY SURCHARGES IN UNIT AGREEMENTS WHEN THE PUBLIC

INTEREST WARRANTS. CONOCO WILL STILL HAVE TO PROVE ITS CASE BEFORE THE DEPARTMENT. THE ISSUE BEFORE THIS COMMITTEE IS NOT WHAT CONOCO'S ROYALTY SHOULD BE; THAT ISSUE WILL HAVE TO BE RESOLVED BY DNR, BASED ON THE CONSIDERATION OF FINANCIAL DATA, SOME OF IT CONFIDENTIAL. THE ONLY RELIEF CONOCO IS ASKING HERE IS TO REMOVE A PERCEIVED AND VERY UNINTENTIONAL IMPEDIMENT TO DNR'S ABILITY TO RECONSIDER THE SURCHARGE.

THERE IS URGENCY TO THIS LEGISLATION. AS YOU KNOW, THE UNIT HAS ALREADY HAD TO SUSPEND NEW DRILLING AT MILNE POINT, AND IN LIGHT OF THE RECENT DRAMATIC DECLINE IN OIL PRICES THE SURCHARGE IS JEOPARDIZING NOT ONLY FUTURE DEVELOPMENT, BUT EXISTING PRODUCTION AS WELL. IN A LETTER TO SENATOR STURGULEWSKI, COMMISSIONER WUNNICKE STATED (AND I QUOTE) "IT IS ALSO VERY LIKELY THAT IF CURRENT CONDITIONS PERSIST (OR GET WORSE), THE FIELD WILL BE SHUT IN IF THE ROYALTY REMAINS AT 20%."

CONOCO AND DNR HAVE ATTEMPTED TO RESOLVE THIS MATTER THROUGH NEGOTIATIONS. IN THOSE NEGOTIATIONS, COMMISSIONER WUNNICKE AND

HER STAFF HAVE USED THEIR BEST EFFORTS TO WORK WITHIN THE PERCEIVED CONSTRAINTS. SPECIFICALLY, DNR HAS DONE AS WELL AS ANYONE COULD TO CHANGE THE NATURE OF THE SURCHARGE WITHOUT REDUCING IT, AND AT THE SAME TIME AFFORD SOME MEANINGFUL RELIEF TO CONOCO. WE COMMEND DNR FOR THE EFFORTS THEY HAVE MADE IN THIS REGARD; HOWEVER, THEIR JOB MAY BE AN IMPOSSIBLE ONE UNDER THEIR VIEW OF THE STATUTE, FOR IT IS VERY HARD TO REDUCE A ROYALTY WITHOUT IN FACT REDUCING IT.

CONOCO'S INTENT IS A LONG-TERM COMMITMENT TO REMAIN AN OPERATOR IN ALASKA. WE HAVE CONTINUED TO BE ACTIVE IN BOTH STATE AND FEDERAL LEASE SALES, AND MILNE POINT IS AN IMPORTANT KEY TO THIS COMMITMENT. WITH THE CURRENT CRUDE PRICES, WE ARE NOT MEETING OUR OPERATING COSTS. PASSAGE OF THIS BILL WILL PROVIDE SUBSTANTIAL ENCOURAGEMENT FOR THE CONOCO AND ITS PARTNERS TO STAY IN OPERATION DURING THESE DIFFICULT ECONOMIC TIMES.

THANK YOU FOR THE OPPORTUNITY TO TALK WITH YOU TODAY REGARDING SB 430, AND I WOULD BE DELIGHTED TO TRY TO ANSWER ANY

QUESTIONS YOU MIGHT HAVE.