583 SRES HB 854

The language in the proposed legislation should but does not distinguish between, "raw", "processed" and "interpretative" data. We are unalterably opposed to providing the state with the results of the efforts of our interpretative staff. Industry cannot operate under this law. We urge the committee to delete this section.

We are also opposed to giving the state our basic geophysical data. We are not convinced that the state can hold this data confidential because of its large staff and turnover rate. Any leak of this sensitive information to our competitors definitely will have an immediate and adverse impact on our exploration program in this state.

The third provision we object to (Sec. 38.05.180(v)) gives the state the right to purchase up to 16 and two-thirds percent of the lessee's share of the oil and up to 100 percent of the lessee's gas.

We are not opposed to the state's right to take its royalty share of oil or gas in kind, but we oppose any provisions which empowers the state to take any portion of the lessee's share.

In order to justify the risk and expense of exploration and development, and be able to satisfy its contractual commitments, the lessee must retain the right to dispose of all of its share of production. Without this right, the state of Alaska lands become less desirable to explore and develop. We believe this is another step toward the state's entry into the oil and gas business, which should stay with private industry.

It seems inconceivable to Chevron that the state would take a portion of the lessee's share when that is the very incentive for industry to explore in the state initially.

AGO 546757

Another provision we oppose is Paragraph Q. Paragraph Q refers to drilling and development contracts and to the authority of the state to share in the cost of exploration.

We're not clear on the meaning and intent of this paragraph. If it means the state intends to become a working interest participant in leases, then we strongly object.

Our next objection concerns the terms and conditions of the lease itself. Because of the remoteness of most of Alaska's land and the seasonal restriction on operations, Chevron prefers a ten-year primary lease term. We feel this length of time is necessary to adequately evaluate a lease under Alaskan conditions.

There is one provision which would allow the Commissioner to grant rights on leases only to the depth drilled at the time production begins. Chevron is at a total loss to see how this provision can benefit the state in any way. It will certainly cause waste in time and money for the industry because wells will be drilled far beyond primary objectives--just to ensure earning the rights of a normal lease. In effect, this will delay production and thereby delay revenue to the state.

Considering the geological, legal and practical ramifications of this provision, one must conclude that it is totally unacceptable to the industry and can do the state no good. It should be stricken from the bill.

Our next objection is to any effort to restrict joint bidding between majors or multinational companies. In Alaska, particularly, with its accompanying expensive costs of exploration and production, it is essential for large and small companies to be able to join together to share the risk.

AGO 546758

A ban on joint bidding by majors does not necessarily increase state income. In fact, a recent study by the Department of Interior showed that joint bidders tend to bid higher, on the average, than solo bidding competitors. (November 1976 issue of the Journal of Petroleum Technology.)

The next provision we wish to discuss deals with the need for the Commissioner to submit and defend his leasing program to the legislature. We prefer that the various reporting methods set out in this section not be prescribed in law. We believe this review is an administrative function and that public hearings are an adequate and effective vehicle for gathering comments and reactions to the proposed action. Neither the timber leases nor any other types of state lease are submitted to the legislature, and to require this approach in law for the petroleum industry will lead to further delays in development of the state's natural resources. Particularly objectionable to us is the requirement that the Commissioner must defend his previous year's program and explain why he used certain methods. This is certain to toss the entire leasing program into an interminable bureaucratic morass.

And finally we oppose the provision which deals with acreage chargeability. We believe the reduction to 200,000 acre limitation on uplands is arbitrary and unjustified. The 500,000 acre limitation in this state, where there are large areas of state lands potentially available for bid, is not unreasonable. A large acreage position is necessary as an incentive for an operator to explore frontier areas.

In closing, Mr. Chairman, Chevron believes H.B. 854 is an unreasonable, unwise and unworkable piece of legislation that simply is not in the best interest of the citizens of Alaska.

ASO 546759

As I said at the outset of my remarks, my own company would be faced with the prospect of seriously reassessing its current and future exploration activities on Alaska state lands if this bill is enacted.

It is our opinion that this legislation will only serve to inhibit or prevent the orderly exploration and development of Alaska's oil and gas properties.

We oppose a shift away from the successful cash bonus bidding system because we believe that the cash bonus ensures a fair and equitable return to the state, as well as ensuring the fair share of any revenue resulting from production.

It is conceivable that Prudhoe Bay may not have been found if royalty or net profits bidding or percentage acreage option had been employed.

Mr. Chairman, members of the committee, we have serious concern that if this legislation becomes law, the ultimate losers will be the citizens of this state, as well as the consumers of oil and gas.

Thank you for giving Chevron this opportunity to comment on this proposed legislation.

* * *

AGO 546760

TESTIMONY ON COMMITTEE SUBSTITUTE
FOR HOUSE BILL 854 (FINANCE)

PRESENTED BEFORE THE
SENATE RESOURCES COMMITTEE

BY
J. R CARSON
CHEVRON, USA, INC.

May 22, 1978
Juneau, Alaska

AGO 546716

TESTIMONY ON H.B. 854

Madam Chairman, members of the committee, my name is John Carson, and I appreciate the opportunity to comment on Committee Substitute for House Bill 854. (Finance)

I am a petroleum geologist and I'm presently Division Geologist in Alaska for Chevron U.S.A., the principal domestic oil and gas subsidiary of the Standard Oil Company of California. Since 1965, I've been actively involved in all state lease sales and the two OCS sales in the Gulf of Alaska and the Lower Cook Inlet.

Chevron is aware of the amount of preliminary work done by the state administration and the Department of Natural Resources in researching and drafting this legislation.

We commend efforts in drafting legislation that proposes a long term leasing program for Alaska. We believe the state should be encouraged in its effort to establish and maintain such a program, with appropriate industry participation.

Members of the committee, the petroleum industry--as indicated by its response to the State's solicitations--clearly desires a realistic plan that can serve as the basis for an effective working relationship between the industry and the state.

Frankly, we believe the proposed legislation will inhibit or prevent orderly development of oil and gas resources in Alaska--to the detriment of the state government, its taxpayers and my own industry.

AGO 546717

I will say candidly that this legislation is untenable from our point of view. If enacted into law, Committee Substitute for House Bill 854 would have a serious and far-reaching impact on my own company, and would give us serious cause to reconsider our exploration activities in the high-cost, high-risk frontier state lands of Alaska.

854 as now written would be counter-productive. It actually would be a step backward at the very time our nation desperately needs an effective oil and gas exploration program.

Generally stated, we object to provisions covering: 1) the wide variety of bidding methods to be employed; 2) the Commissioner's access to all the lessee's data, including proprietary data; 3) the state's call on production; 4) short and restrictive lease term and conditions; 5) the need for the Commissioner to submit and defend his lease plan to the legislature, and 6) the Commissioner's right to ban joint bidding for approval.

Time does not permit me to discuss in detail each of the provisions, but I will attempt to outline our most significant objections:

First, the wide variety of bidding methods, starting on page 3, section (f):

In advocating numerous bidding schemes--actually a shift from only cash bonus bidding, a system that has worked well--the administration hopes to maximize its financial return from state lands.

AGO 546718

But Chevron believes a move away from the cash bonus method means the perilous abandonment of a proven concept that has brought stability to the state's leasing program. The bonus system would be replaced by an array of untested leasing methods, particularly in the frontier areas.

We believe this provision, if enacted, will transform Alaska into a trial-and-error laboratory in oil and gas leasing. It means replacing orderly development with uncertainty and the unknown. It's not a gamble Chevron feels is worth taking.

Before discussing each bidding system, all concerned parties should be aware that a move away from cash bonus bidding will result in three key developments:

First, it will shift a substantial part of the burden of risk from industry to the taxpayer.

Second, it will serve as a substantial deterrent to exploration and development, and

Third, it will cause the rapid and constant growth of state agencies to administer, evaluate and audit the leases and subsequent production. This places increasing demands on taxpayers to support this bureaucracy.

Chevron believes these are unacceptable consequences which would be intolerable to the taxpayers and leaders of this state.

As you know, cash bonus bidding provides that leases be awarded to the highest cash bonus bidder. This bonus is paid before the lessee can proceed with exploratory drilling on the lease.

AGO 546719

The other bid methods provide for bid variables such as royalty, net profit, or work commitment. In these cases, the state receives nothing other than perhaps a small fixed bonus at the time of leasing. Other revenue is not forthcoming under the royalty and net profit schemes unless there is production. Simply stated: No production, no revenue.

In our opinion, cash bonus bidding is the only method that will strongly encourage the petroleum industry to lease and explore the state land.

We further believe that this method will result in the production of the most oil and gas and consequently will provide the most revenue, both to the state and the petroleum industry.

The other methods, employing biddable royalties and net profits, reduce the incentive to explore and produce. These alternatives, particularly in the case of biddable royalties, serve to shorten the economic life of the fields--resulting in less production and, therefore, less revenue.

Cash bonus bidding is particularly advantageous to the state in frontier areas of high risk. Most of Alaska's lands are in this category.

Now let's compare other proposed bidding methods with traditional cash bonus bidding. Because of time limitations, I can only touch briefly on these, but I am prepared to go into more detail if questions arise.

AGO 546720

The royalty bidding method, although it allows oil and gas companies to acquire land with little cash, is a strong deterrent to early drilling. Very simply, it is easier and cheaper to wait on others to bear the risk and expense of exploratory drilling.

Having spent little capital to acquire the lease, an operator is tempted not to spend a dime to evaluate the lease, hoping an adjacent leaseholder may do it for him. Carried to the extreme, the effect of this would be that no wells would be drilled to evaluate the leases. This same problem is inherent in the net profits system, which I'll talk about shortly. On the other hand, when cash bonus is involved, the winning bidder has a strong incentive for early drilling because his bonus investment is earning him nothing.

In cash bonus bidding the state assumes none of the risk but still receives revenue from leases, whether or not they are productive.

The advantages of this system were clearly demonstrated a few years ago in the sale of federal leases off the coasts of Mississippi, Alabama, Florida and Louisiana. Successful bidders paid $743 million for several tracts on one structure, the Destin Anticline, and spent over 10 million dollars drilling seven dry holes on the structure--all at no cost to the taxpayer. Under royalty or net profit bidding, the government would have received nothing.

AGO 546721

What would government have received if it had sold the Gulf of Alaska on a royalty bid basis? As in the Gulf of Mexico case I previously cited, nothing. Should the taxpayer and the government be forced to suffer the loss of more than one-half billion dollars--when to date, no royalty appears forthcoming?

The NPRA comes to mind as another example of an area adjudged to possess high potential, but which so far is a disappointment. Again, if sold on a royalty bidding method, the lessors would have received nothing to date.

Let me emphasize that in all these cases, the areas were considered extremely attractive to both the industry and government. These are precisely the types of areas in which the state might be enticed to use a royalty or net profit bidding method. Yet none of these has led to any discovery or government revenue.

Proponents of royalty bidding believe it encourages competition among bidders and allows the small company and the independent improved entry into oil and gas lease bidding. Cash bonus bidding usually is blamed for tending to discourage small companies from bidding.

This is not supported by the facts. Small companies gain entry into the sale by joining with a larger company or with several other smaller companies. In the recent Lower Cook Inlet sale, independents and smaller companies bid on royalty and cash bonus tracts with about the same frequency as the

AGO 546722

majors. Of the 34 companies which bid in the sale, 18 were smaller companies. These 18 made successful cash bonus bids on 26 tracts, of which 13 were sold for more than one million dollars. Moreover, the small companies are represented in half of the top bonus tracts of the sale.

Provisions are made for reducing the royalty in the event the lessee cannot operate profitably. While we agree that such a provision may be necessary, we think this only serves to point up a major weakness of royalty bidding. Due to the highly competitive nature of the business, industry is encouraged to bid and agree to terms that may be truly ridiculous. Another commission will almost certainly be necessary to review and rule on the long list of plaintiffs for reduced royalties.

The second proposed bidding method we are concerned about is net profit bidding. This system has most of the disadvantages of royalty bidding plus one more: It requires a huge staff to administer and audit. For example, each property would require a battery of accountants to audit the companies' production and costs. Just as in the case of royalty bidding, the risks are passed on to the government. Furthermore, net profit bidding discourages cost-effective, efficient development practices.

At this point, I would like to summarize why we believe a majority of the industry prefers cash bonus as the best method for both the state and the energy explorers.

AGO 546723

First, we believe it is the foundation for all free enterprise contract arrangements;

Second, it is the simplest and eas_ _st to determine and administer by all parties;

Third, it is fair and equitable; by this I mean that all parties travel at their own risk, and finally,

The right to explore is paid for in advance.

In 1977 the Department of Natural Resources completed a report entitled, "A Study of Petroleum Leasing Methods and Possible Alternatives." H.B. 854 apparently is based on this study and its conclusions.

I would like to make a few comments about the Department of Natural Resources' report. The one overriding conclusion of that study was that a variety of bidding methods, wisely employed, would increase the state's return from its commitment of oil and gas properties.

Chevron believes this conclusion is biased against cash bonus bidding, and we feel that the odds are against anyone knowing all they need to know to use the right method at the right time. The state, even if armed with a skilled staff and large amounts of data, can hope to do no better than an individual company in evaluating potential and risks, and these companies are more often wrong than right in their appraisals.

We believe the state's report, and particularly its main bias against cash bonus bidding, is based on a few but major faulty economic assumptions.

AGO 546724

First, the authors of the report assume that the industry will make an 18 percent rate of return. Although this is very desirable, and would not be out of line considering the high risk involved, past experience shows that the industry has averaged no more than seven to eight percent from OCS ventures which approximates Alaska lands, according to several exhaustive studies. For example, in May 1977 Prof. Walter J. Mead of U.C. Santa Barbara testified before a U.S. House of Representatives Committee that weighted average rate of return from 184 leases issued in the Gulf of Mexico in 1954-55 amounted to only 7½ percent before taxes. This sale period was selected because these leases have a 20-year production history which provides a comprehensive data base.

Second, no reduction of state income was assumed in royalty cases, but it almost certainly will occur. The economic limit of a field is going to be greatly influenced by the amount of royalty. The higher the royalty, the earlier the economic limit is reached. When an operator can no longer produce oil or gas profitably the result will be oil and gas left in the ground and neither industry, nor the state, will make any money on it.

Next, I would like to turn to the provision of the bill that would require the lessee or permittee to make available to the Commissioner all data obtained from exploration and production activities on the lease or permit. Found on p. 11 - section (aa). We believe this provision raises fundamental

AGO 546725

questions about the appropriateness of the state's entry into the exploration business, and secondly, points to grave problems--from our point of view--about the preservation of confidentiality.

The language in the proposed legislation is not clear as to what non-interpretive data will be required. If the intent is to provide access to data existing prior to the lease, we are unalterably opposed. "Non-interpretive" is a loaded word which needs strict definition.

We are also opposed to giving the state our basic geophysical data. We are not convinced that the state can hold this data confidential because of its large staff and turnover rate. Any leak of this sensitive information to our competitors definitely will have an immediate and adverse impact on our exploration program in this state.

The third provision we object to gives the state the right to purchase a specified volume of the lessee's oil or gas. This is found on p. 11, section (Z).

We are not opposed to the state's right to take its royalty share of oil or gas in kind, but we oppose any provisions which empowers the state to take any portion of the lessee's share.

In order to justify the risk and expense of exploration and development, and be able to satisfy its contractual commitments, the lessee must retain the right to dispose of all of its share of production. Without this right, the state of

AGO 546726

Alaska lands become less desirable to explore and develop. We believe this is another step toward the state's entry into the oil and gas business, which should stay with private industry.

It seems inconceivable to Chevron that the state would take a portion of the lessee's share when that is the very incentive for industry to explore in the state initially.

If such a clause remains in the bill, Chevron feels it is mandatory that the state make its intention known on this matter <u>prior</u> to the lease sale. Otherwise, it will be totally inoperable. The industry, without contractual commitments for its product, cannot bid on oil and gas leases.

Our next objection concerns the terms and conditions of the lease itself. I refer to p. 6, section (n). Because of the remoteness of most of Alaska's land and the seasonal restriction on operations, Chevron prefers a ten-year primary lease term. We feel this length of time is necessary to adequately evaluate a lease under Alaskan conditions. We appreciate that the proposed legislation gives the Commissioner the right to grant a ten-year lease under certain conditions. However, it should be stated that this decision will be made and announced prior to this sale.

Our next objection is to any effort to restrict joint bidding, found on p. 10, section (y). In Alaska, particularly, with its accompanying expensive costs of exploration and production, it is essential for large and small companies to be able to join together to share the risk.

AGO 546727

A ban on joint bidding does not necessarily increase state income. In fact, a recent study by the Department of Interior showed that joint bidders tend to bid higher, on the average, than solo bidding competitors. (November 1976 issue of the Journal of Petroleum Technology.)

The final provision we wish to discuss deals with the need for the Commissioner to submit and defend his leasing program to the legislature. See p. 1, section (b). We prefer that the various reporting methods set out in this section not be prescribed in law. We believe this review is an administrative function and that public hearings are an adequate and effective vehicle for gathering comments and reactions to the proposed action. Neither the timber leases nor any other types of state leases are submitted to the legislature, and to require this approach in law for the petroleum industry will lead to further delays in development of the state's natural resources. Particularly objectionable to us is the requirement that the Commissioner must defend his previous year's program and explain why he used certain methods. This is certain to toss the entire leasing program into an interminable bureaucratic morass.

In closing, Madam Chairman, Chevron believes CS for H.B. 854 is an unreasonable, unwise and unworkable piece of legislation that simply is not in the best interest of the citizens of Alaska.

AGO 546728

As I said at the outset of my remarks, my own company would be faced with the prospect of seriously reassessing its current and future exploration activities on Alaska state lands if this bill is enacted.

It is our opinion that this legislation will only serve to inhibit or prevent the orderly exploration and development of Alaska's oil and gas properties.

We oppose a shift away from the successful cash bonus bidding system because we believe that the cash bonus ensures a fair and equitable return to the state, as well as ensuring the fair share of any revenue resulting from production.

It is conceivable that Prudhoe Bay may not have been found if royalty or net profits bidding or percentage acreage option had been employed. Our sincere suggestion is to retain the leasing statute now in effect and supplement it with provisions for a long term leasing program.

Madam Chairman, members of the committee, we have serious concern that if this legislation becomes law, the ultimate losers will be the citizens of this state, as well as the consumers of oil and gas.

Thank you for giving Chevron this opportunity to comment on this proposed legislation.

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AGO 546729

H.B. #854

Gov's. Bill

TESTIMONY ON

ALASKA LEASING POLICY BILL

(H.B. 854)

By
Rod L. Boane
Alaska District Manager
Exxon Company, U.S.A.

Before The
State of Alaska
House Resources Committee

Juneau, Alaska

March 17, 1978

AGO 546703

Mr. Chair-- - and Members of the Committee --

I am Rod L. Boane, District Manager for the Alaska Exploration District of Exxon Company, U.S.A. I appreciate the opportunity to be here today and present the views of my Company concerning the proposed Leasing Policy Bill.

First, let me say that Exxon believes the existing provisions of Section 38.05.180 of the Alaska Statutes are quite satisfactory in administering adequate control over exploratory and development activities on State leases. Therefore, we do not believe these new amendments to the Statutes are needed to protect the public interest. On the contrary, we think the proposed amendments would create unnecessarily involved and cumbersome procedures that will neither foster needed exploration nor benefit the State of Alaska. Although we take exception to almost all features of the proposed amendments, in the interest of time, I intend to discuss only the more troublesome provisions, with particular emphasis on the proposed bidding methods.

Exxon believes that the best method for awarding leases is on a cash bonus basis. This system has several advantages which I would like to review.

- First, the successful bidder sees very strong incentives to explore and develop rapidly and to recover the maximum economic volume of hydrocarbons at the lowest possible cost. This is necessary in order for him to maximize the return on the cash bonus invested.

AGO 546704

- <u>Second</u>, under the cash bonus system, the State bears none of the risk that commercial reserves will not be found. This risk is placed directly on industry where it belongs. This is a particularly critical concept in Alaska which is still essentially a frontier province where very little exploratory drilling has occurred and thus very little is known about the oil and gas potential of most of the State. When one further takes into account the fact that Alaska is a very high cost area due to its remoteness and harsh operating environment, it should be easy to see that the exploration risks and costs are indeed great. The Gulf of Alaska history should prove this point as, thus far, no commercial discovery has been made.

- <u>Third</u>, under the cash bonus system there is no possible way that the awards will be made in an arbitrary manner since the highest bid is obvious.

- <u>Finally</u>, the system is simple and inexpensive to administer, and its integrity is unaffected by future events. The State would not have to expand its staff to implement this system.

Now I would like to compare the alternate bidding methods proposed in this legislation to conventional cash bonus bidding with fixed royalty. Basically, the proposed alternative bidding methods fall into one of three categories. The first category involves some form of royalty bidding. The second category uses

AGO 546705

some form of net-profit bidding. The third category uses some form of work commitment. All three categories require a cash bonus, either as a bid variable or a fixed amount. Let's first examine the royalty bidding systems.

(1) It is not uncommon for operators to discover reserves of lesser magnitude than anticipated. With high fixed royalty, some of these discoveries could not be developed profitably unless the State agreed to accept a lower royalty than originally bid. Downward adjustment in royalty rate prior to any development would be difficult to administer and could undermine the integrity of this bidding system.

(2) With royalty bidding, the successful bidder does not have a strong incentive for rapid exploration and development since front-end cash investment is small. Speculators could therefore see incentives to acquire leasehold interest, and then wait in hopes that they will be able to cash in on the discoveries made by others. This situation would obviously result in delayed exploration and development activities.

(3) With exclusive royal bidding, the public bears the major portion of the exploration risk because if the tract doesn't contain commercial hydrocarbon reserves, as the majority will not, the public receives no compensation whatever. As an example, the State received $900 million in bonus for acreage on the North Slope in the September 1969 sale. Under a royalty bidding system the State would have received little income to date. We strongly believe that risk-taking and its associated rewards or losses are more properly the province of private enterprise.

AGO 546706

The second royalty bidding system involves a sliding scale royalty system which would be difficult to monitor and, practically speaking, would make it impossible to compare bids unless you know the total reserves, the price at which production would be sold, and the rate of production. Sliding royalty could result in widely differing positions on prudent development. Also, unitization of tracts would be a very complex and difficult job.

With these comments in mind, let's review recent experience with royalty bidding in the Federal sector. A program of experimentation began with the recent sale in the Lower Cook Inlet. Thirty-four percent of the tracts were put up for royalty bidding. Selection of these tracts was in such a manner that they were scattered over the entire sale area. When this type of tract distribution is coupled with a forced unitization lease stipulation, it is not difficult to conclude that the owners of the royalty tracts have no incentive for rapid evaluation. They can just sit back and wait for the owners of cash bonus tracts to do the initial drilling. They can then join the units covering any reservoirs that extend under their tract.

After the Cook Inlet sale, this problem apparently became obvious to the Department of Interior. For the North Atlantic Sale (Sale #42), they attempted to "fix" this problem by grouping the royalty tracts together and having them removed from the cash bonus tracts. They further expanded the experiment by having a group of cash bonus tracts that had a fixed royalty of 40 percent.

AGO 546707

Industry comments relating to royalty bidding have apparently begun to create some concerns about this system. In the upcoming South Atlantic Sale (Sale #43), we see another attempt to "fix" difficulties in the previous system. Tracts are being offered by cash bonus bidding with a sliding scale royalty. They have attempted to "fix" the unitization problem by again grouping the sliding scale royalty tracts together. However, they did not address how a group of sliding scale royalty tracts or sliding scale royalty and cash bonus tracts would be unitized.

Now that this experimentation process has begun, we see the continuing creation of new difficulties and complexities as attempts are made to correct previous difficulties and problems. It appears that this process is going to have a "snow-balling" effect and may eventually reduce competition. In this situation, only the companies that can afford to dedicate a large professional staff to the long unitization negotiations and wait long periods for initial production will servive. This certainly does not promote increased competition.

Now let's look at the second bidding category a profit-sharing system, which has most of the same adverse characteristics as royalty bidding, but with four added complications and disadvantages.

(1) Using net profits will be much like selecting a contractor to perform a job. The operating efficiency of the bidder could become an important consideration in determining which of

AGO 546708

several bidders had submitted the high bid inasmuch as the gross proceeds to be received by the public would be a direct function of the efficiency of the operator. Thus, the successful bidder would no longer be obvious. Since the relative operating efficiency of companies cannot be determined quantitatively, the Commissioner would be vulnerable to charges that bid awards were being made in an arbitrary or discriminatory manner.

(2) A profit-sharing system would be difficult and costly to administer. A large administrative organization would likely be established to audit and monitor the continuing activities of lessees. Discretionary judgments would be required by the State with regard to what costs were to be included or rejected in the profit base. This system could lead to State control of expenditures.

(3) A profit-sharing system would significantly reduce the incentive for a successful bidder to operate at maximum efficiency. Any prudent operator utilizes a priority system when restraints of either manpower or materials create limitations. When these restraints exist, net-profit tracts will have low priority. The result - reduction of efficiency. It would also reduce the timing and incentive for development of advanced technology currently in progress by industry.

(4) Most important, sharing in net profits would signal the State's entry into the production phase of the oil business. It might be politically and economically difficult for the State not

AGO 546709

to be deeply involved in decisions about day-to-day operations and thereby become an operating partner. This step would not be consistent with the maintenance of a strong private enterprise system either within the oil industry or within the State itself.

The third category of bidding system is work commitment which can be combined with any of the other methods. A work commitment bid becomes a form of cash bonus bidding. If an operator has a high interest in a tract, he will bid a work commitment which is equivalent to what he would bid in a cash bonus system. In many instances, this commitment would be much larger than required for evaluation. If early exploration results are negative, the operator remains committed to drill more wells than would normally be prudent or necessary.

The provision that the Commissioner can terminate a work commitment further complicates the issue. Termination of a work commitment for one operator would undoubtedly result in inequities because he has received an unfair competitive advantage. Continuation of this practice could result in extremely high work commitments in anticipation of cancellation after performing only a portion of the work.

A work commitment bid will be nothing more than a form of cash bonus. The same result can be accomplished more easily and efficiently with a cash bonus bid.

Now I would like to discuss a few other provisions which give us concern.

(1) AS38.05.180(v) Right to Purchase - The provision gives the State the right to purchase not more than 16 2/3 percent of the oil and 100 percent of the gas. The most onerous portion of this provision is the right of the State to purchase 100 percent of the gas.

The present and potential supplies of gas within Alaska far exceed reasonably anticipated demands by the State residents. Therefore, to find a market, this gas will have to move into interstate commerce. This requirement, that the State could remove the gas from the market, could severely hamper a producer's ability to market the reserves. Without a reasonable expectation that the developed gas can be marketed, there is greatly reduced incentive to explore.

It would also retard development of natural gas for State residents. The risk that the gas could be diverted would have significant impact on ventures to install gas transportation systems.

In addition to these concerns, it raises other questions such as:

1. Determination of fair market value
2. Use of gas for lease fuel
3. Timing and rate of production - could the State control these to satisfy their own requirements or desires?

AGO 546711

(2) AS380.05.180(w) - Exxon is strongly opposed to this proposed section which requires any lessee or permittee conducting exploration for, or development or production of, oil or gas on State land, to provide the Commissioner access to all data obtained from such activity and to provide copies of such specified data, as the Commissioner may request. Access to all data could potentially permit endless intrusions into private business. Much of this data is very costly. In a competitive industry such as ours, a considerable amount of data is proprietary. Disclosure of this type of data could result in the loss of a competitive edge. In none of the other producing states are operators required to provide access to all data. In addition, we feel that any such requirement would, in effect constitute a "taking" for which compensation by the State would be required. We believe this proposed amendment is unnecessary and should be deleted because the existing regulations provide the State with adequate control over exploration and development activities.

(3) AS38.05.100(1) - We are strongly opposed to the concept of earning production rights only to the depth drilled at the beginning of production from a lease. We are not aware of this language in lease forms for any other producing state.

This language is somewhat similar to that commonly used by a lessee in "farming out" acreage for the purpose of evaluating specific geologic objectives by a third party. In a frontier

AGO 546712

province like Alaska it doesn't make any sense to place such restrictions in the lease form. The idea should be to give the lessee maximum flexibility in evaluating his acreage - not to curtail or to require unreasonable and costly actions on his part. We, therefore, strongly suggest that this language be deleted.

We also recommend that reworking be added to the list of actions which will hold a lease in force. In fact, a grace period of 60 days should be allowed between cessation of production and initiation of drilling or reworking operations. This useful and desirable feature is in the present law.

(4) AS38.05.180(j) Lease Term - A five-year primary lease term is very restrictive in Alaska. The remote location of most prospects, rugged terrain, short construction season, and reduced drilling season, either necessary or imposed, make completion of the exploration cycle a difficult and time-consuming process. Once a discovery is made, additional drilling is required before an estimate of the field size can be made. All of the previously mentioned factors affect this drilling too. Once the lengthy process of discovering a field and establishing its commerciality is complete, the long development phase must begin. We strongly recommend that the 10-year lease term be retained.

(5) AS38.05.180(c) Uplands Acreage Limitation - The proposed 200,000-acre limitation on all lands other than tide and submerged lands is very restrictive compared with the current 500,000-acre limitation in a State like Alaska which has so many frontier

AGO 546713

interior basins to explore. In a hostile high cost environment such as Alaska, a large block of acreage may be necessary in order to justify exploration. We believe the proposed 200,000-acre limitation would be a strong disincentive of an operator to explore these frontier interior basins and strongly recommend maintenance of the current 500,000-acre limitation.

(6) AS38.05.180(u) Joint Bidding - The provision allowing the Commissioner to restrict joint bidding, if he so desires, could prohibit the involvement of some companies most capable of operating in the Alaskan environment.

A study was performed by the University of Southern California and the USGS to determine the effects of restricting majors from bidding jointly in the OCS. They concluded that on the average, this restriction resulted in more bids per lease by the major oil companies.

(7) Legislative Review - We object to the requirement for submission of the leasing program for annual review by the Legislature because we believe it will result in unnecessary delays in implementing leasing programs.

(8) AS38.05.180(q) Drilling and Development Contracts - The proposed amendment which would allow the State to share in exploration costs is inconsistent with the provisions of the lease agreement, as the State's royalty interest is free of all exploration

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and development costs. If this is intended to allow the State to share in working interest, we are opposed since it would signal entrance of State Government into the oil and gas business.

In closing, I would like to reiterate that Exxon believes the current leasing statutes and the implementing and regulations have served the State and industry well and do not need to be changed.

Passage of this bill will require the State to embark into an experimental program. Because these systems are unknown, many mistakes will be made. New "wrinkles" will be tried in order to correct these mistakes. In fact, the State of Alaska will find itself taking a course which is identical to the course presently being followed by the Federal Government. The end result will be an extremely complex system which may allow only a few companies to survive.

This concludes my prepared testimony, and I will be happy to answer any questions which you may have.

* * * * *

AGO 546715

Anchorage Division
Production Exploration, U.S. & Canada

Marathon
Oil Company

P.O. Box 2380
Anchorage, Alaska 99510
Telephone 907/274-1511

May 22, 1978

Ms. Kay Poland, Chairman
Senate Resources Committee
Pouch V
Juneau, AK 98911

Dear Ms. Poland:

We wish to submit herein Marathon's thoughts, concerns and suggestions regarding the proposed legislation entitled "An Act relating to the leasing and exploration of state land for oil and gas development".

First and most important, the present statues and regulations have worked well for the State and they have a background for proper legal interpretation and understanding. The State has under the existing laws authority to protect itself and to judge whether it is receiving fair value for leases sold at that time with the then known information. Hind sight makes instant experts of persons unknowledgeable in a given field of endeavor. Oil and Gas exploration is a risk business and it deals with many unknowns until it has the opportunity to prove or disprove a theory or imagitative interpretation by drilling a test well. Therefore it is our

feeling that the proposed legislation being considered here today is unnecessary.

Specific comments to provision of HR 854 are as follows: 38.05.180(b) requires the commissioner to annually submit a proposed leasing schedule, wherein the legislature has the opportunity to disapprove all or part of it. It has long been the theory that the legislature makes the law and the Administration implements them. This proposed procedure gets the legislature involved with implementation of the laws. We feel there is much more important work for the legislature than looking at a specific leasing schedule, unless of course, there has been some impropriety.

38.05.180(f) provides for numerous bidding methods the commissioner may use to issue oil and gas leases. Other than the cash bonus bid and a fixed royalty reserved to the state, we believe the systems would not be in the best interest of the State of Alaska. When royalty bidding and net profits bidding methods are used the citizens of the state are then assuming a portion of the risk. Also, these methods will require additional personnel to administer and could result in less net return to the citizens. The small population of the State of Alaska does not need laws that would enlarge the bureaucratic organization.

When leases in a given area have various royalty provisions it would be difficult if not impossible for the individual companies to agree on a unit operation. With

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differing royalty provisions the companies would have different economic incentives and philosophies which would be impossible to overcome.

In Section 38.05.180(n), we encourage its modification to provide for ten (10) year term leases as provided for in existing statues. The short operating seasons and continuing environmental concerns and lengthy process to obtain permits to drill are reasons to justify a ten (10) year term lease.

In line 11 on page 7 of this same section, it is recommended that the words "or is capable of" be added following the word "produced". This would in our opinion clarify the intent. Also we recommend the following sentence be added to this section "No lease issued under this section expires because operation or production is suspended under an order, or with the consent of the commissioner".

In Section 38.05.180(o), we recommend that a fixed rental be established for a lease and that it continue for the life of the lease or until production commences. That a minimum royalty be established and it be payable at the expiration of each lease year beginning on or after a discovery of oil and gas in paying quantities on the lands leased. Also that there be no dual payment of rental and royalties as presently provided for in the proposed leasing bill.

In Section 38.05.180(z), we feel the provision for the

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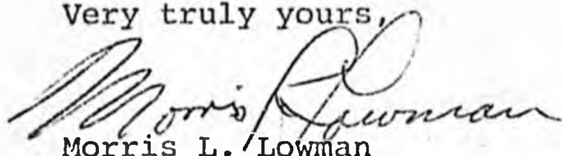
state to take or purchase any volumes of discovered hydrocarbons over and above the reserved royalty share would be counter productive. Such provisions could eliminate or impair the ability of lessees to utilize gas sale contracts or production payments as a method of financing, likewise discourage exploration.

In 38.05.180(aa), we have strong misgivings about furnishing data as provided for therein. Information garnered from ones own initiative and imagination is valuable and proprietary and should be retained by ones own self. These provisions will certainly be counter productive.

In our statement, we have voiced some of our concerns and objections as well as some suggested modifications to HR 854, however, it is our hope that this proposed legislation will languish in committee without further action. We feel the existing law is satisfactory and workable. HR 854 will create confusion and misunderstanding in its implementation and will unnecessarily enlarge the bureaucratic organization and we recommend its rejection.

Very truly yours,



Morris L. Lowman
Senior Landman
MLL/pr

cc: Resource Committee Members

AOGA COMMENTS -- HOUSE BILL NO. 854

Comments on Section 1:

Sec. 38.05.180(a)(1)(B)

In the description of the legislative purposes of this bill, there is a negative connotation given the word "exploitation" in Sec. 38.05.180(a)(1)(B). This section in general suggests sinister motives to the oil and gas industry which need to be "minimized." A possible modification should read, "regulate the development of these natural resources in protection of the public interest."

Sec. 38.05.180(a)(2)

Underlying this section is the notion th t it is in the State's best interest to maximize the leasing methods available to the State. However, it is our view that the new leasing methods proposed are largely untested and may result in reduced revenues to the State. Further, it is not at all clear how a unit agreement could ever be formulated for a group of lessees who had obtained their leases under a combination of the proposed bidding methods.

Sec. 38.05.180(b)

This section deals with the Commissioner's obligations to prepare a leasing program for the following 5 year period and his obligation to keep the legislature informed. We are in favor of such a long-range leasing program and support the State's acknowledged

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goal of "stability and predictability" in a petroleum leasing program. However, the long-range benefits intended and the State's goal are frustrated by the ability, and, indeed requirement, that the Commissioner review and possibly revise the leasing program at least annually. Perhaps the possibility of revision could be limited to the last two years of the ongoing five year programs so that industry could expend exploration dollars with some certainty that a sale will be held. Alternatively, Sec. 38.05.180(b)(3) should be deleted.

The annual submission to the legislature of the leasing program, although for "its information," would seem to presuppose further modification of the leasing program. Again, opportunity for yearly modification of the leasing program abrogates the State's goal of a stable and predictable petroleum leasing system. As an alternative to reporting to the legislature, the Commissioner could be required to make an annual public report of the leasing program.

Additionally, in Sec. 38.05.180(b)(5)(E), the Commissioner is required to justify in his report to the legislature why more than 50 percent of an area is leased under any one method of leasing. This requirement of justification seems to be an incentive, if not explicit direction, to utilize the full array of leasing alternatives for any one sale and to, in effect, "experiment".

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The language in Sec. 38.05.180(b)(2) is extremely confusing and should be clarified. Further, it is not clear whether or not this section is directed to or will have any effect, intended or otherwise, on the Beaufort Sea sale.

Sec. 38.05.180(c)

This section authorizes four generic categories or methods of leasing: (1) "Bonus bidding," (2) "Royalty bidding," (3) "Net profit bidding," and (4) a "Work commitment bid." Several combinations or variations of methods are authorized under each of the generic headings.

The first method of conventional bonus bidding has the best overall record from the lessor's standpoint. A study of federal OCS sales through 1975 showed that industry had invested $35 billion in bonuses, exploration and development on OCS leases while receiving $22 billion in revenue.

Net profit bidding opens up a multitude of problems as to the definition of "net profit." This method would allow many companies to get into a land position for speculative purposes. It is a

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fierce deterrent to early drilling as it is far easier and cheaper to wait out the competition. It is extremely cumbersome to administer and audit, and is even more costly to operate than royalty bidding methods.

The last method of bidding, a work commitment for a lease which cannot, by definition, exceed 5,760 acres, seems completely unworkable as such an area is much too small. This method is usually used in European and mid-east concessions or Canadian permits or reservations which share a common characteristic of being very large geographic areas.

In each of the four leasing methods, the language describing the State's royalty is troublesome. Each description of the State's royalty provides, "... royalty share reserved to the state of not less than 12 1/2 cent in amount or value of the production removed or sold from the lease or <u>unit area encompassing the lease</u> ...." (emphasis added) This language would preclude anything but 100 percent state units. Unitization of lands involving federal or native lands and state lands would be impossible because of the inability of the participants to give the state at least 12-1/2 percent of the production from the "unit area encompassing the [state] lease."

Further, it should be noted that all of the methods and components of the alternate leasing methods will necessitate substantial increases in the budgets and personnel of the agencies involved.

Finally, if some minimum flexibility in leasing methods is desired, the same could be accomplished with minor changes in the existing law.

Sec. 38.05.180(d)

This section allows the Commissioner to reduce royalty when production becomes uneconomical, but only after two years of production. The most recent federal leases require only one year of production, which would be more in line with the stated goal of the bill to minimize revenue from marginal production. Given the explicit description of the royalty in Sec. 38.05.180(c) as "not less than 12 1/2 percent ...," it is not clear whether the Commissioner could ever reduce royalty to any figure below 12 1/2 percent.

Sec. 38.05.180(e)

This section purportedly authorizes the Commissioner to defer payment of any part of a cash bonus bid, provided the bonus is paid within five years. This authority is in direct conflict with AS 38.05.335(c), neither referenced nor repealed by the bill, which requires a deposit of 20 percent, in cash, of the bid.

Sec. 38.05.180(f)

This section authorizes the Commissioner to withhold acreage from leasing in a particular sale. It is assumed that the motive of

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this provision is a desire to increase the state's income from leasing by leasing, for example, only part of a structure, and then, once proven productive, leasing the remainder for higher amounts. However, this authority to withhold acreage can just as easily decrease the state's income, in the event the first acreage leased is found non-productive.-- which is usually the case. In essence, this section is authorization for the Commissioner to "gamble" on the productivity of state lands.

This section also seems unfair to the first lessees, who, if the first tracts leased prove productive, are faced with the prospect of having to buy themselves back into the fruits of their own risk at a higher rate.

Sec.'s 38.05.180(g) and (h)

These sections relate net profits and work commitment leasing which, as previously discussed, are ill-advised.

Sec. 38.05.180(i)

There are no objections to this section so long as the trading or storage of royalty oil remains and is clearly the subject of mutual agreement.

Sec. 38.05.180(j)

This section concerns several of the provisions to be included in state oil and gas leases:

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First, this section reduces the primary term of state leases from 10 to 5 years. It should be understood that in most areas of Alaska the ability to carry out exploration work is limited to a four month period per year, consequently a five year lease allows only 1-2/3 years of exploratory work. This is clearly insufficient in such a high cost, high risk area.

Second, this section provides that a state lease will be "renewed", if and for so long thereafter as oil and gas is produced in paying quantities or if the lease is committed to a unit. The term "renewed" should be replaced with the term "extended" as this is the long-understood and recognized effect of production or commitment to a unit.

Third, the section's provision concerning shut-in wells should be clarified, since, in its present form, it appears as though the shut-in well must be located on the land prior to the issuance of a lease.

Fourth, this section authorizes the Commissioner to increase rentals up to 150 percent of the preceding year's rate and to provide that a lessee earns production rights only to the depth drilled at the beginning of production. Both of these provisions should be deleted as unnecessary and unworkable.

As to rental increases, as noted, Alaska is already a high cost, high risk area. The prospect of substantial rental increases

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during the primary term of a lease will serve only to curb exploration not encourage it.

The provision concerning production rights only as to the depth drilled is unnecessary and unfair. Aside from an obvious example of the lessee drilling into the top of a reservoir and being mechanically unable to go deeper and thereby losing the main body of the reservoir, it also could result in split ownership of a lease with one party having to drill through another's rights to reach his own with possible damage to the upper reservoir resulting.

Finally, the means of extending a lease by drilling are set forth in this section. Given the seasonal nature of drilling in Alaska, the 90 day grace period after drilling has ceased should be expanded if further drilling is prevented by environmental considerations or other circumstances imposed by the State.

Sec. 38.05.180(k)

The increased rentals proposed in this section will discourage exploration and will not increase income to the State because the extra expense will be compensated by lower bid totals. The present $1.00 per acre per year rental should be retained.

Further, this section alters substantially the nature of the ordinary rental provisions in oil and gas leases. The rental to be paid under these provisions is no longer a delay rental. This

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section provides, "Rental is payable in advance and continues until income to the state from royalty, net profit, or exploration work commitment exceeds rental income to the state ... for three consecutive years ...." There is no provision for credit or set-off of rental paid during those three years against the state's income from production. Consequently, for the first three years of production, the state would receive both rental income and production income.

Sec. 38.05.180(1)

This section should be modified to provide that the state shall issue a State shorelands lease, as AS 38.05.180 presently reads. Also, the Commissioner should be given the discretion to grant a shorelands lease in excess of five years.

Sec.'s 38.05.180(m) and (n)

These two sections concern the unitization of state leases and are re-enactments of present law. However, given the alternate leasing methods of the bill, and the previously discussed, implicit direction to the Commissioner to "experiment" with these methods, unitization of state leases will be extremely difficult, if not impossible.

It is entirely reasonable to assume that under this bill, a proposed unit will be composed of leases involving highly disparate royalty percentages and one net profits or other kind

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of lease. The extreme difficulty of applying these completely different lease burdens to the production allocated to each lease under a proposed unit are obvious. These difficulties constitute a disincentive to unitization and therefore nullify the conservation benefits of unitization.

Sec. 38.05.180(o)

This section concerns the acreage chargeability of KGS leases and is unobjectionable.

Sec. 38.05.180(p)

This section is a re-enactment of the present authorization for the pooling of state leases. Like the provisions concerning unitization, the problems inherent in alternate leasing methods will make pooling more difficult, to the detriment of the conservation objectives of pooling.

Sec. 38.05.180(q)

This section authorizes the State to share in the costs of exploration under a drilling or development contract. Oil and gas exploration is extremely risky and historically the province of private enterprise. Financial participation by the state in an exploration venture raises fundamental questions as to the appropriate role of state government. Given the fact that most wells drilled are unsuccessful, and the substantial sums involved in drilling in Alaska, additional challenges may be anticipated as to the authority or wisdom of the State to participate in a particular drilling project.

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Sec. 38.05.180(r)

This section is a re-enactment of present law concerning the subsurface storage of oil or gas on state leases. However, the present law's provision concerning the extension of the lease used for storage for the period of storage and so long thereafter as oil and gas are produced was deleted. This extension provision should be retained.

Sec. 38.05.180(s)

This section concerns the employment of state residents on state leases is substantially the same as the existing law.

Sec. 38.05.180(t)

This section is an attempt by the state to encourage exploration on lands on which no bids have been tendered. This philosophy is laudable. However, the Commissioner should not be restricted by the leasing details of this section.

Sec. 38.05.180(u)

This section would restrict joint bidding and should be deleted. Joint bidding can very well be to the advantage of the state as it tends to increase the size of the bids submitted and facilitates the exploration process. See, for example, the paper in the November 1976 issue of "Journal of Petroleum Technology" in which the authors conclude that "joint bidders tend to bid on more sought-after (and apparently more valuable) leases and that they tend to bid higher, on the average, than solo-bidding

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competitors". Industry testimony before the U.S. Senate has indicated that since the first OCS sale in 1954, 172 companies have purchased OCS leases. 42% of these leases were not purchased by the major companies, and in recent years the smaller companies have increased their share of OCS production at the expense of the major oil companies.)

Depending on the content of the regulations adopted, this section may violate Article 8, §17 of the Alaska Constitution. This Constitutional provision requires that laws and regulations governing the use or disposal of natural resources must apply equally to all persons "similarly situated".

Sec. 38.05.180(v)

This section grants the state an unfettered option to purchase 16-2/3 percent of oil and up to 100 percent of gas produced from a state lease. This section will in effect eliminate the lessee's ability to use the gas sales contract as a method of financing. Consequently, gas exploration in Alaska will be discouraged if not precluded. Similarly, if the state should wait several years before deciding to take up to 100 percent of the gas, the discoveror of a gas field would be deprived of all income from his legally obtained gas, because he could not enter into a contract with any other user. This section would also eliminate or impair the ability of lessees to utilize the production payment as a method of financing, likewise discouraging exploration.

Sec. 38.05.180(w) This section requires state access to all of a permittee or lessee's exploration data and should be eliminated from the bill. This section is, in essence, a confiscation of valuable proprietary data, for the sole purpose of deciding whether the explorer has found anything or not. If the state decides he has, the area could then be thrown open to all other competitors, thereby removing any incentive for an aggressive company to be a leader or employ innovative ideas to discover new resources. This section completely removes that incentive, and thereby will cause significant state natural resources to remain unsought.

In addition, grave problems as to the preservation of the confidential nature of the data are inherent in this section. It is common knowledge that such information is extremely confidential and closely guarded by the individual members of the industry.

The existing law upon which the oil and gas industry has relied for the confidentiality of information is contained in AS 38.05.035(a)(9)(C). This existing provision requires the director to keep geological, geophysical and engineering data confidential "upon request of the persons supplying the information." As the Bill's provision requires disclosure of information to the Commissioner, not the director, and since it requires also access, as distinct from supplying copies, are the confidentiality provisions incumbent upon the director not

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applicable to the information required to be disclosed to the Commissioner?

If this section is to be applicable to existing exploration data, then the Commissioner's access and utilization of such existing data is almost certainly an unconstitutional taking of this valuable and expensive property. If the Commissioner is to be allowed access at all to such data, such access should be limited to future data only. Further, there should be a requirement of the adoption of regulations prescribing the confidentiality of this data and the addition of statutory criminal penalties for intentional disclosure of such data.

Section 2

There are no objections to this section concerning notice of mineral leasing.

Section 3

This section would amend AS 38.05.140(c) to reduce the upland acreage limitation from 500,000 acres to 200,000 acres. In Alaska, where there are large areas of state lands which are potentially eligible for bid, a 500,000 acre limitation, which the present statute contemplates, is not unreasonable. The effect of a 200,000 acre limitation would clearly be to limit the participation of those individuals who are most active in exploration business in Alaska, i.e., those individuals who have

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historically submitted the highest bids to the state. It is not at all clear why the state would seek to discourage, rather than to encourage, the continued involvement of those individuals in Alaska. Further, this section's applicability to the holding of existing lessee's -- requiring them to reduce their holdings within 5 years -- is an unconstitutional taking of leasehold estates.

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Alaska State Legislature

Senate

Committee on Resources

Official Business

Pouch V
State Capitol
Juneau, Alaska 99811

LIPTON on LEASING

The following notes summarize Lipton's major points on proposed leasing legislation in his testimony before the Senate Resources Committee on 1/28, 3/15, and 4/28. The initial two testimonies relate to HB 854, while the latter refers to changes later incorporated into CS HB 854 (Finance).

.2 line 3
B 854

Subsection (d) of the initial findings contains an unusual but exemplary approach to leasing - that is to "maximize state revenue from profitable oil and gas production, while minimizing revenue from unsuccessful exploration and from marginal economic oil and gas production." (Deleted in present version)

With respect to the eight leasing methods proposed, his specific comments were confined to:

Royalty Bidding - a method not preferable except when the lease is on a known structure with known risks. There is a potential problem if royalty bidding is permitted as an option and if the commissioner is also given discretion to abate royalties where there is an insufficient rate of return. The successful bidder may overbid a royalty with the expectation of a future royalty reduction. The section on abatement (page 5, line 18 CS HB 854) is still present, but modified from original bill.

Net Profit Bidding - this method may be attractive to both the state and the industry under certain circumstances. Allows the oil company to keep more front-end captial for exploration. (Retained in CS HB 854)

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Work Commitment Bidding - not a particularly useful method. May cause company to over-commit itself in relationship to actual profitability of the lease, resulting in premature abandonment. (Deleted in CS HB 854)

Lipton's general comment on the leasing methods is that it may not be desirable to itemize 7 or 8 options with minimum fixed commitments on each variable. The commissioner should have greater flexibility to design the lease sale to conform to the structures to be leased.

.6 line 15
B 854

"The commissioner may withhold acreage from leasing in a particular lease sale." This is an important section as it may often be in the state's best interest to do so. Suggested a more positive statement to encourage utilization of this authority. (Deleted in CS HB 854)

.7 line 15
IB 854

There should be a provision for reasonable extension of exploration deadline beyond 5 years under certain circumstances. The bill allows for leases up to 10 years - but does not specifically address extensions of 5 year leases. (Same in both versions)

11 line 13
IB 854

This section authorizes the award of non-competitive leases when no bids have been received at a sale. Lipton advises against this because changing circumstances may result in a favorable lease agreement later if the state is not too hasty. (Modified in CS to prohibit non-competitive leasing)

p.12 line 1
HB 854

Gives the state the right to purchase up to 16 2/3% of oil and 100% of gas from a lease at fair market value. Lipton cautions state to use this judiciously as it may hurt the leaseholders under some conditions. CS HB 854 was rewritten to delete specific percentages, but still allows the state to buy "specified volumes" cited in the lease.

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.6 line 22
B 854

Work Obligations - should be made a part of every lease agreement - This section is modified but still present in CS HB 854 (Finance). The committee might consider changing may to shall on page 4, line 26 in the CS.

.5 line 2
S HB 854
Finance)

Exploration Credits - See attached letter from Lipton to Cowper dated May 5, 1978.

.11 line 7
S HB 854
Finance)

Confidentiality of Exploration Data - there should be a provision to extend the period of confidentiality beyond two years if a scheduled lease sale is postponed.

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CHAPTER 81: OIL AND GAS PRELEASING PROCEDURES

ARTICLES

1. (GENERAL PROVISIONS) AFFECTED LANDS AND EXCEPTIONS
2. PRELEASING PROCEDURES
3. SOCIAL, ECONOMIC, AND ENVIRONMENTAL ANALYSIS
4. ALASKAN ADVISORY COMMITTEE ON LEASING
5. NOTICE AND REVIEW
6. DEFINITIONS

ARTICLE 1: AFFECTED LANDS

SECTION

10. General Provision
20. Joint Federal-State Beaufort Sea Lease Sale
30. Limited Acreage Provision
40. Drainage Situation Provision

ROUGH DRAFT ONLY

11 AAC 81.110. General Provision. (a) These regulations apply only to competitive leasing as specified in AS 38.05.020, 38.05.135, 38.05.145, 38.05.180.

11 AAC 81.120. Joint Federal-State Beaufort Sea Lease Sale (a) The proposed joint Federal-State Beaufort Sea Lease Sale is exemted from the requirements of these regulations.

11 AAC 81.130. Limited Acreage Provision (a) Should an area of up to but not greater than one township in area be deemed leasable, the Commissioner may at his discretion, offer the area for lease under the following method.

1) The Commissioner will publish a notice of intent to lease and a notice of public hearing.

2) The Commissioner will hold the public hearing in the affected area to guage public opinion to the proposed lease sale.

3) Upon completion of subsection two the Commissioner will publish a notice of a lease sale and a chart delineating the tracts to be offered.

11 AAC 81.140 Drainage Situation Provision (a) Should a situation arise whereby the leasing of land by another party adjacent to State owned lands, threaten the mineral interest of the State lands through possible drainage situations, the

Commissioner may, at his discretion, offer that threatened land for leasing under the following methods:

1) The Commissioner will publish a notice of intent to lease and a call for public reaction and nomination.

2) Upon completion of subsection 1 and receipt of nominations, the Division will prepare an economic analysis on the sale area.

3) The Commissioner will then call for and hold a public hearing within the affected area to gauge public sentiment to the proposed lease sale.

4) The Commissioner, taking into account information gathered at the public hearing, will issue a list of the tracts proposed to be leased and a notice of a lease sale.

5) Lands offered for lease under this section may total no more than 100,000 acres.

ARTICLE 2: PRE-LEASING PROCEDURES

SECTION

10. Notice and Publication
20. Soliciation of Comments
30. Initial Tract Selection
40. Social, Economic and Environmental Analysis
50. Public hearings on Social, Economic, and Environmental Analysis
60. Final Social, Economic, and Environmental Analysis and Final Tract Selection
70. Preparation of Leasing Conditions
80. Public Hearings on Lease Conditions
90. Final Lease Conditions Set and Notice of Lease Sale

ROUGH DRAFT ONL

11 AAC 81.210 Notice and Publication. (a) The commissioner, at a date no greater than 24 months prior to any proposed lease sale, will publish a set of charts with accompanying written descriptions adequately locating the general geographic area in which the proposed lease sale will be.

(b) The commissioner will, concurrent with provision (a) cause to be published a notice for the Solicitation of Comments.

Chapter 81: Oil and Gas Pre-Leasing Procedures.

Due to a new article one being inserted into this chapter, articles 1 - 5 of the previous draft are now 2 - 6 with article six being re-titled to read "Definitions." Within article six, sections 520 and 530 have been deleted.

Article 2: Pre-Leasing Procedures

1) 11 AAC 81.210 Notice and Publication (a) The phrase ...date no less than 18 months prior..., has been amended to read...date no greater than 24 months.... The phrase...any lease sale, will cause to be published...has been amended to read ...any proposed lease sale, will publish.

2) 11 AAC 81.230 Initial Tract Selection (a) The phrase...date no less than 16 months prior to any lease sale..., has been amended to read...date no greater than two months after the first notice date of the Solicitation of Comments period,.... The phrase "utilizing industry and public comments" has been added to the end of the sentence.

3) 11 AAC 81.240 Social, Economic, and Environmental

a) the phrase "each tract, group of tracts, and/or," has been deleted.
b) the phrase "all or part of" has been deleted.
e) New Paragraph

From the date of notification by the commissioner of his decision under section 230 of this article, the concerned state agencies will have a maximum of four months in which to prepare their components of the SEEA.

4) 11 AAC 81.250 Public Hearings on Social, Economic, and Environmental Analysis.
c) ...date no less than nine months prior to the lease sale, has been amemded to read...date no greater than three months after the completion of the SEEA.

5) 11 AAC 81.260 Final SEEA and Specific Tract Selection
c) ...date no less than six months prior to the lease sale, has been amended to read"...a date no greater than 12 months from the date of notice of Solicitation of Comments under section 10 of this article.
c) The commissioner will, upon completion of paragraph (c) of this section, announce to the public a date by which, barring unforeseen circumstances, the proposed lease sale will be held.

ROUGH DRAFT ONLY

6) 11 AAC 81.280. Public Hearings on Lease Stipulations
c) ...date no less than four months prior to the lease sale has been amemded to read...date no greater than three months from the date of completion of paragraph (c) section 60 of this article.

7) 11 AAC 81.290 Final Lease Stipulations Set and Notice of Lease Sale (a)
(a) a) ...date no less than three months prior to the lease sale, has been amended to read...date no greater than four months from the date of completion of paragraph (c section 60 of this article.

8) 11 AAC 81.320 Economic Component (c)...committee not less than 14 months prior to the lease sale, has been amended to read...committee not greater than one month after completion of section 40 article two of this chapter.

9) 11 AAC 81.420 Composition of Committee (a) the phrase "the Division of

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Minerals and Energy Management will be represented on this committee by both its leasing and petroleum managers."

b) the phrase "leasing manager of the" has been inserted between the words "by the"...and;;;"Division of....

c) A new paragraph has been added - "For each lease sale, a delegate from the borough government affected by the sale, will be invited to participate on the committee.

ROUGH DRAFT ONLY

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

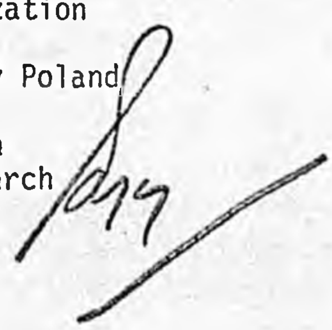
POUCH Y · STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

MEMORANDUM May 30, 1978

SUBJECT: CSHB 854 and the Effects of Using Multiple Oil and Gas Leasing Methods on Unitization

TO: The Honorable Kay Poland

FROM: Gregg K. Erickson
Director of Research



Summary

At the Senate Resources Committee meeting on Friday you received testimony to the effect that the use of differing leasing methods on adjacent tracts, as would be permitted under HB 854, would make it difficult to establish unitized development and production of the pools over which those tracts lie. Generally, our studies of this question, which we have conducted since the matter was first raised several months ago, do not support this conclusion. On the contrary, they show that the incentives to unitize will not be seriously reduced by diverse lease arrangements, and that the difficulties of reaching unit agreements will not be increased as a result of this diversity.

The Incentive To Unitize

Unit arrangements exist and are encouraged by state policy because centralized, unitized operation of an oil or gas field can and usually will result in substantial reduction in the expenses of extracting the resource, and in absolute gains in the total amount of oil and gas recovered. That the potential for these gains exists is, under the circumstances we have had in Alaska, almost never a matter of contention among the leaseholders who would be a party to a unit.[1] The most

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[1] See Bradner, Tim, "Oil and Gas Regulation in Alaska," *Alaska Review of Business and Economic Conditions*, 1971.

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important question here is therefore: Will the use of differing leasing systems as contemplated in HB 854 significantly reduce the incentive to unitize that is provided currently by the very real benefits of joint, unitized field development and operations?

We think not. At a high royalty rate, as might be encountered under straight royalty bidding, the benefits in the form of increased production are, of course, shared with the landowner on the basis of the royalty percentage. But all the benefits in the form of reduced costs remain with the lessee. In a net profits arrangement the benefits of increased production and reduced expense are both shared with the lessor, but still leave the lessee with substantial incentive to partake of the advantages of unitization. Naturally, if the royalty or net profits rates were set at or close to 100 percent these incentives would disappear, but so would the incentive to develop the tract at all.

Difficulties in Unitization

Despite the retention of a clear incentive to unitize under a mixture of leasing methods as in HB 854, it is possible that a mixture of systems might create a practical barrier to unitization. This might occur, for example, if the differing lease terms made it impossible for the lessees to agree on the proper apportionment of the unit's expenses and produced oil and gas.

Current Alaska law provides only general guidance as to how this allocation is to be made.[2] The usual practice has been to allocate the costs and production generally on the basis of the costs and production that would accrue to an individual leaseholder were he to operate the tract on an individual, non-unitized basis. Another method less frequently employed, but used, at least partly, in the formation of the Prudhoe Bay unit, is to allocate expenses and actual production on the basis of the original petroleum in place underneath each lease. Other factors, or combinations of these factors, may also be considered, and one study has distinguished examples of 42 different methods of apportioning participation.[3]

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[2] AS 31.05.110(c) provides that "each plan of unitization shall contain fair, reasonable and equitable provisions for...the division of interest or formula for the apportionment and allocation of the unit production, among and to the several separately owned tracts within the unit area such as will reasonably permit persons otherwise entitled to share in or benefit by the production from such separately owned tracts to produce and receive, instead thereof, their fair, equitable and reasonable share of the unit production or other benefits of it; a separately owned tract's equitable, and reasonable share of the unit production shall be measured by the value of each such tract for oil and gas purposes and its contributing value to the unit in relation to like values of other tracts in the unit, taking into account [1] *acreage*, [2] *the quantity of oil and gas recoverable from it*, [3] *location on the structure*, [4] *its probable productivity of oil and gas in the absence of unit operations*, [5] *the burden of operations to which the tract will or is likely to be subjected*, or so many of these factors, or such [6] *other pertinent engineering*, [7] *geological* or [8] *operating factors* as may be reasonably susceptible of determination...." (emphasis and numbers added)

[3] A. A. Khan and H. H. Power, "An Analysis and Comparison of Engineering Bases of Participation in Unit Agreements," *IOCC Committee Bulletin*, December 1960, p. 101.

Reaching an agreement on the theoretical basis for allocating participation and resolving all the associated technical issues can be a complex, difficult and protracted process. Although all parties usually have a clear view of the overall benefits to be gained from unitization, some may "hold out" in hopes that by doing so they may be able to extract a better deal from their fellow lessees concerning the allocation of the benefits of unitization.[4]

The question here, though, is whether differing lease arrangements will make reaching an agreement *more* difficult. In our view, the question answers itself when considered in the context of Alaska's unitization law and the permissible bases for apportionment of participating unit interests enumerated therein.[5] For example, is the "acreage" in a lease altered by the fact the lease contains profit sharing arrangements? Is the "location or the structure" affected by the royalty arrangements? Or are the "engineering, geologic or operating factors" influenced by either? We believe it is obvious that they are not.

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[4] For a listing of the problems that can arise in unitization negotiations see Stephen McDonald, *Petroleum Conservation in the United States: An Economic Analysis* (Resources for the Future, Washington: 1971), pp. 198-201.

[5] AS 31.05.110(c). See note 2, *supra*.

A Final Point

As a final point, we note that tracts bearing differing royalty burdens have already been included in units, in Alaska and elsewhere, wherever individual holders of federal and state noncompetitive leases have sold those leases while retaining overriding royalties. Moreover, differing lease arrangements are likely to exist in the future side by side wherever Native corporation or federal and state oil and gas lands are contiguous. It is possible, of course, that if the legislature gives the commissioner of Natural Resources authority to use alternative leasing methods that these differences may be reduced or eliminated.

GKE:jm

cc: Members, Senate Resources Committee
The Honorable Chat Chatterton
The Honorable Hugh Malone
Mr. Phil Holdsworth

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STATE of ALASKA

MEMORANDUM

TO: Joe Green, Director, DMEM JACK Roderick

Thru: Pat Dobey, Petroleum Manager

FROM: Blair Wondzell
Petroleum Engineer

DATE: March 3, 1978

FILE NO.

TELEPHONE NO.

SUBJECT: Sliding Scale Royalty Considerations, Examples, Bidding Methods

Our proposed legislation, House Bill No. 854, contains provisions for utilizing sliding scale royalties as the fixed parameter in some bidding methods and as the bid parameter in others. Since there have been several questions on how we would set up a sliding scale royalty schedule for use as the fixed parameter and how we would request and evaluate sliding scale royalty bids, I have prepared this discussion and some examples.

The basic elements of my recommendations are that production steps will be in multiples of the approximate economic limit (1000 B/D, 2000 B/D, 3000 B/D, etc.). The percent royalty to be applied to each production step is based on increasing by equal increments (x+y, x+2y, etc.), the royalty percentage applied to the base (economic limit) production step. This criteria will make it easy to definitely determine the top bid when industry is asked to bid the sliding scale royalty reserved to the state. For example: The production rate steps are fixed (1000 B/D, 2000 B/D, etc.) as is 12.5% royalty at 1000 B/D, industry then bids on the equal incremental royalty percent increases to be applied to the higher steps.

I noticed that in Jack Roderick's letter to the commissioner, he is also looking at sliding scale royalty schedules. His schedules and discussion should be compared to my data as set out in this memo.

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TO: Joe Green
FROM: Blair Wondzell
RE: Sliding Scale Royalty Schedules

TYPICAL SLIDING SCALE ROYALTY SCHEDULES

NORTH SLOPE AREA

Daily Average Prod. Rate (Bbls./day)	Incremental Royalty Rate (%)	Royalty For Specific Producing Rates: Producing Rate (Bbls./day)	Royalty Production (Bbls./day)	Equivalent Royalty Rate (%)
-1000	12.5	1000	125	12.50
1001-2000	25.0	2000	375	18.75
2001-3000	37.5	3000	750	25.00
3001-4000	50.0	4000	1250	31.25
4001 and above	62.5	5000	1875	37.50
		7000	3125	44.64
		9000	4375	48.61

SOUTH CENTRAL AREA

Daily Average Prod. Rate (Bbls./day)	Incremental Royalty Rate (%)	Royalty For Specific Producing Rates: Producing Rate (Bbls./day)	Royalty Production (Bbls./day)	Equivalent Royalty Rate (%)
-500	12.5	500	62.5	12.50
501-1000	25.0	1000	187.5	18.75
1001-1500	37.5	1500	375.0	25.00
1501-2000	50.0	2000	625.0	31.25
2001-2500	62.5	2500	937.5	37.50
		3500	1562.5	44.64
		4500	2187.5	48.61

Note: The Sliding Scale Royalty Schedule for the North Slope area is significantly higher than for the South Central area because the higher North Slope operating costs result in a much higher economic limit.

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TO: Joe Green
FROM: Blair Wondzell
RE: Sliding Scale Royalty Schedules

SLIDING SCALE ROYALTY
Considerations, Example Schedules, Bidding Methods

CONSIDERATIONS:

1. Sliding scale royalty use is based on the intent that the ownership royalty share be small from economically marginal production and be large from very profitable production.

2. Ideally, at production rates below the economic limit there should be no royalty. ("EL" is herein defined as the production rate necessary to pay direct operating costs; overhead and amortization are not included). Immediately above the EL level or rate of production, industry's share should include an amount for pay back of investment - beyond this pay-back production rate, the State and industry should share the profits which are represented by production. Based on royalty rates actually bid, at very high well rates the State's royalty share should exceed 50%. As the field declines, individual well rates would decline with a corresponding decrease in average or equivalent royalty; therefore, if the State is to obtain a field life average royalty in the 50% range, royalty rates during the peak production years must be higher than the intended overall average equivalent royalty rates.

3. Computer programs for the determination of the correct slide/percent royalty do not, to my knowledge, exist. Because of the many estimated factors which would go into such a program (normal capital, operating cost, production rates, and number of wells producing), the results would be somewhat unreliable.

4. The problem of setting the slide steps and royalty rates can be solved from another direction, however. A good schedule can be obtained based on logical reasoning consistent with the guidelines stated in paragraph #2 above.

5. Since State statutes require a minimum royalty of 12.5%, the "ideal" situation is not obtainable. However, it can be approximated by gradually increasing State royalty - above the EL production rates - to a partial sharing and then to a full sharing of the production. Following are typical sliding scale royalty schedules for the North Slope Area and for the South Central Area.

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6. Sliding scale royalty bidding may be a future bidding method. This can be handled in at least 2 ways.

Method #1: Industry can be requested to furnish a sliding scale royalty bid with the only provision being that the minimum royalty be 12.5%. The determination of the winning bid would require multiple economic computer analyses. These analyses would be based on a multitude of estimates and would therefore vary depending on estimates of the input parameters. Industry would most likely, and justifiably, contest the awarding of bids by this method.

Method #2: Industry can be requested to bid royalty percentages having equal incremental increases which will be applied to preset production steps: or industry can be requested to bid the equal increment production steps for preset royalty percentages. Bids based on either of these alternates (preset production steps or preset royalty percentages) can be precisely compared to one another and the winning bidder can easily and definitely be determined.

Method #2 types of a sliding scale royalty bid is shown in the following examples:

EXAMPLE

LEASE AWARDS

A lease will be awarded on each tract to the responsible qualified bidder offering the highest percentage royalty for the production steps as specified below under Bid Method . . . . .

ALTERNATE I

Royalty percentages bid, preset production steps.

BID METHOD

All bidders must designate the percentage royalty reserved to the State for each of the below listed production steps which are average daily production rates based on monthly production volumes for each well as defined in regulations ___________. Minimum royalty percentage as required by State Statutes is 12.5%. A royalty percentage of 12.5% is specified for the base production step which is 0 to 1000 B/D and will be

increased in equal increments for each subsequent production step. The Following production steps will be utilized:

Average Daily Production Rate (Bbls./day)	Incremental Royalty Rate (%)
0-1000	x (must be 12.5%)
1001-2000	x+y
2001-3000	x+2y
3001-4000	x+3y
4001 and above	x+4y

ALTERNATE 2

Production steps bid, preset royalty percentages.

BID METHOD

All bidders must designate the daily average per well production steps for the royalty percentages reserved to the State which are listed below. The daily average production steps are based on the monthly production volumes from each well as defined in regulation ______________. The production steps above the base step will be increased by equal increments. The following royalty percentages reserved to the State will be utilized.

Incremental Royalty Rate (%)	Average Daily Production Rate (Bbls./day)
12.5	x
25.0	x+y
37.5	x+2y
50.0	x+3y
62.5	x+4y and above

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Kotanick

SCENARIOS FOR LEASING

Bonus Bids

Bonus bidding should be applied in cases where the state has either.

(a) A very great amount of knowledge about the resource or

(b) The prospect is of extremely high risk, the lessor has little knowledge of the resource and expected value revenues would be marginal.

The first case (a) where tracts might be offered for Bonus Bidding could be that of a drainage or near drainage situation where the state wished to maximuze its near term discounted revenues. It would be advisable to not offer all of the tracts for bonus bidding, but to withhold a percent of acreage to be sold at a later date, (Report 2-77). Also, since royalty and other bidding methods have shown to offer higher expected value revenues for lower risk cases it could be advisable to mix royalty bidding with the bonus bidding, a practice followed by the Federal Government in the recent Cook Inlet OCS sale.

In the second case (b), that of extreme high risk, bonus bidding can be used as a filter to determine the value of marginal tracts. This is discussed under the section on (t) low potential, high risk and previously leased.

Report 2-77 indicates that for very high risk cases all bidding methods approach the same level of expected value income for the state. In cases of small and marginal potential reservoirs the bonus bid method with its ease of administration might afford optimum state revenues. Report 2-77 also indicates that in probability of success percents of 1 percent or less bonus bids could afford higher revenues, but the state should ensure that leasing under such high risk cases only occurs when sufficient knowledge is gained to indicate that the land to be leased is of such a low potential. For example, a geologic structure as large as the Prudhoe Bay anticline may have had a high degree of risk before it was drilled but its potential to hold enormous reserves was there. Bonus bidding should not have been used in that instance.

In summary, bonus bidding can be used when

(1) Very small potential reservoirs are expected;

(2) Extreme risk is expected and the gaining of sufficient knowledge to determine the presence of reservoirs is unwarranted because of marginal to low potential indications.

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(3) A sliding royalty should be considered in all bonus bid cases;

(4) This method could be used in a mixture with other methods such as royalty bidding;

(5) Also, in general, this method should only be considered when leasing in the less desirable state areas, i.e. those below the top 10 rank.

Royalty Bidding/Fixed Bonus

Report 2-77 indicates that royalty bidding and profit sharing deliver the highest expected value revenues to the state of all bidding methods. It is particularly effective where the probability of occurrence is high (i.e. low risk) and especially when the expected reservoirs are large. A sliding scale should be added in the declining production years to eliminate the problem of premature shut down. Cases for royalty bidding would be when

(1) The state has enough knowledge to assess the ~~risk~~ size of potential traps.

(2) Potential reservoirs are not extremely small or of extreme risk.

The Beaufort Sea sale is a good example of a case for using Royalty bidding on tracts. Ingeneral, this method should be considered when leasing in the top 10 leasing areas on the desirability scale.

Net Profit Bidding

Net profit bidding would be most advantageous when costs and oil prices

~~[illegible]~~ In remote high risk areas, this method might attract stronger bids than the royalty or the bonus bid method.

Of the 35 potential state leasing areas, this method might be used to advantage on those areas below the top 10 in desirability.

Work Commitment

(See section (t)).

This bidding method can be best used where the state has a large (i.e. 100,000+ acres) area of probable low potential where industry has shown a general lack of interest in exploration and leasing. By offering a large area for lease to one lease owner the state provides an extra incentive to undertake exploration and the state assures the exploration by making it the bid variable.

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This method would be used in remote low potential high risk areas. Some of the states 3 mile limit lands such as Area IX might be ~~used in this~~ method.
Applicable to this

<u>Low Potential & High Risk and Previously Leased</u> Section (e)

On the basis of exploration knowledge, lack of interest by industry and reasonable analysis, the department may determine that lands have very low potential for oil and gas.

As a means of encouraging the evaluation and possible development of these low potential lands the department could:

(1) Offer the lands for competitive lease using a bonus bid with a sliding royalty. A minimum bid equal to the first year's rentals could be used to filter the bids. This should give a check on the potential of the lands. The sliding royalty would act as a safeguard for very low value bonus bid tracts if a discovery is made later on the lands.

(2) On tracts that receive no acceptable bids, the commissioner could hold a non-competitive simultaneous drawing after proper notice (30 days). Tracts not receiving applications for the drawing could then be opened for over the counter applications. Tracts could be offered at fixed 50¢/year rentals, 5 year terms. A sliding scale royalty would be used in all cases to provide a revenue safeguard against future potential discoveries.

(3) In some cases, all tracts not receiving acceptable bids could be aggregated into large blocks (100,000 acres or more) and offered for work commitment bidding or development contracts.

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STATE of ALASKA

MEMORANDUM

DEPARTMENT OF NATURAL RESOURCES
DIVISION OF MINERALS AND ENERGY MANAGEMENT

TO: Robert E. LeResche
Commissioner Natural Resources

DATE: February 28, 1978

FILE NO:

TELEPHONE NO:

FROM: [redacted]

SUBJECT: Rationale and Apparent Objections to HB 854- Oil and Gas leasing Bill.

Predictability, certainty and an acceptable political climate. These are the three things the petroleum industry looks for in an area attractive for exploration.

I contend it is the availability of land, not the method by which land is offered, that is the critical consideration. In other words, Alaska will become more attractive, less subject to severe criticism by the industry, once land is made available for leasing. The methods of leasing will quickly become secondary.

This contention, of course, will be disputed by the industry. They will argue that because the law allows administrators to choose from a wide variety of leasing methods the industry will remain uncertain about what to expect. I contend that the industry will be given plenty of advance notice of what method will be used in a sale and will therefore have enough time to plan financial strategy.

Industry's contention that Alaska must compete with other areas in the world within company budgets is, of course, correct. This does not mean, however, that Alaska has to settle on one, or perhaps two, leasing methods so as to make the Alaska budget dollar compete within a particular company. The company can estimate how much Alaska's prospective oil is worth to them and can calculate how much will be spent on a particular sale based on the method of lease offering, along with a multitude of other considerations. My basic assumption, of course, is that the oil is here and, eventually, the companies will come looking for it.

Which brings me back to my first point. Certainty and predictability will be established once the industry is convinced that a regular, stable procedure for offering oil and gas lands has been established by Alaska. Once lands are available and administrators are directed to offer leases to the public, most of the pressure will relax.

Industry's objection to the two reports to the legislature by the executive, I think, dramatizes my point. I think the industry will eventually accept the 5-year leasing program as a giant step toward predictability and, even though given wide public accountability, will come to believe that the report will not result in more governmental interference. Industry looks,

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however, I think on the annual leasing method report as a way for the legislature to probably work its way into the day-to-day leasing decisions best left to the governor. They fear "politics" in leasing, and I am less sure of this one that I am the leasing program report.

The underlying criticism of HB 854 you will hear, I believe, is that Alaska is "experimenting" with leasing methods. We are said to be trying to adapt all the good features used in other states and jurisdictions and are trying to make them work where they were not designed to work. Alaska is frontier; Alaska is different, goes the argument.

I believe I was to take the first cut at a comprehensive review of Alaska's oil and gas leasing law following Dr. Gaffney's study. I do not claim infallibility but I do claim to have weighed the many considerations which make Alaska like and unlike other jurisdictions. As I have told you, I have tried to con-front, head-on, the question of the question of the number of participants in exploration in Alaska. You have mentioned the concept of "incentives", at least as it applies to information, and I have indicated that whereas incentives are not directly dealt with in the legislation I think we may get there in the future.

So, with that background let me set forth the rationale for and some of the anticipated objections to HB 854.

Several concepts were examined and rejected. Found to be not applicable, at least at this time, are the so-called dual-leasing system (Ted Stevens' amendment to S-9). Congress may yet include something like it in OCS legislation. Also, the concept which involves distinguishing between exploration leases and those development and production activities which would be allowed after oil or gas is discovered. We have not included this concept because we believe that Alaska can know before it offers its land for drilling what development and production activities it expects to take place. (Incidentally, the conference committee on S-9 and HR 1614 is scheduled shortly.)

We examined the "ante" versus "post" royalty impact. The post (after) charge is the economic recommendation Dr. Mason Gaffney drew in his study of February, 1977 for the legislature. Dr. Gaffney concluded that the ideal way for a government (any lessor) to determine its economic rent was to determine such rent after a discovery at the price then existing and based upon the size of the field discovered. Determining the value of the field after the discovery is much like the present

calculations of the reserves tax. Its newness, being untried and the unsettling effect its introduction and application would have had on exploration activities in Alaska we felt would be primarily negative. Also, we felt that the legislature could follow-up on Dr. Gaffney's recommendations if they wished. Canada, in its new law for leasing of the North and offshore, has proposed a "progressive incremental royalty" similar in concept to Dr. Gaffney's ad valorem charge. Perhaps, it will be in Alaska's future.

We examined the incentive programs existing in the Province of Alberta, and other jurisdictions, and determined that although some incentives may be needed in the future, they should not be dealt with in this bill. Giving direct tax and other incentives to exploration operators may be necessary, particularly to stimulate the much needed geological and geophysical information data, but we felt future legislatures could deal with this basic policy charge. Rather than incentives, we believe the pace of exploration can best be determined at the time and by the terms of the original lease. And, as I note later, the work commitment lease method can be used to offer incentives.

We examined the trends all over the world toward governments retaining ownership interests (equity) in leases, and toward government-owned and operated exploration companies. We rejected both of these ideas for Alaska. Equity interests in leases makes no sense so long as the state has the flexibility to deal with the many and varied leasing situations which will confront it. Government sponsored exploration, if at all, can be achieved by contract with industry rather than by bureaucrats.

Again, the petroleum industry, not unlike any business, needs certainty and predictability in order to be comfortable doing business. A "stable and predictable leasing policy" - Tom Kelly. "The industry will initially tend to go where it's wanted and an orderly contract and dependable lease sale schedule would undoubtedly provide an impetus to further exploration in the state" - Pennzoil.

The state's need for a flexible, comprehensive, all-inclusive means of leasing appears to conflict with the industry's desire for predictability. One company (Chevron) in an informal paper went so far as to say that giving these many alternatives to the state (HB 854, before a significant change) amounts to "overkill" and makes Alaska an "experimental laboratory in oil and gas leasing." They conclude by saying: "We consider this to be capricious".

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In the name of predictability and certainty, oil operators of size almost without exception opt for the cash bonus bid with a fixed royalty as the preferred leasing method. They want

I believe Alaska needs a flexible leasing law so that it may adjust to changes as they occur. The world, national and Alaska energy and oil and gas future is in a state of flux and will remain so for the two decades for which this bill is designed to accomodate. No one can be sure what future developments in energy will be and particularly in Alaska where exploration condition are so diverse.

Alaska is now one of the largest oil owning entities in the world. It will be dealing with petroleum matters, directly, for at least the next two decades, probably much longer. It's immediate future depends in large part on how it deals with petroleum matters. As such, it should become familiar with most of the alternative methods it can use to control petroleum exploration. HB 854, we believe, once it is enacted and in operation will provide the industry the certainty it requires. Admittedly, it calls for State land to be offered by methods including but also other than bonus bid where feasible. The bill introduces more alternatives than now exist, but once these methods are in place and have been used, we believe, most uncertainty will disappear.

One last word on flexibility. In addition to the State, the Federal government and Native Regional Corporations will be leasing land for oil and gas exploration for the next several decades. Terms and conditions under which leases are issued by these entities will include all the variables addressed in HB 854, and, undoubtedly, more. To protect its interest and to operate effectively in this constantly changing exploration picture, the State needs a flexible leasing law by which to respond.

Following, are an itemized list of the objections which I anticipate will be made to HB 854.

1. Term of 5 years. All operators want a lease term as long as possible. In HB 854, Commissioner can go up to 10 years if "extreme conditions, etc." exist. The majors usually know what they intend doing when they bid and lease. The smaller companies will argue that they need more time to put drilling blocks together. The State's interest is to have leases explored and it is not in having leased acreage on the books paying rentals only. Deals can be made in five years. Drilling should proceed as soon as possible, or the land should be offered again to a more agressive operator.

   The time between Cook Inlet lease sales in 1962 and 1965 until first production was begun from Middle Ground,

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McArthur, Trading Bay and Granite Point averages under 4 years. Note this is production, not beginning drilling date. Average time from sale to drilling in New Mexico is 6 years.

As I have indicated before, I believe this is the most important term in the lease. The ideal would be for the commissioner to have discretion to set the length of the lease, but I do not believe the legislature or the industry would accept such discretionary authority.

2. Methods of leasing

a. Royalty bidding creates no incentive to develope leases (Chevron). This is particularly true if "surrounding leasehold were such that early evaluation was likely" -(Champlin Petroleum). Same lack of incentive argument is said to apply to high net profits and/or work commitment.

Loss of revenue to state, too risky and premature shutdown problem - (SE Alaska Empire editorial; a reprint of Fairbanks News-Miner editorial, 1977-no date) Rumor has it the USGS in Anchorage (Jones, et al) don't like royalty bidding and DOI forced it on So. Cook Inlet sale. But ARCO's first location appears to be on a royalty tract.

b. Work commitment is faulted for several reasons. Economists, including Gregg Erickson, see it as stimulating activity which the marketplace would not otherwise require. In fact, it can be used to stimulate exploration and, specifically, to acquire exploration information in areas which otherwise might not be explored. There can be an element of incentive in this method.

Tom Kelly sees the use of work commitments as pre-empting small companies. (It is interesting to note that Chevron favored the work commitment so long as the bonus or royalty was fixed and the work commitment was the sole biddable factor). Kelly sees it discouraging the promoting of participations (partners?) in drilling deals because the amount of dollars bid has been fixed. Frankly, I don't quite understand his argument, and contrary to hurting the small companies, I believe it could be used to encourage them to explore. Kelly believes a work commitment works best when it is negotiated and I agree with

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him, but we agree that it is unlikely that the Alaskan legislature and public would condone negotiated lease terms by public officials. (unlike royalty sales.)

c. No mention is made of sliding scale royalty by any of the AOGA participants or companies who replied to your letter. All in the department, including Easy Gilbreth and Pedro Denton (from past memorandum in file), feel this is a most satisfactory answer. We are preparing several sliding scale examples for the Cook Inlet and the North Slope so as to focus on the factors which must be taken into consideration in setting the appropriate scale for an area.

d. Net profit will be objected to because it gets the government into the oil company's books and it will will be more costly to administer. Economists Lipton, Erickson, et al will argue it returns the most to the state.

Most economists will agree, I believe, it is the best way if "gold plating " can be controlled, but there seems to be disagreement as to whether it is best used where risks are high or low. Government encroachment will underlie the opponent's arguments.

3. The acreage limitation of 200,000 acres on state uplands (rather than present 500,000) has been objected to thus far only by a few majors. The reduction in the maximum is obviously aimed at the larger companies, and we should so state directly. (A list of state leaseholdings as of 2/10/78 is attached).

Some background may be helpful. No other state that I am aware of, has an acreage limitation. But no other state is Alaska's size nor has any state tens of millions of acres available to lease.

The Federal government has an acreage maximum for its land within each state. During Alaska's territorial days the Federal oil and gas acreage limitation in Alaska was 100,000 acres. In other states it was 46,080.

After 1961, Alaska's rose to 300,000 in the Northern district (approximately north of the Yukon River) and 300,000 in the Southern district. These apply today. Presently the acreage limitation is 246,080 acres of Federal leases per state, other than Alaska.

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Finally, note that in HB 854 companies are given five years from the effective date of the act to comply with the 200,000 acre maximum.

Hopefully, a lesser upland acreage maximum in Alaska will act as, albeit a small, incentive for companies other than the majors now here to explore in Alaska.

4. The state's right to purchase up to 16 2/3% of the oil and 100% of the gas will be opposed on the grounds that it is a negative incentive for integrated companies who wish to find and use the oil and gas. We should be careful of this one, but suffice to say that in 1972 New Mexico passed a similar law (N. Mexico can purchase 100% of gas and oil), which though never exercised or tested in court, remains on the books. (a copy attached).

5. Rentals may be opposed as being too high. The authority of the commissioner to up the rental at least 150% each year on shut-in leases may begin to bind the operator without a market, but there is no easy answer to the shut-in field unless we investigate something like the reserves tax concept, which I don't believe will solve the problem.

6. Leases offered noncompetitively after receiving no bids appear to be favored by the industry. Tom Kelly comments that such leases should be offered immediately (automatically?) after the competitive sale.

   Please note that HB 854(t), as written, allows the commissioner three options. He can offer tracts immediately, at any time up to 5 years after receiving no bids, or not at all. If he intended to offer tracts noncompetitively immediately after a competitive sale he would so announce in the notice of the competitive sale.

   The problem inherent in giving the administrator this many options, it will be argued, is that unpredictability will occur. Unless the operator knows before hand that he can fill out his block of acreage, he is at a distinct disadvantage. The administrator should take these matters into consideration before he notices a sale.

   Milton Lipton, Gregg Erickson and others may oppose this open-ended authority to lease noncompetitively following an unsuccessful competitive sale on the grounds that an administrator might rig a compe tive sale so that it will not elicit bids so that an immediate noncompetitive lease can be awarded. I don't think such a hit-and-run transaction can exist these days, particularly with HB 854's public disclosure procedures, but, perhaps, I'm too naive.

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7. Sealed bids or oral auction or sliding sealed bids (like Alberta). HB 854 permits the commissioner to use any or all of these. Sealed bids will be most commonly used. They are easy to administer. Oral bidding is used in New Mexico and Colorado. Champlin recommends oral bidding on "low potential" land so as to avoid preparing bid forms and "leaving money on the table." New Mexico, on the contrary, uses oral bidding about 50% of the time when it perceives that there will be alot of competition in a sale. About 50% of the time New Mexico offers tracts by sealed bid.

   Alberta allows bidders to slide bids from one tract to another in a sale. Thus, if bidder A's sealed bid fails to win on tract 1, he can direct his bonus be slid to tract 2, and so on.

   Tom Kelly, when commissioner, had his staff investigate this sliding bid method in Alberta in hopes that it might be used for the 1969 Prudhoe Bay $900 million sale. The idea was rejected because the industry objected on the grounds that it would cause too much uncertainty so close to the time of sale. Score one for certainty. Obviously, the advantage to the state would be that more money would be paid at the sale if bids were allowed to slide. Before actually using this system, Alberta's procedures should be studied again.

8. By regulation, the lessee may earn only to the depth drilled(j). I envision that the state would not invoke this right until it felt deeper horizons contained oil, and then would give the lessee a reasonable time to explore deeper. If the lessee failed to drill deeper, the deeper horizons would be offered at a competitive lease sale. Alberta woke up to this problem late and solved it by changing terms of existing lease contracts with all that political controversy.

   I will ask Peter Froehlich to research whether this issue of drilling deeper might not be solved by tightening-up terms of the lease form to require due diligence by the operator at the request of the state.