lished, moreover, such an enterprise may have a monopoly status, with the power to abuse or exploit that status, and seem thereby to demand public control or ownership.

Many governmental enterprises (and regulated utilities, which they resemble in important respects) combine subsidies for some activities with appropriation of monopoly rents or resource rents from others. A common practice in both regulated private firms and government enterprise in transportation, communications, and utilities is *cross-subsidization*, in which monopoly profits earned from one area, line of business, or class of customers are dissipated in subsidizing others that are deemed to be socially meritorious. Thus, airline and railroad tariffs on heavily travelled route segments typically exceed cost (including a "fair" return), while service on lower density segments is provided at a loss. Hydroprojects in the Western United States typically subsidize users of irrigation water from revenues earned by water sales to municipalities and industry and by sales of electric power. In Alaska, revenues from both state and federal timber sales are sacrificed to support otherwise uneconomic lumber and pulp mills.

Turning to the mineral industries of Western Canada, there is little evidence that suggests they need to be subsidized by formation of a public corporation or otherwise. The province of British Columbia does not have, for example, a great but decaying industry upon which the community depends both for energy and employment, as the British had in the coal mines of the 1940's.

The British Columbia-Yukon Chamber of Mines may occasionally assert that each mining job generates seven additional jobs in supporting industries, but there is no respectable analytical foundation for such a claim. Even if the extractive industries had such an employment multiplier, it does not necessarily follow that job creation *per se* is a benefit that deserves subsidization from the public purse, much less the creation of a government enterprise. New employment opportunities are a *net* benefit to the existing community only to the extent that they are filled by residents who would otherwise be unemployed or working at more poorly paid jobs. In an "open economy" like that of British Columbia or Alaska, there is no predictable relationship between local job creation and local unemployment, because new employment opportunity attracts immigrants who tend to offset the employment gain. Even if the new jobs directly created were reserved for long time residents, displacement of residents from old to new jobs and their replacement by nonresidents can be expected to make overall unemployment rates relatively unresponsive to employment growth.[1]

National self-sufficiency in minerals and the earning or retention of foreign exchange are sometimes claimed as external benefits of mining that justify preferential treatment. In Canada, paradoxically, some of those

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(including the National Energy Board) who place the highest priority on national self-sufficiency in one or another mineral resource tend to advance policies that *deter* investment, on the grounds that the beneficiary of current development tends to be the export market, at the cost of future diminished Canadian self-reliance. In this country, moreover, balance of payment effects are often used as part of a case *against* mineral development for export rather than in favour of it. In a world of floating exchange rates, however, one might question whether there is any relevance at all to the balance of payments problem in its usual sense. Finally, the impacts upon environmental quality and the dispersion of population are more likely to be regarded as external *costs* of mining than as *benefits* that justify the government's promotion of mining ventures that otherwise would not be self-supporting.

It is hard to make a respectable case that mining (including oil and gas production) creates beneficial *externalities* for the surrounding community, as distinct from the net value of the minerals produced, or the factor payments (wages, profit, rents, and taxes) which make up that value. The current Canadian interest in state enterprise in the mineral industries does not seem, in summary, to be a result of the belief that they are inevitably unprofitable under private enterprise. On the contrary, it rests in part upon the notion that mineral extraction can indeed be very profitable, and that unearned profits (rents) ought to be controlled and disbursed in socially approved ways. This attitude is sometimes experienced as a concern whether the people of the nation or of the province, who are the nominal owners of its natural resources, are receiving as high a return for the products of their land as they might. One issue is, in short, whether the state is effectively maximizing its revenues from disposal of minerals.

Where effective capital markets exist together with a large enough number of potential operators to create workable competition for resource rights, the government (as landlord and/or sovereign) is more likely to maximize its revenues if it does *not* engage in production. This conclusion does not presume that particular government owned entities are necessarily less enterprising and less effective in cost control than profit motivated private corporations. There may well be a bias against efficiency in most forms of state enterprise, if only because their owners (the public) and managers do not have a clearly defined standard of performance as private managers have in the imperative to maximize the present worth of their firms. But more importantly, by operating a productive enterprise in the extractive industries, the government loses the ability it would otherwise have as landowner to exploit the competition among potential private operators.

At oil and gas lease auctions in the United States, for example, the bid prices on a single tract may vary by a factor of two, ten, or even one

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hundred. These variations reflect widely differing geological evaluations of the tract, exploration strategies, and capital and other costs. Thus each tract tends to be won by the bidder with the *most favourable combination of capital cost and expectations* among all the bidders regarding future product prices, the particular tract's recoverable reserves, and their development and lifting costs. The landlord (state or private) who operates on his own land, however, would have only one management team, one exploration strategy, one team of geologists and engineers, and one supply function for capital. Only by rare accident would the landlord's *actual* performance over the average of all his properties tend to be better than the *expectations* of the most optimistic bidder. If, therefore, he were to lease each tract to the highest bidder among the competing operators, he might anticipate receiving a greater net revenue on each property than he could expect from developing the property himself.

The foregoing prediction is implicitly supported by empirical studies of United States Outer Continental Shelf leasing by Walter Mead and others, who show that successful bidders on the average earn a discounted cash flow rate of return on lease acquisition costs substantially less than the oil industry's average rate of return on capital (see Mead's article, "Cash Bonus Bidding for Mineral Resources," contained in this volume).

The effective use of competition to optimize revenues does not dictate the use of a cash bonus bidding system for *all* minerals or even for petroleum under every circumstance. The degree of knowledge or uncertainty regarding the volume and value of minerals present and their cost of extraction, the relative weight of fixed and variable costs in total extraction costs, the number of potential competitors, and the relative preferences of the government and private operators for certain present income versus uncertain future income are all appropriate considerations in the choice of leasing or disposal systems and taxes on the mineral industries. These questions have been discussed elsewhere,[7] and other articles in this volume give close attention to the relative merits of location, leasing, and sale as systems for disposing of minerals; to royalties and severance taxes, and whether they should be reckoned on gross value or net profits; to bidding on cash bonuses, deferred bonuses, gross or net royalty rates; to the use of acreage rentals; to the optimum size and configuration of tracts; to the amount of geological information the landlord ought to obtain and publish before opening land for lease or disposal; and to the duration of the primary term of a lease or permit, its terms for renewal, and so on.

In summary, state enterprise in the business of developing and producing minerals is surely *one* way to capture and redistribute resource rents, but it is unlikely to be as effective a device for maximizing those rents as the combination of a leasing system that takes full advantage of competition

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among private firms (considering the technology and institutional characteristics of each branch of the mining industry) and an appropriate tax system.

The most powerful cases for public enterprise in developing regions (like much of Western Canada and the Territories) relate to transport facilities which create external economies for other economic sectors, including mining. In these instances, both the first motive for socialization (the desire to subsidize) and the second (the need to overcome barriers of scale and risk) may justify investment by the government on projects into which private enterprise will not venture. Neither of these motives, however, creates a case for state enterprise in mineral extraction. Capital and enterprise for mineral exploration and development are plentiful and mobile. Specialized technical inputs, such as geophysical surveys, drilling, and heavy construction can be purchased on contract in a highly competitive market (so that great petroleum and mining companies carry out very few of these activities themselves). Capital sums in the hundreds of millions, or even billions of dollars can be mobilized privately, even without government guarantees, for projects like the Trans-Alaska pipeline, in remote regions.

Development of minerals, like the collection of revenues from their development, is likely to be more rapid and more efficient if it utilizes the diversity of skills, techniques, enterprise, and access to capital in the private economy and the competition between firms differently endowed in these respects. Nationalization or municipalization of producing operations, in my view, has an inevitable price—both in state revenues and in social efficiency—the payment of which must be justified on other grounds.

The hard core of Canadian interest in public enterprise today seems to stem not from a perceived shortage of capital and entrepreneurship (much less an ideological opposition to capitalistic enterprise as such), but from a perceived surplus of foreign capital and entrepreneurship. The problem, it seems, is to assure that mineral development (and, presumptively, related activities like oil refining or oil and gas transportation) are under the control of Canadians or the people of British Columbia, rather than great multinational (read United States) corporations.

It is probably not politic of me as an American to ask what practical difference the nationality of a company's owners or management makes as long as it is subject to the same laws (and obeys them) and pays its proper share of taxes. Foreign companies in Canada have often been berated for not paying enough taxes, but it was after all a *Canadian* decision, reflecting a long-standing Canadian developmental philosophy that the extractive industries should remain largely untaxed. The satisfactions and grievances of Americans regarding the major oil companies apply in the same way to

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Mobil and Texaco, which are domestically controlled, as they do to Shell and Sohio, which are foreign controlled. I am afraid I don't see how any more in the way of real resources for Canadians could be squeezed from a government owned business than could be squeezed from American or Canadian owned private enterprise under a well designed leasing and tax system. Nevertheless, one billion American dollars invested in Canada is more conspicuous than one billion Canadian dollars invested in the United States, and the nationality of your managers and stockholders obviously does make a difference to many Canadians. (I must confess, also, that some Americans become hysterical about the very idea of the Arabs or Persians taking over United States businesses.)

Government enterprise is one way to "nationalize" the mineral industries, but it is not, of course, the *only* possible way to foster Canadian equity and enterprise. Stricter nationality criteria could well be applied to holders of claims and leases or of permits to build pipelines, concentrating plants, and refineries. Such policies raise the further question, however, whether there is in fact enough private equity capital and enterprise in Canada to effectively take the place of foreign equity and enterprise. This is an empirical question to which I do not have an answer. If the answer is negative, consideration must be given to the fact that establishing a government enterprise does not *create* any new Canadian resources. It only uses tax money or potential resource revenues to bid capital and talent away from some other employment in Canada. The cost of Canadianization (either by restrictive licensing of private industry or by government enterprise) may be minimal, however, if preferences for nationals result in bidding home significant amounts of Canadian capital and Canadian talent which would otherwise be employed in other countries. (Presumably, the net effects of even these moves would have to take into consideration remittances that would otherwise flow back to Canada from investments abroad.)

Government capital need not be regarded strictly as a *substitute* for private capital, Canadian or foreign. In North America during the first half of the nineteenth century, and in almost every country at one time or another, state companies were used as a vehicle to *attract* foreign debt or equity capital, usually British, to ventures they would not otherwise consider. A government owned (or guaranteed) railroad company was often naively regarded by Lombard Street as a safe investment, while the promotions of unknown overseas entrepreneurs were viewed with little regard in the world's principal money market.

The use of government participation is still a major instrument for encouraging foreign investment in developing areas. Joint ventures between American, European, or Japanese private companies and governmental entities of the host country are common in almost all the extractive

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industries and in many countries at different levels of economic development. Canada has at least one government enterprise created largely with this function in mind, Quebec's SOQUEM, whose activity consists mainly of joint ventures in mineral exploration with private companies. Petro Canada also *seems* to be interested in this kind of approach.

In addition to being a means by which domestic enterprise becomes a trustworthy borrower (or partner) of foreign capital, state enterprise can also be a means of offsetting a shortage of domestic equity and entrepreneurship. In this role, it has one advantage over promotion of domestic private enterprise through nationality restrictions on investment, management or licences: it avoids the spectre of open discrimination, which could lead to retaliation and might otherwise undermine trade and investment relationships that are beneficial to Canada. The nearly open border allows this country to draw on a much larger pool of capital, technology, and talent than it would with policies fostering autarky. Although this openness is a major element in the ambiguity and insecurity of Canada's national identity, its economic benefits to Canada are relatively greater than they are to the United States. (That is, its impact on the size of the resource pool available to Canada is greater than on the size of the pool available to the United States.) It is therefore a circumstance to be modified only carefully and selectively. Establishing a provincial oil company is one way of containing the side effects of a move in the direction of autarky in a single industry. Such a move might, in fact, limit these side effects even in the industry in question. Suppose the best candidate for executive officer for a British Columbia based oil company were a Texan; there might well be fewer misgivings about hiring him to work for the province than about his heading a subsidiary of an American private firm.

I will conclude this article with some suggestions for the structure and policy of public corporations in the mineral industry, suggestions aimed at combining some of the best features of government and private enterprise, rather than their worst.

First, before establishing a governmental enterprise, be clear what its purpose is to be, what the incentive for the management to accomplish that purpose will be, and, quite rigorously, what will be the measure of the enterprise's success. (I owe this first and most vital point to Milton Moore's critique of the draft of this article.)

Second, do not set up a monopoly. There is no surer formula for inefficiency and social irresponsibility. Economies of scale do exist in mining and petroleum exploration, but they are very small when compared to some other industries or relative to the opportunities for development in an area the size of British Columbia. In petroleum refining, the minimum efficient size of a refinery is probably about the size of the British Columbia

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market for petroleum products, but if a new government owned refinery needs a monopoly or protectionist legislation to be profitable, it will almost certainly be a serious burden on consumers. Industries in which scale economies are narrow and where ingenuity and intuition are still crucial, as in mineral exploration or onshore oil and gas production, are probably not the most appropriate candidates for nationalization; but where it is determined to establish a state enterprise, consideration might be given to the establishment of more than one competing public enterprise.

Third, do not clothe the corporation in sovereign immunities. Such immunity can be, and often is, a cover for inefficiency, irresponsibility, and even lawlessness. The corporation should be suable; it should pay taxes or their equivalent (federal, provincial, and local); and it should be subject to environmental and safety laws and regulations and, above all, subject to the bankruptcy laws. Its operations should not be protected by any version of an official secrets act. There is no good reason why the directors, officers, and employees should be excused from the same civil and criminal liability for their actions to which their counterparts in private enterprise are subject.

I would urge hesitation even in providing guarantees for the corporation's debt. A public mining or oil corporation will be pursuing a line of business in which private enterprise regularly borrows money without such guarantees. The more intense scrutiny of bankers and underwriters toward a corporation whose debt must stand on its own merit might well save the corporation's owners—the public—more money than the small interest differential associated with government guarantees.

Fourth, give the public and the corporation's officers and staff a material interest in its success and its efficiency. The government need not hold all the shares but only a controlling interest, not necessarily even a majority. One block of shares (enough to elect at least one director) can be held in trust for the company's employees and voted by them. The remainder of the shares would be offered to the public; they would be voted by their owners and publicly traded. Not only would this provision broaden interest and participation in management, but the market price of publicly traded shares would be a continuing indicator of management performance and of the value of the government's equity. I see no compelling reason to restrict share ownership to residents; it might in fact be useful to encourage minority participation by major oil companies or mining companies. A residence requirement for shareholders, however, would reinforce symbolically the corporation's identity as a national or provincial investment, and would, of course, limit remittance of dividends abroad.

Fifth, the corporation's policies should be responsive to public policy but not bend to every political wind. I would suggest that only a minority of the

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government directors serve at the pleasure of the Cabinet and be regarded as spokesmen for its policies. The remaining directors representing the government's equity would be chosen indirectly for long and staggered terms.

Sixth, the corporation should be under pressure to pay dividends. A majority of the shares (and directors) should represent parties who have a material interest that the corporation *not* retain, reinvest, or dissipate all its earnings: private shareholders, the employees, and the members who serve at the pleasure of the Cabinet (who would presumably be responsive to the fiscal interest of the government). The influence of this group will be a constant corrective to tendencies of management, inside directors, and permanent directors toward complacency, empire building, pyramid building, or gold plating.

Seventh, maintain a clear distinction between the corporation and the government as landowner. The public enterprise should obtain resource rights on crown lands only in competition with other prospective operators. The corporation should not receive a concealed (and indeterminate) subsidy by access to resources at no charge or at a lower price than a competitor might offer. If it must have a preferent right, let it be at most a right to match the highest bidder.

A preferent right on the best offshore leases is a feature of the federal oil and gas corporation (FOGCO), proposed recently in the United States Congress. In view of the prices oil companies have been recently willing to spend in these lease sales, such a preference would guarantee that FOGCO would appear profitable, however incompetent its management, and that the federal treasury would lose billions of dollars in lease revenues.

Eighth, take advantage of the division of labour and competition. The corporation should not attempt to do for itself the things that even the greatest oil and mining companies contract out to others, such as seismic surveying, core drilling, well drilling, well logging, and construction. There is virtually no chance that a state corporation could improve on the performance of private firms in these exceedingly competitive areas.

In summary, I am generally skeptical of the case for public enterprise in the minerals industry but hopeful that such enterprises could be established free of many of their usual shortcomings, providing some thought is given to their purpose, organization, and standards of performance.

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Notes

1. In a study aimed at projecting the employment impact of the Trans-Alaska pipeline, we found that *unemployment* in individual labour market areas was almost totally insensitive to the level of *employment*; that is, on a *net* basis, at least, new jobs in Alaska's petroleum and wood products industries and government were entirely filled by immigrants. [Arlon R. Tussing; George W. Rogers; and Victor Fischer; with Richard Norgaard, and Gregg Erickson, *The Alaska Pipeline Report: Alaska's Economy and Gas Industry Development and Impact of Building and Operating the Trans-Alaska Pipeline*, Institute of Social, Economic and Government Research Report no. 31 (Fairbanks: University of Alaska, 1971)].
2. Arlon R. Tussing and Gregg K. Erickson, *Mining and Public Policy in Alaska* (Fairbanks: Institute of Social, Economic and Government Research, University of Alaska, 1969).

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TEXACO'S TESTIMONY CONCERNING CS FOR HOUSE BILL NO. 854
PRESENTED TO THE STATE OF ALASKA SENATE RESOURCES COMMITTEE
ON MAY 22, 1978

Texaco is opposed to CSHB 854, the State Leasing and Exploration Bill, in its entirety for reasons which we will enumerate in our following comments.

It is our firm belief that the present Statute AS 38.05.180, in effect since 1959, has proven equitable to both the State and the oil industry and has served to maximize economic benefits to the State. We firmly believe that industry competition has fluorished under the present regulations, to the State's benefit.

In reviewing the proposed bill, #854, we would like to point out some of the areas that we believe are not in the best interest of the State and do not follow the goals stated in (a) (2) (A) and (B) (Page 1).

Legislative Review of Leasing Programs-Section (b) (Page 1)

We completely concur with proposed long range leasing programs giving industry sufficient lead time to acquire subsurface information and to budget costs of lease acquisitions and subsequent exploratory drilling. However, should annual reviews result in major revisions or reductions in areas to be leased, or complete elimination of sale areas, substantial

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human and monetary efforts by both State and industry personnel will have been wasted. We believe this would be contrary to: 1) the State's goal of a stable and predictable petroleum leasing program, and 2) the State's interest in maximizing the economic recovery of its resources.

Leasing Methods-Section (f) (1) through (7) (Pages 3 & 4)

Paragraph (1) providing for bonus bidding with a fixed royalty is the most desirable and will have the greatest economic benefit to the State. Experimenting with other types of bidding, i.e., royalty, sliding scale royalty and net profits variables, places a greater risk on the State of the loss of revenue. As an example, let's use the Gulf of Alaska OCS sale. To date, 8 wildcat wells have been drilled without a single commercial hydrocarbon discovery; a very discouraging situation. Had the Federal Government resorted to bidding methods other than the conventional bonus bid, the result would have been a loss of $400 million+ in needed revenue. Although State lands have great potential for discovery of hydrocarbon reserves, it must be clearly realized that these lands have thus far been virtually unexplored. Undesirable consequences may result from royalty or net profits bidding. These bidding methods which allow many companies to establish a land position with very little cash outlay is a deterrent to early drilling. These companies would probably drill only

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under the most favorable conditions as it would be much easier and cheaper to await the results of exploration in the same general area by competitive lease holders. In view of these conditions, the State can ill afford to assume the risk of experimenting with alternate types of bidding.

Minimum Work Commitment-Section (h) (Pages 4 & 5)

This section enables the Commissioner to impose a minimum work commitment on any oil and gas lease, with penalties for noncompliance. That is a very poor provision, for these reasons: A work commitment is sensible only when applied to entire concessions or other large geographical areas. Applied to individual leases, it is unworkable. If a dry well is drilled on an adjacent lease, and if it proves that there is no hope for oil or gas on the subject lease, then it would be senseless waste of exploration dollars to carry out the work commitment. It would serve the State much more effectively if that lease were surrendered, with the money saved to explore elsewhere, where there is a more reasonable chance for a discovery.

Defferal of Cash Bonus-Section (k) (Page 6)

This section allows the Commissioner to defer any part of a cash bonus payment, allowing up to 5 years for full payment.

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This is in direct conflict with AS 38.05.335(c), which requires a deposit of 20 percent of the bid in cash. Moreover, it opens the possibility for a bidder to deposit a small fraction of the cash bonus, and then to default on the balance no oil or gas is indicated by his neighbors' drilling programs. It also appears to conflict with section (a) (1) (A), to "maximize the economic recovery of the resources."

Lease Term-Section (n) (Pages 6 & 7)

This section mandates a 5-year term for oil and gas leases, with a possible extension to 10 years where operations are restricted by the environment. As the great majority of the State is subject to environmental conditions which limit an exploration season to about 4 winter months, a 5-year lease allows only 1 and 2/3 years of exploratory work. This is quite insufficient in such high-risk, high-cost areas of Alaska. We therefore would urge that the present statute be maintained whereby leases contain a 10-year primary term.

Non-Competitive Leasing-Section (x) (Page 10)

The proposed bill requires competitive leasing for all State lands. This basis may be good for many areas within the State having a high prospective value; however, this system is not suitable for low prospective areas, many of which would

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attract little or no bids at a competitive sale. In line with the objective to maximize the economic recovery, the State should provide for non-competitive leasing in certain areas of low prospectiveness and in instances where tracts received no bids in an earlier competitive lease sale. This procedure is comparable to that used very successfully by the Federal Government and would provide additional revenue to the State.

Joint Bidding Restriction-Section (y) (Pages 10 & 11)

Texaco believes that the State would lose revenue by adopting a policy of restricting joint bidding. The theory of the author of the bill was that one must restrict joint bidding in order to promote competition. This, however, may have the opposite effect since many small companies, or large companies with limited budgets, may be precluded from participating in a competitive sale if joint bidding is not permitted. Joint bidding combinations may be the only means of acquiring lease acreage for these companies. In addition, the federal experiment in joint bidding restrictions on the OCS has not demonstrated that any additional revenue has been received by the government as a result of higher bids. On the contrary, a recent study indicated that higher bonus bids were received in joint bidding rather than by sole company bidding.

State's Call on Oil and Gas Production-Section (z) (Page 11)

Texaco objects to the State having a call on production for the reason that it will discourage oil and gas exploration within the State. An increasing number of wells are being drilled within the State as a result of financing from various utility companies interested primarily in the production to serve their customers. If the State were to include a call on production in excess of its royalty share, this will effectively preclude the utility form of financing from future exploration, reduce industry exploration on State lands, and, therefore, not be in the State's best interest.

State Access to Exploratory Data-Section (aa) (Page 11)

Texaco is particularly opposed to supplying any of its valuable proprietary seismic data to the State.

This section would remove the incentive for an aggressive companv to be a leader in initiating new or innovative ideas in an effort to discover new resources. It is common knowledge that geophysical data, in particular, is extremely confidential and closely guarded by the individual members of the industry. Leakage of this information, whether by accident or other means, could cost an individual company its competitive advantage in a given area, expecially an area which has

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heretofore been relatively unexplored. We believe such a requirement would discourage rather than promote exploration of the State's lands.

Acreage Limitations-Section 3(c) (Page 11)

The acreage limitations should apply only to non-competitive leases. To limit the amount of competitive acreage a company holds effectively precludes that company from participating in some future leases sales at such time as its lease holdings approach the limitation figure. This reduces the competition by lowering the number of companies bidding for the leases, which will most likely reduce the revenue to the State.

In the event the State insists on limiting oil and gas lease holdings by an individual or company, Texaco requests that the present statute providing for the holding of leases on 500,000 acres of tide and submerged lands, and 500,000 acres of all lands other than tide and submerged lands be maintained in effect.

Summary

There are numerous other conflicts and ambiguities contained in this bill which we are sure your Committee will detect in

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your review of the various sections. After a thorough review of CSHB No. 854, taking into account the testimony and comments presented by various individuals, we sincerely trust that your Committee will determine that: 1) such legislation will not fully accomplish the intent set forth in Section (a) (1) and (2); 2) that such legislation may in fact seriously discourage and delay an assessment of the State's oil and gas resources; and 3) that your deliberations will result in your finding the existing leasing statute AS 38.05.180 to be in the best interests of the State and the most equitable for the State and industry to work in concert in accomplishing the desired goals.

Claude H. Brown

AGO 547071

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

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

M E M O R A N D U M

April 4, 1978

SUBJECT: Oil and Gas Leasing Bill: Major Issues in Drafting CS for HB 854

TO: The Honorable Hugh Malone
The Honorable Merle Snider

FROM: Gregg K. Erickson
Director of Research

Here, as you requested, is our list of some major issues the committee will probably want to address in drafting a committee substitute for this bill. They are listed in no particular order.

1. DEGREE OF LEGISLATIVE INVOLVEMENT IN THE LEASING PROCESS. As currently written, the legislature would not be involved in any formal way in the leasing process, except as a recipient of information from the department. We discuss this issue in more detail in an accompanying memorandum.

2. WORK COMMITMENT BIDDING. Work commitment bidding, including the system of drilling incentives proposed by BP/Sohio, implies a subsidy from the state in favor of oil exploration and/or development. If the committee decides that such a subsidy is desirable, then the question of whether or not this is the most appropriate method of providing it should be addressed. Finally, the committee may wish to put some limitation on the extent of the subsidy, and consider the specific terms under which it is offered. For example, the period of time over which the commitment can be worked off, and its transferability among lessees and between tracts are all issues which you might wish to consider.

3. NON-COMPETITIVE LEASING. HB 854 would allow non-competitive leasing where tracts have been offered under competitive conditions but where no bids have been received. Theoretically, tracts could be offered with very high minimum bids, or with other terms which make them very unattractive. This would ensure a lack of competitive interest, and make it possible for the lands to be reclassified as non-competitive, and essentially given away. If noncompetitive leasing is to be retained, the committee should probably review the question of whether these arrangements are appropriate.

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4. REDUCTION OF ROYALTY. This provision has been fairly widely criticized by the various witnesses before the committee, particularly in combination with the royalty bidding arrangements.

5. NET PROFITS BIDDING. The bill has been criticized for being insuffici tly precise about how the net profits would be calculated. The department has indicated that this can and would be taken care of in regulations. The committee could attempt to provide a general description of this calculation in the bill.

6. ROYALTY BIDDING WITHOUT THE SLIDING SCALE. Almost all economists who've looked closely at this method have been critical of it.

7. PUBLIC OUTCRY BIDDING. HB 854 allows this method of bidding; a number of scholarly studies have indicated a tendency toward collusive and non-competitive behavior in situations where natural resources are disposed of by this method.

8. ONE HUNDRED PERCENT GAS ROYALTY RESERVATION TO THE STATE. It has been asserted fairly convincingly that this provision will reduce gas company interest in exploration. On the other hand, particularly in the Cook Inlet Basin, the utility of having large gas reserves controlled by the state may be very high.

9. FIVE YEAR LEASE TERM. Most economists and the Department of Natural Resources would argue for the shorter term. Most industry representatives believe longer terms are necessary in many circumstances.

10. MINIMUM LEASE SIZE. Under the bill before you, individual leases are limited to 5,760 acres except under non-competitive leasing. It is clear from testimony of the department that it is contemplated that larger tracts should be made available in cases of low potential lands. Most economists and industry represenatives would agree. The department seems to believe that it could amalgamate tracts, in which case the acreage limitation would be of no effect. The committee may want to retain the existing acreage limitation, but provide that the commissioner may lease much larger tracts when he makes specified findings.

11. ACREAGE LIMITATIONS. The maximum acreage that can be held by any one lessee is reduced in this bill over present law. Apparently, two companies would be affected by this reduction. The provision has been criticized by the industry. It becomes more significant as the term of lease is increased, so this provision should probably be considered together with number 9, above.

12. STATUS OF EXISTING OFFERS FOR NON-COMPETITIVE OIL AND GAS LEASES. No non-competitive oil and gas leases have been issued during the past two years, although many offers have been made for such leases under the existing law. Options for dealing with these "prior rights" will be discussed in a later memorandum.

13. RESTRICTION OF JOINT BIDDING. The committee may want to require such restrictions, or it may want to eliminate the provision entirely. Federal regulations currently limit joint bidding between the twelve largest oil companies. A similar provision is in pending federal legislation.

14. ACCESS TO AND CONFIDENTIALITY OF EXPLORATION DATA. The industry seems to generally oppose this provision. The department believes it is very important but would be willing to specify that the confidentiality of this information would be as established in current law.

GKE:jm

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File
HB 854

NOTE: Professor Norgaard in his study which accompanied Dr. Mason Gaffney's leasing policy study recommends a "more sophisticated analysis" of the affect of bonus bidding in Cook Inlet. See Recommendation III. B. 1 on page 25, attached. A comparison of other bidding methods could be done, also.

UNCERTAINTY, COMPETITION, AND LEASING POLICY

by

Richard B. Norgaard*

B. Bonus Bids and Rent Collected by the State

It is now well known to Alaskans that approximately 90 percent of the Prudhoe Bay field was acquired by ARCO and British Petroleum in mid-1960's sales which, along with considerable other Arctic Slope acreage, brought $10,500,000 in bonus bids. After oil was discovered, the small amount of remaining Prudhoe Bay acreage brought $900 million in bonus bids. Clearly, had the state known

*Associate Professor of Agricultural and Resource Economics and a member of Energy and Resources Group, University of California, Berkeley.

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about the Prudhoe Bay field in advance, between $5 billion and $10 billion more would have been collected in bonus bids. Several years after the sale, petroleum prices tripled. Presuming that industry had not predicted this increase at the time of the sale, then the state probably "lost out" on perhaps an additional $15 billion to $30 billion. Prudhoe Bay is clearly a "tough luck" story for the state, and industry is quick to point out that at other times and places they have bid large bonuses and lost. Offshore Cook Inlet is undoubtedly more representative than Prudhoe Bay due to the larger number of sales and smaller size of fields discovered.

The discounted value of oil produced and estimated to be produced from Lease Sales 7 and 9 is $1.3 billion (Table 3, column 7). Ideally, we would like to determine what portions of this value have gone to cover production costs, what portion has been collected in royalties and similar per barrel taxes, and what portions of the remaining amount were paid in lease bonuses and retained by the industry. The following discussion will be complicated by (1) imprecise measures of the value of future natural gas production; (2) imprecise estimates of production costs; (3) uncertain shares of rent collected or to be collected by royalties, severance taxes, and other taxes; (4) the value of oil and gas in fields which are under lease but have not yet produced; and (5) the number of lease sales to be included in the analysis. The effect of alternative assumptions for items 1 through 5 could be incorporated a computer-modeled sensitivity analysis. For the purposes of this report assumptions will be made which are biased in favor of the effectiveness of the bonus bid as an instrument for collecting rent. If the bonus bid appears to be ineffective under these favorable assumptions, then we can be reasonably confident that it, in fact, has been ineffective.

AGO 547076

Natural gas sales from Cook Inlet fields are now approximately 11 percent of the value of oil sales. This percentage, however, has been increasing historically and is expected to continue to increase significantly in the future. Nevertheless, the discounted value of oil will only be increased by 13 percent to $1.5 billion to account for gas sales. Production costs (exclusive of interest charges since petroleum flows have been discounted to the present) in 1975 dollars are assumed to be $1.25 per barrel, which may be somewhat low, or $2.50 per barrel which is definitely high. The average wellhead price of crude oil in 1975 dollars reached a high in 1965 of $5.66 a barrel, declined to $4.26 in 1973, rose dramatically to $5.38 in 1974, and is likely to increase gradually in the future. Nevertheless, for this analysis, we assume a constant price of $5.00 per barrel. The state collects a 12.5 percent royalty, a severance tax of 3 percent to 8 percent depending on the rate of production, and has occasionally levied other smaller production taxes as well as occasionally granted discovery credits. For the purposes of this analysis, we assume these payments average 20 percent of the value of petroleum produced which is undoubtedly somewhat higher than actually the case. Lastly, we assume that all the oil and gas fields that will ever be produced up to Lease Sale 16 are now producing, and we assume that these 11 sales constitute a meaningfully large sample.

Given the above assumptions, production costs plus royalties and related payments come to 0.45 to 0.70 of the discounted value of the petroleum. The 0.30 to 0.55 remaining share has a discounted value of $450 million to $825 million. What proportion of this amount was collected in lease bonus payments? The value of the lease bonus payments discounted to 1961, roughly the year of the sales for the tracts in which oil was discovered, equals $74 million. Thus, assuming the high production cost estimate, bonus bids transferred 16 percent

AGO 547077

of the remaining rent, after royalties, etc., to the state. With the low production cost estimate, this percentage diminishes to 9 percent. Even given the favorable assumptions, the effectiveness of the bonus bid as a method for transferring rent to the state appears to be very low.

RECOMMENDATION III.B.1. The Department of Natural Resources should conduct a more sophisticated analysis along the above lines, with attention given to the sensitivity of the conclusions to alternative assumptions.

One might still argue that offshore Cook Inlet is another bad-luck example for the state of Alaska but that, with a large number of sales, the state will earn a fair return over the long run. This may be true in theory. But given the tremendous variations around the mean which are possible due to the great uncertainties involved, the state should (1) consider whether it has enough petroleum lands to lease to be reasonably certain that the law of large numbers is relevant and (2) whether it has sufficient planning expertise and access to capital to cope with the variations in bonus bid flows over time.

RECOMMENDATION III.B.2. The Department of Natural Resources should employ a statistician to assess alternative confidence limits about the mean for bonus bid revenues in 2-year, 5-year, and 10-year intervals given the projected pace of acreage to be leased in the future.

AGO 547078

IV. Conclusions

The lease bonus bid appears to have been between 5 and 20 percent effective as a means of collecting rent over and above that collected through royalties. Its historic ineffectiveness may be due to extensive risk discounting on the part of industry, low levels of competition and the use of game theory by industry in determining bids, simply bad luck, or a combination of all of these. Regardless of the reason, both the theory and evidence brought out in this report suggest the state of Alaska should seriously consider (1) alternative leasing systems, (2) initiating or participating in presale exploration, (3) acquiring the expertise to establish competitive bid rejection values for each tract, or a combination of all three of these.

This portion of the overall study does not address alternative lease terms or procedures for determining lease winners. If the state retains the lease bonus bid approach, especially with current royalty levels, its effectiveness can be increased in two interrelated ways. First, the state could (1) contract or provide incentives for limited exploratory drilling with public dissemination of information prior to lease sales. This information could reduce uncertainty substantially and thereby increase the level of competition. Second, the state could, itself, behave as a (2) bidder by establishing competitive bid rejection criteria for each tract. Such an approach at least would increase the level of competition substantially, for example, from 2.2 to 3.2 serious bidders on likely tracts in Lease Sale 9. But more importantly, the state's bid could reduce the effectiveness of game theoretic strategies significantly, thereby having a bigger impact than merely increasing the number of bidders. Each of these approaches can be developed over time with increasing intensity or sophistication. There effectiveness and cost can be monitored and optimal levels roughly

AGO 547079

determined. These proposals cannot be rejected on the grounds that staffing and expenditures comparable to Exxon's exploration division would be required.

Even if the lease bonus bid approach is abandoned, some changes along the above lines would probably be desirable. First, there is no known perfect set of lease terms or procedures of determining lease winners under conditions of uncertainty and limited competition. While other leasing strategies may be better, there will probably still be advantages to reducing uncertainty and increasing competition. Second, the state could better plan sales over time and predict revenue flows if it had information on areas to be leased. Again, such information might be gathered by initiating or providing incentives to industry to drill. Or it may be sufficient for the state to participate in industry-initiated seismic exploration and to employ several seismologists or contract for the analysis of seismic data.

In summary, the Department of Natural Resources should seriously consider increasing its level of expertise and role in exploration, incrementally over time but substantially during the next 5 to 10 years.

AGO 547080

Notes on HB 854

1. 5-year leasing program submitted to each regular Legislature specifying land to be leased in the 3rd and 4th years after the year in which leasing program is submitted. The 1979 through 1983 leasing program will be submitted to next year's Legislature.

   THIS WILL PERMIT THE LEGISLATURE, THE PUBLIC AND THE OIL & GAS COMPANIES TO KNOW LONG-RANGE LEASING PLANS OF ANY PARTICULAR GOVERNOR OR COMMISSIONER OF NATURAL RESOURCES.

2. Commissioner would also submit an annual report to the Legislature on the bidding methods used, or proposed to be used, and why.

   THIS WILL HELP ALL ALASKANS TO UNDERSTAND BETTER THE ECONOMICS OF OIL EXPLORATION.

3. Methods include:

   a. Cash bonus with a fixed royalty of not less than 12½% (present method);

   b. net profit bidding, and

   c. royalty bidding, but only where "unleased acreage is subject to drainage by offsetting wells."

4. A "minimum work commitment" may be included in a lease. (to be amended?)

5. Exploration incentive credits -- based on footage drilled and geophysical work done -- can be made part of the lease and may be taken against royalties; rentals and taxes, but may not exceed 50% of the payment toward which it is being applied.

   THE CREDIT SYSTEMS WILL PROBABLY NOT BE NEEDED AT THIS TIME, BUT SHOULD BE IN THE LAW TO PERMIT THEIR USE IN THE FUTURE, IF NECESSARY.

6. The Commissioner may reduce royalty but only when a clear showing is made by the lessee that in the later stages of production his rate of return, based on his total investment in the field, is insufficient.

   ANOTHER SECTION OF THE LAW IS AMENDED TO DELETE COMMISSIONER'S EXISTING POWER TO REDUCE ROYALTY AT ANY TIME.

AGO 547081

7. The lease term is reduced from 10 years to 5 years, except when "environmental conditions severely restrict operations", the term can then be 10 years.

   IT IS IN THE STATE'S INTEREST TO HAVE THE LESSEE EXPLOR[illegible] AS QUICKLY AS POSSIBLE AFTER HAVING BEEN AWARDED A LEA[illegible], OR RETURN IT TO THE STATE FOR RE-LEASING.

8. Rentals have been increased from $1.00 per acre to $1.00 - 1st year; $1.50 - 2nd year; $2.00 - 3rd year; $2.50 - 4th year and $3.00 for the 5th and following years. "Shut-in" field rentals may be increased but not to exceed 150% of the rate for the preceding year.

9. The existing law concerning unitization has been left as is. (See HB 815)

10. Leases which draw no bids may be offered by another competitive method but the rental may be less and the lease size greater.

11. All non-interpretive data obtained from activity on the lease may be made available to the State by the lessee, but the information shall be controlled by the existing law on confidentiality.

AGO 547082

LUM LOVELY, Geologist
P.O. Box 99
Anchorage, Alaska 99510

Offices located at
1016 W. 6th Ave., Suite 440
Anchorage, Alaska 99501
Phone (907) 277-1551

March 31, 1978

Dr. Robert E. LeResche, Commissioner
Alaska Department of Natural Resources
Pouch M
Juneau, Alaska 99811

Re: Issuance of non-competitive oil and gas leases in Susitna Basin

Dear Dr. LeResche:

It has just come to my attention that you or Governor Hammond will be announcing within the next few days that a relatively small area near Flaxman Island on the North Slope will soon be opened for competitive oil and gas leasing, and that many non-competitive oil and gas (and coal?) leases will finally be issued by the State pursuant to applications filed by numerous individuals as long as 2½ years ago. It is also my understanding that you will be announcing your intention to reject all currently pending non-competitive lease applications filed by oil and gas companies in Susitna Basin (many were filed nearly 2 years ago), in order that the land now covered by those applications might be reclassified for competitive oil and gas leasing only.

Your proposed North Slope competitive lease sale will surely generate spirited bidding because of Exxon's recent nearby oil discovery. And, you are certainly to be commended for acting affirmatively at long last on those non-competitive oil and gas lease applications which so many individuals filed in good faith so many years ago. If you have been adivsed that competitive interest will be high in those areas which are now covered by oil company applications for non-competitive leases in Susitna Basin, however, then your advisors are sadly out of touch with reality.

As an independent geologist who makes his living principally from oil and gas leasing activities, and as the one person who has more leasing experience in Susitna Basin than any other individual, I can assure you on the basis of real world experience that interest in Susitna Basin is extremely low at this time despite Union Oil Company's current reconnaissance seismic activities in the southwestern corner of the basin.

Rejection of oil company applications in Susitna Basin at this time will serve only to dampen what little interest there is in Susitna Basin already. Even if competitive interest were eventually to develop in the basin, however, required cumbersome and time consuming pre-leasing and leasing procedures would necessarily result in undue delays in exploration and development activities. If it is your intention to encourage early exploration for natural gas and/or oil in Susitna Basin, therefore, you will approve, rather than reject, all oil company non-competitive oil and gas

AGO 547083

lease applications in the Basin, forthwith, just as you contemplate doing for those non-competitive lease applications which were filed by individuals in the area.

Please bear in mind that Susitna Basin is an extremely low-priority geologic province where oil possibilities are believed to be nil and possibilities for natural gas are marginal at best. The sedimentary section is thin in Susitna Basin, and structural information there is extremely scarse.

Moreover, hundreds of thousands of acres remain unleased (or even applied for) in the basin, despite the fact that this land has been available for non-competitive oil and gas leasing for many years now. I also wish to stress that Texaco dropped its oil and gas leases on over 150,000 acres in Susitna Basin after first conducting an extensive seismic program there some eight years ago. Furthermore, to my knowledge Texaco has no plans to drill its remaining 70,000 acres of leases in the basin before they expire next December.

I also think you should know that oil companies haven't exactly been stumbling all over themselves trying to buy my leases in Susitna Basin, either. It took me 7½ years to sell my 40,000-acre Yentna River lease block (to Union Oil Company and Pacific Lighting) in the southwest part of the basin, for example, and, after nearly eight years, I still haven't found any takers for my 47,000-acre Highway Bridge lease block in the east-central part of the basin despite the fact that Union Oil Company is now conduct seismic operations only 25 miles away. As a matter of fact, I still own leases in the immediate vicinity of Union's current shooting area which I haven't yet been able to sell or farm out!

I caution you not to interpret as an indication of high general interest the over-the-counter non-competitive oil and gas lease applications which Amarex Inc. and Gas Supply Corporation of Alaska (GASCOA, a subsidiary of Anchorage Natural Gas) filed jointly on 40,000 acres in the southeastern part of the basin, and on 36,000 acres in the north-central part of the basin nearly two years ago. These companies are so cautious about Susitna Basin, in fact, that, prior to filing the aforementioned applications, they were unwilling to purchase either my Yentna River lease block (which Union Oil and Pacific Lighting now own) or my Highway Bridge lease block, even for as little as $3.00 per acre (my rental investment at that time). In their view, there were (and still are) simply too many geological unknowns in Susitna Basin to justify spending more than a state filing fee of $20.00 per application plus the required annual rental of 50¢ per acre for leases there. Inasmuch as Amarex and GASCOA filed their applications with my help, I can also attest to the fact that their applications cover prospects which are inferred, only, on the basis of best-guess extrapolations from old, incomplete, and now publicly available seismic data which Pure Oil Company filed with the U.S.G.S. over 14 years ago.

Neither should you misconstrue Union Oil Company's recent over-the-counter filings for oil and gas leases in Susitna Basin as an indication that an abundance of favorable geological data is available in that area.

AGO 547084

As a matter of fact, in filing its recent applications for non-competitive oil and gas leases on approximately 100,000 acres west of Mt. Yenlo, Union Oil Company had even less geological information to go on than Amarex and GASCOA had when they filed their aforementioned applications elsewhere in Susitna Basin. No outcrops are present where Union filed, for example, and neither has any seismic exploration ever been conducted in the area. Moreover, it should be obvious from the simple rectangular pattern of Union's filings west of Mt. Yenlo that the company hasn't the foggiest notion of what to expect geologically in the area. It would therefore be unrealistic, indeed, to expect Union (or anyone else, for that matter) to pay any more for leases in the area than the small filing fees and rentals which are presently required for state non-competitive leases.

Amarex, GASCOA (now McAlester Fuel Company), and Union Oil Company obviously filed their respective non-competitive oil and gas lease applications in Susitna Basin with the intention of eventually exploring large areas where geologic information is currently sparse or non-existent. In data deficient areas such as these, however, history shows that 90% or more of the land will be condemned geologically by future exploration. These companies are therefore faced with the unpleasant task of condemning most is not all of their respective areas of interest as cheaply as possible!

In these circumstances, of course, it would be totally unrealistic to expect that any of the aforementioned companies (or any others) would suddenly become spirited bidders for competitive leases in any of the geologically questionable areas mentioned above. In fact, it is safe to say that no exploration whatsoever will be initiated in the aforementioned areas by either Amerex, McAlester, or Union Oil unless inexpensive non-competitive leases are first issued to them by the State pursuant to their currently pending applications

The facts make it clear that reclassification of the aforementioned areas for competitive leasing, only, would result in postponement, if not total abandonment, of new exploration and development efforts in Susitna Basin. The question is, however, "Can the State afford to block exploration in Susitna Basin at this time in hopes that competitive interest in the area may pick up at some indefinite time in the future?" I don't believe it can. Here's why.

As you know, Mr. Pat Dobey of the Division of Minerals and Energy Management here in Anchorage has warned the Administration and the public that the Anchorage Bowl area will be faced with a critical shortage of natural gas by 1985 (just seven years from now), unless more discoveries are made in south-central Alaska soon, or, in the alternative, unless a state-built-or-subsidized gas pipeline is laid from Prudhoe Bay to Anchorage.

It would of course be unwise for the State to spend taxpayers' money on a gas pipeline from Prudhoe Bay to Anchorage, when oil companies such as those who have filed for non-competitive leases in Susitna Basin appear ready, willing, and able to spend money from the private sector to explore for and develop natural gas reserves right here in Anchorage's own back yard.

AGO 547085

It therefore behooves the State to approve the aforementioned oil companies' non-competitive oil and gas lease applications, forthwith, in order to clear the way for new exploration in Susitna Basin as soon as possible. Remember, Anchorage is rapidly running out of gas, and new discoveries of oil and gas generally require lead times ranging from five to ten years. The State simply cannot afford to hold up development in Susitna Basin any longer. To do so would be totally irresponsible.

While new exploration in Susitna Basin could be highly beneficial to the State of Alaska in general, and to Anchorage natural gas consumers in particular, it could also result in a significantly broadened tax base for the Matanuska-Susitna Borough in which Susitna Basin is situated. Obviously, any further impediments to early leasing, exploration, and development in the aforementioned areas will definitely not be in the best interests of the Matanuska-Susitna Borough. It is therefore to be expected that your proposal to reclassify lands for competitive leasing in Susitna Basin will be denounced by the Matanuska-Susitna Borough Assembly and Planning Department when your competitive reclassification proposal comes up for notice and review pursuant to Section 38.05.305 of the Alaska Statutes. Undue delay in broadening the borough's tax base could be avoided, of course, if you would simply approve all currently pending oil-company (and individually-filed) applications for non-competitive oil and gas leases in Susitna Basin forthwith.

While I believe you can justify immediate approval of all pending non-competitive oil and gas lease applications in Susitna Basin on the basis of the foregoing reasons alone, you must of course also consider the moral and legal aspects of your forthcoming proposal to reject all lease applications filed by oil companies while approving similar applications filed by individuals.

First of all, it must be remembered that all of the now-pending applications were filed in good faith pursuant to laws and regulations which were in effect when the applications were filed (and still are in effect). Moreover, it clear that most of these applications would have been approved already, were it not for the current land freeze.

The land freeze, of course, was originally designed to protect certain aggrieved parties until such time that their grievances could be reconciled by the courts and/or the Legislature (these grievances have since been reconciled). It was not intended to be used as a means of cheating oil companies out of non-competitive oil and gas leases when it was first instituted, and it should not be used as a weapon to be turned against oil companies now.

The oil companies which are involved here (and individuals, too, for that matter) have filed their lease applications pursuant to laws and regulations which are supposed to protect their first-priority rights to the lands in which they have revealed their interest to the world in good faith (their areas of interest are described in their applications, of course, and their applications are on public file for all to see). Accordingly, use of the land freeze as a means of selectively blocking the issuance of leases to

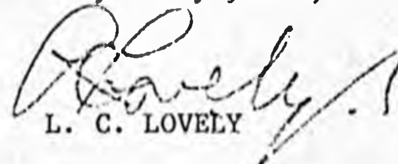
oil companies, while allowing the issuance of such leases to individuals, not only would constitute a reprehensible breach of trust on the part of the admininstation but also would serve double duty as an arbitrary and capricious abuse of administrative power which probably could be challenged successfully in court.

While oil and gas possibilities in Susitna Basin are generally considered to be marginal (even by those oil companies now holding oil and gas leases and lease applications in the area), the element of surprise in oil and gas exploration is such tnat significant reserves of oil and gas could nevertheless be discovered there. For a low-priority area such as Susitna Basin, however, economic incentives for exploration must be unusually attractive. You can provide this needed incentive, of course, simply by making it easy for everyone (including oil companies) to assemble large blocks of inexpensive non-competitive oil and gas leases in the area.

An early increase in the rate of exploration and development in Susitna Basin will clearly bring economic benefits not only to the State but to the Matanuska-Susitna Borough as well. It will also provide new jobs for oil workers, and it will stimulate new business for the service companies. Moreover, by making it known that you are clearing the way for possible early discoveries which could prevent the occurrence of an impending natural gas crisis in the Anchorage area, you could make considerable political hay in this important election year.

The foregoing observations make it obvious that competitive leasing will not stimulate urgently needed new exploration for oil and gas in Susitna Basin, whereas non-competitive oil and gas leasing will. I therefore urge you to reconsider your present plans to reclassify lands in Susitna Basin for competitive leasing only, and, instead, to approve all presently pending applications which oil companies and individuals alike have filed for non-competitive oil and gas leases in the area to date. I also urge you to lift the current land freeze in order to clear the way for future non-competitive oil and gas leasing in Susitna Basin. The sooner you take these important steps, of course, the sooner exploration can get under way, and the better it will be for all parties concerned.

Very truly yours,



L. C. LOVELY

Copies to: Jay S. Hammond, Governor, Juneau
Joseph P. Green, Director, DMEM, Anchorage
Patrick Dobey, Petroleum Manager, DMEM, Anchorage
Jack Roderick, Special Projects, DMEM, Anchorage
Gregg K. Erickson, Director, Div. of Research, Juneau
Lance Garola, Mat-Su Borough Planning Department, Palmer
Rep. C. V. "Chat" Chatterton, Juneau

(continued)

AGO 547087

(continued)

Copies to: Senator Joseph L. Orsini, Juneau
Dale Teel, President, Alaska Gas & Service Co., Anchorage
R. L. Rich, Manager of Land, Amarex Inc., Oklahoma City
W. B. "Buzz" Sawyer, V. P., McAlester Fuel Co., Magnolia, Ark.
Wayne Rodges, Land Manager, Union Oil Co., Anchorage
Wm W. Hopkins, Executive Director, AOGA, Anchorage
Don Hartmen, Exploration Representative, Texaco Inc., Anchorage

AGO 547088

10-002
(12-23-70)

DEPARTMENT OF NATURAL RESOURCES

INTRA-DEPARTMENT ROUTE SLIP

TO:
DIV/SEC: LOCATION:

ATTN: Hugh Malone

- [ ] Approval
- [x] Signature
- [x] Comment
- [ ] Contact Me
- [ ] Prepare Reply
- [ ] For Your File
- [ ] Note & Return
- [ ] Initial & Return
- [ ] Return As Requested
- [ ] Return For Approval
- [ ] Necessary Action
- [x] Your Information

REMARKS:

APR 26 1978

AGO 547089 +

FROM BY: [illegible] DATE: 4/24/78

DIV/SEC: Special Projects LOCATION: [illegible]

Hugh Malone

STATE OF ALASKA

JAY S. HAMMOND, GOVERNOR

file HB 854

DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

11TH FLOOR, STATE OFFICE BLDG.
POUCH M — JUNEAU 99811

April 21, 1978

RECEIVED
APR 24 1978
Div. of Minerals & Energy Mgt.
Anchorage, Ak.

Honorable D. R. Getty, Minister
Alberta Energy and Natural Resources
319 Legislative Building
Edmonton, Alberta, Canada
T5K, 2B6

Dear Mr. Getty:

Governor Hammond's recently introduced oil and gas leasing legislation for Alaska has now had incorporated into it by the legislature a drilling and geophysical incentive credit system similar to Alberta's. We have looked at the concept and, based on what we know, believe that the system could become useful in Alaska. However, we do need help in understanding how it has actually worked in your province.

Could we ask your assistance in explaining the operations of the system, both conceptually and technically, to some members of our legislature. The bill, HB 854, a copy of which is enclosed, is expected to begin Senate committee hearings sometime in May.

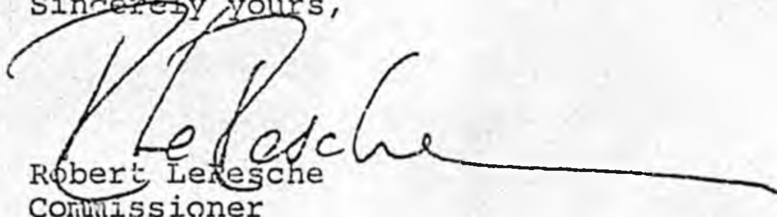
It would be of particular help to us if someone from your department could come to Anchorage to brief my staff and to Juneau to testify before the Senate Natural Resources Committee. We would, of course, cover all expenses. The exact dates of the visit would have to wait on the progress of the bill, but it is likely to be in mid or late May, 1978.

Over the past several years, Jack Roderick, my Special Projects Coordinator, who has been in charge of this particular legislation, has kept in contact with Michael J. Day, and others, in your minerals disposition division, on land tenure matters and he, or someone of your choice, would be most welcome. I will have Mr. Roderick arrange for the visit, subject to your authorization.

AGO 547090

Tha.k you for your assistance in this matter. We believe Alaska can benefit from Alberta's experience with the exploration incentive credit system.

Sincerely yours,



Robert LeResche
Commissioner

cc: Dr. G. B. Mellon, Deputy Minister
Michael J. Day, Asst. Deputy Minister
Petroleum Plaza, South Tower
9915-108 Street
Edmonton, Alberta T5K 2C0

Jack Roderick

AGO 547091

STATE of ALASKA

MEMORANDUM

file copy
O&G leasing

TO: Robert E. LeResche, Commissioner
Department of Natural Resources

DATE: December 22, 1977

FILE NO:

TELEPHONE NO:

FROM: Jack Roderick
Special Coordinator

SUBJECT: Meeting with AOGA landmen
Juneau, 12/15/77
Proposed Leasing Legislation

Presented copies of draft oil and gas legislation to oil company representatives (Alaskan Oil and Gas Association land and legal committee) at a meeting in Baranof Hotel, Juneau on December 15, 1977. This is the same proposed legislation which was presented to Speaker Hugh Malone's ad hoc leasing committee on December 9th in Anchorage. A 3-hour give-and-take discussion was had. Representing the State in addition to Roderick were Joe Green and Pat Dobey. Carl Smith took notes.

In the order of discussion the oil company representatives felt:

1) No need to change existing laws, leasing or other.

2) Opposed to Commissioner having to "report" to legislature, either 5-year leasing program, or annual leasing methods. Feel executive should maintain complete control over leasing i.e. "keep politics out", perhaps a Leasing Board, like Louisiana, Colorado, etc., (a) and (b).

3) Opposed to requirement that federal agencies must be consulted prior to leasing. Failure to consult might result in law suit, (b) (4) (C).

4) Opposed to restricting any one leasing method to no more than 50% of area, (5) (E).

5) Opposed to royalty, net profits and work commitment type bidding (c) (but see Chevron's position, attached.) BP thought that allowing the Commissioner to postpone any part of the payment of the cash bonus would result in the state being "ripped off" by the irresponsible operator.

6) Opposed to permitting legislature by joint legislation to disapprove new leasing method, (g). Stated that State Attorney General believes this kind of attempted delegation is unconstitutional.

7) Questioned whether State should have the right to store or trade its royalty even with "consent of the majority" of the effected field lease holders". (j) Phillips (Swetnam)

8) Pointed out that (k) as written would allow State to terminate a 5-year lease which was capable of production in paying quantities but had no market available. Recognized State's need not to allow fields to remain "shut-in".

9) Opposed to accelerating rentals of this magnitude. (Roger Herrera, BP, suggested "freezing" rentals after a dry-hole, thereby giving incentive to drill quickly and yet continue to explore.) (1).

AGO 547092

TO: R. E. LeResche
FROM: J. Roderick
DATE: 12/22/77
SUBJ: Meeting with AOGA landmen, Juneau, 12/15/77 - Proposed Leasing Legislation

10) Suggested that a State "shorelands" preference lease, due to a determination of navigability, be given on fee (Native) acreage, also, (m).

11) Didn't believe development contracts are workable and certainly opposed to State sharing in "the costs of exploration." (r)

12) Favored lands being offered non-competitively if no bids received at first sale. (u) Stressed the need for lands to be made available on a regular, continuous basis.

13) Opposed to restriction on joint bidding.(v)

14) Opposed to State's right to "purchase not to exceed 16 2/3% by volume of the oil and gas produced". Might accept an amount equal to original royalty in lease.(w)

15) Opposed to State's right to "all data". (x)

16) Opposed to lowering acreage limitation on uplands to 200,000 acres. Pointed out that there would have to be a "phase-in" period during which companies now at the maximum would be allowed to continue to lease. Otherwise, those companies who have acted aggressively in the past would be penalized. Sec. 3 (c).

Summary: AOGA Land and Legal Committee believes that the Legislature asked the Administration to review not revise oil and gas leasing law. Present bonus bid system is sufficient. Federal OCS law still not passed by Congress. Royalty bids on OCS will result in "less money to U.S. government." State administration should maintain complete and strict control over leasing; legislature should be informed only as they are presently.

Proposed law will hinder, not help, exploration in Alaska. "This will kill exploration in Alaska. We are categorically opposed to it." Herrera, BP. The methods, other than bonus bid, will not work. Work commitments will be impossible to administer.

Cash or performance bond requirment will discourage exploration even if commissioner can credit work against cash deposit. Perhaps statewide performance bond based on a percentage of amount bid would satisfy.

Reaction was as I expected. Despite the overwhelming negativism, some constructive ideas came from the exchange.

Recommendations:

1) Redraft legislation taking into account some of AOGA's suggestions. This has been done (see attached draft #8, in which I have made the changes noted below.)

Key issues still appear to be:

AGO 547093

TO: R. E. LeResche
FROM: J. Roderick
DATE: 12/22/77
SUBJ: Meeting with AOGA landmen, Juneau, 12/15/77 - Proposed Leasing Legislation

a. executive-legislature relationship (have retained the "reports" to legislature).

b. number and kind of leasing alternatives (have retained net profits and work commitments).

c. escalating rentals and lease term (have shortened to 5 years).

d. "shut-in" status of fields (have added "reasonable" time in which to produce).

e. state's right to purchase oil and gas (have retained 16 2/3%).

f. acreage limitation reduction on uplands (have included a "phase-in period).

g. restriction on joint bidding (have retained).

h. maintenance of non-competitive leasing in some form (have specified "noncompetitive" as option).

i. state's right to store or trade (have retained).

2) Contact Hugh Malone to see how extensive a leasing law change is possible in the upcoming legislative session. If taken at their word, AOGA is prepared to fight "any change" in the oil and gas leasing statute.

3) I believe AOGA realizes that Alaska will eventually demand to have at least as much flexibility in leasing as the Federal government. I believe our fortunes ride to some extent on the OCS legislation now pending in in the U.S. House and for that reason I feel we should follow the OCS legislation closely and time our legislative effort accordingly.

4) Contact independent oil operators who will support methods of leasing which the major oil companies may oppose. (See enclosed sample letter for you to send to attached list of "independents" and others, including the AFN.)

5) It appears as if the high tax, low development profile of the State government over the past few years have the major oil companies in a fighting mood. The "tax ads" are the leading edge of the attack. Any leasing changes will be caught in the 1978 "political" year. Thus, consultations with key legislators is doubly important. The key policy decision remains: what changes are essential to proceed at this time toward the Beaufort lease sale in 1979 and beyond?

6) You will need to consider the disposition of the nonco petitive offers which were chosen in simultaneous drawings several years back, and over-the-counter offers. Also, the question of pending Federal oil and gas offers which appear to have a State preference right at the time

TO: R. E. LeResche
FROM: J. Roderick
DATE: 12/22/77
SUBJ: Meeting with AOGA landmen, Juneau, 12/15/77 - Proposed Leasing Legislation

of TA under existing law. The draft legislation no longer grants an automatic preference right to these Federal oil and gas offerors, so the status of these pending offers will come into question.

I will be willing to meet with you at any time to decide what course of action should be taken on these matters.

AGO 547095

COPY (MEMO ONLY) TO SNIDER

STATE OF ALASKA
THE LEGISLATURE

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

LEGISLATIVE AFFAIRS AGENCY

HAVE ENTIRE THING PUT IN MY HB 854 FILE

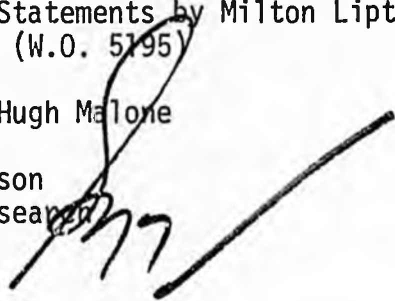
MEMORANDUM

March 28, 1978

SUBJECT: Comparison of Statements by Milton Lipton on Oil and Gas Leasing Policy (W.O. 5195)

TO: The Honorable Hugh Malone

FROM: Gregg K. Erickson
Director of Research



As you requested, we have analyzed recent statements by Mr. Milton Lipton concerning oil and gas leasing policy, and compared these with the positions taken in late 1969 and early 1970 by Mr. Lipton (Economic Considerations for Alaska's Future Oil and Gas Leasing Policy, W. J. Levy Consultants Corporation, N. Y., 1970). Although a number of the points discussed in the 1970 memorandum were not the subject of more recent comments, and vice-versa, we generally find the Lipton positions to have been consistent. We have summarized some of the high points and are attaching a copy of the 1970 memorandum.

In general, the 1970 memorandum made its strongest recommendation with respect to the rate at which lands are made available for exploration. It was suggested that a continuous and steady supply of exploration acreage would be appropriate, but that the state should feel no compunction about withholding acreage for future lease sales adjacent to lands being currently disposed of. With respect to leasing systems, the memorandum expressed general approval of the competitive leasing system currently in place, a somewhat qualified disapproval of royalty bidding, and a strong disapproval (with only minor exceptions) to the use of non-competitive leasing systems.

In 1970, as this year, Lipton argued for the establishment of work obligations in leases, but did not consider their use as a bid variable. The sliding scale royalty device, though not considered as a bid variable, was given a qualified endorsement as a lease term. However, from the context, it appears that Lipton's 1970 discussion contemplated that the highest royalty rate in the sliding scale would be 25 percent, substantially lower than the percentages presented in the hypothetical calculations made by the Department of Natural Resources.

All of the foregoing positions are consistent with Lipton's most recent testimony. In one minor change of emphasis, Mr. Lipton now seems to have some question about the desirability of acreage limitations. In the 1970 memorandum, these were explicitly endorsed.

AGO 547101

Net profits leasing and work commitment bidding were not discussed at all in the 1970 memorandum.

Please let us know if you need a more detailed analysis of any of these points.

GKE:jm
Attachment

AGO 547102

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

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

April 4, 1978

M E M O R A N D U M

SUBJECT: Legislative Role in Leasing of Oil and Gas Land - HB 854

TO: The Honorable Hugh Malone
The Honorable Merle Snider

FROM: Gregg K. Erickson
Director of Research

In testimony and private conversations concerning HB 584, administration representatives have strongly argued against any direct legislative involvement in the oil and gas leasing process. This opposition creates an important political dimension to the decision as to how (or whether) the legislature should be involved in this process. The purpose of this memorandum, however, is to explore other aspects of this issue, and to present some options for your consideration.

As currently structured, HB 854 would place the legislature in an almost totally passive position with respect to leasing. The administration would be required to make certain reports to the legislature, but any other direct influence would have to be through enactment of future legislation (including appropriations). Two major areas where some legislators might desire a more active involvement are in the choice of leasing systems, and in the selection and scheduling of acreage to be offered for lease. In each of these cases, legislative involvement could take the form of:

AGO 547103

1. A requirement that the leasing program (bidding systems) be approved in advance by joint resolution, or

2. A stipulation that the leasing program (bidding systems chosen) would be subject to a legislative veto, by joint resolution or by simple resolution of either house.

If you desire to include either of these methods (with respect to the choice of acreage, the choice of systems, or both), we would suggest that the formal document to be acted on by the legislature be a two or three year "program" and that the commissioner be required to update this each year. A legislative veto could stop all leasing, or it could simply mean that the program would go forward under the previously approved plan.

While we have not secured a formal legal opinion on the requirement for legislative approval, or legislative veto, informal consultation indicates that both systems have been used in the past in other instances, and that both would be constitutionally sustainable.

In a sense, a committee decision to advocate legislative approval of individual leasing decisions, implies that the committee cannot or is unwilling to deal in a comprehensive way with the various issues that will arise in the course of the life of this act. In any event, if the

legislature decides not to formally inject itself into the leasing process, it is likely to want a much more tightly drawn and carefully conceived piece of legislation. On the other hand, a bill which includes a provision for legislative veto could probably be written allowing much more latitude for the commissioner in his conduct of leasing policy.

Finally, it should be noted that legislature could specify more formal oversight of the leasing function without intruding directly into the leasing process. For example, the bill could require that a standing or special committee of the legislature, or a legislative staff agency submit formal reports to the legislature each year on the manner which the legislative policy is being carried out.

GKE:ftc

AGO 547105

STATE OF ALASKA
THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

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

March 15, 1978

MEMORANDUM

SUBJECT: Leasing of State Land for Oil and Gas Development - HB 854 (W.O. #11/R)

TO: The Honorable Alvin Osterback

FROM: Gregg K. Erickson
Director of Research

You requested that we provide an analysis of this bill. We have done this below in a cursory manner, and have attached additional material provided by the Department of Natural Resources (DNR). We have also noted some areas where we see potential problems. You will undoubtedly be taking a great deal of testimony on this bill from DNR, the legislature's consultants (Milton Lipton and Mason Gaffney), and the industry. After you have heard the testimony we would be pleased to address any points that you may at that time wish to have analyzed in depth.

Under current law the state is restricted to leasing oil and gas lands under the bonus bid system, or by the non-competitive system, which is essentially a lottery. However, the use of the non-competitive system has been of little importance during the past fifteen years, since all lands of medium or high potential have been classified so as to make them only eligible for bonus bidding.

In recent years other jurisdictions, most notably the federal government, have been moving towards expanding the number of bidding systems that could be used in leasing oil and gas lands. The U.S. Senate and House of Representatives have passed different versions of a bill that would accomplish this, and are about to enter conference on this legislation.

The legislation before your committee, HB 854, resembles this federal legislation in a number of important ways. The major thrusts of both the Alaska bill and the federal legislation are directed at expanding a number of leasing systems that may be used by the government in disposing of its land, increasing the opportunities for smaller firms to participate in development of oil and gas resources, and at insuring that the government achieves an appropriate return for the leasing of its oil and gas lands. In addition, the federal legislation establishes

AGO 547106

procedures for coordination and review of federal leasing plans by adjacent states, and establishes institutional arrangements for protection of the environment.

The attached material headed "Description of Leasing Methods in HB 854" sets out in summary form the systems that would be allowable under the Alaska legislation as it now stands. Also attached is a memorandum from Mr. Jack Roderick to Commissioner LeResche which describes the rationale which went into choosing these systems. This particular memorandum has been released by the Department with the request that its circulation be restricted to legislators and legislative staff. All the other attached material may be released to the public, if you so choose.

Some points which you may particularly wish to look into in your consideration of HB 854 are noted below:

1. Legislative Review. The legislation calls for submission by the commissioner to the legislature of an annual "leasing program". The administration apparently intends that no lease would be issued unless "it is for an area included in" the program (page 2, line 19). If this is indeed the intent, it perhaps could be clarified by amending language at this point. In any case, the you should note that the bill has been carefully drafted to avoid any active involvement in leasing policy by the legislature. This, of course, is no change from the current policy, but under HB 854 the latitude of the commissioner, in choosing leasing systems and in other matters, has been substantially increased, and the legislature may wish to be more involved.

2. Expenses Charged Against Royalty Oil. The bill contains language (subsection (c), on page 4) which would insure that future leases are not subject to the same sort of dispute over the cleaning and dehydration costs as the state is now litigating with the Prudhoe Bay producers.

3. Choice of Leasing Systems by the Commissioner. Nowhere in the bill does the legislature give the Commissioner of Natural Resources any guidance as to when he should or should not use a particular leasing system. The commissioner is required, in his annual "leasing program" submission, to explain to the legislature why he believes a particular system should be used in a particular area. However, the choice and the adequacy of the justification remain beyond legislative review. In the attached material DNR has provided some explanation as to the conditions that would call for the use of one system or another. The legislature may wish to consider these explanations, and - if it agrees with them - may wish to include language within the law to give the commissioner (and future commissioners) guidance along these lines.

AGO 547107

4. Work Commitment Bidding. Paragraph (4) (on page 5) would establish work commitment bidding as a leasing alternative. Under this system the bid variable would be the amount of effort the lessee agrees to expend in exploring the land. Use of this alternative will, on the average, result in less revenue to the state, with the revenue that is foregone by the state being expended in developing resources that would otherwise be uneconomic. This is a clear instance of economic subsidy. The legislature may wish to consider whether this subsidy is desirable, and if so, whether this is the most efficient way to provide it.

5. Commissioner's Discretionary Authority to Reduce Royalty. The commissioner now has authority to reduce the royalty rate on tracts having marginal production. So far as we know this authority has never been utilized. Subsection (d) of the proposed law (page 6) retains this authority to lower royalties. It becomes much more significant in the context of this bill, however, because of its use of royalty bid and sliding scale royalty leasing systems. Particularly in the case of the royalty bid arrangement, a lessee may, with a very high royalty bid, acquire a tract on the assumption that the commissioner will reduce that royalty if and when production is developed. The legislature may wish to consider the possibly of limiting this authority to only to royalties paid WHEN the production level is within the lowest block of the royalty schedule, i.e., at the bottom of the "sliding scale".

6. Non-competitive Bidding. HB 854 would allow the commissioner, at his discretion, to offer acreage on a lottery system if the acreage had not received a bid in an earlier competitive sale. The legislature should be aware that this system, in combination with initial offerings at unrealistically high minimum bids, could be used to give away the state's oil and gas resources to private individuals or firms.

We will be pleased to examine these or other questions in more detail. We are confident that Mr. Lipton, Professor Gaffney, and the industry will raise additional questions that the legislature may also wish to examine.

GKE:dh
Attachments

AGO 547108

STATE OF ALASKA
THE LEGISLATURE

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

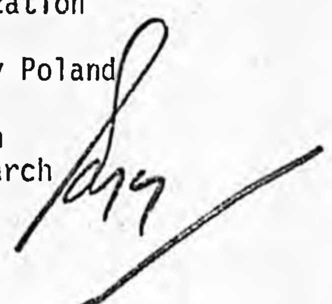
LEGISLATIVE AFFAIRS AGENCY

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

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

AGO 547109

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.

AGO 547110

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]

---

[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.

---

[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

file
HB 854
O & G Leasing

March 8, 1978

Robert LeResche
Commissioner

Position Paper on HB 854
Oil and Gas Leasing

Here is a clause-by-clause analysis of HB 854. Coupled with my memo to you of February 23, 1978, you should have much of the information needed for the hearings scheduled before the House Resources Committee on March 16 and 17. Note that I am already recommending amendments. Perhaps we should offer them on the 16th. Milton Lipton is to testify after us on the 16th; Mason Gaffney will testify on the 17th.

Section 1

(a) Purpose clauses - self explanatory

Choice of the phrase ".......minimize the exploitation of these natural resources...."
(1)(B) meaning to reduce uneconomic exploration, may be unfortunate. These words do not mean that leasing is opposed. Likewise the phrase "....while minimizing revenue from unsuccessful exploration ... (1)(D) which means the state's desire to share less in bonuses and more ... royalties, etc.

(b) Five year leasing program. As precisely as practicable, the commissioner determines the size, timing and location of leasing which he expects to take place during the following five-year period. He "approves" the program and must review "at least once each year." We may wish to change this to "no more than once each year" if more stability is desired. He may "revise" and "reapprove" the leasing program.

The leasing program is submitted to the legislature "for its information" (not approval) within 10 days after the convening of each regular session. The first leasing program is due on or before January 1, 1980.

(4) Leasing program procedures. An AMENDMENT deleting "by regulation" will be necessary. We believe it will be sufficient for the commissioner to establish procedures for the formulation review and revisions to the leasing program. Pre-leasing regulations, which apply to the sales, will be in addition to these leasing program procedures. Should regulations be required for the leasing program, any revisions by the commissioner would probably require a formal hearing or hearings. We feel this would not be necessary.

Included in the procedures will be nominations of areas to be included or excluded from the leasing program, and notice to the federal and local governments and to the public who wish to participate ... the development of a leasing program are called for, as well as coordination with the CZM program.

Perhaps an AMENDMENT specifying which federal (Dept. of Interior?) and local (boroughs?) agencies should review.

AGO 547058

(5) Annual bidding method report is submitted to legislature within 10 days of the convening of each regular session. The report includes:

(A) A schedule of all lease sales held during preceding year and bidding method or methods used;

(B) Schedule of all lease sales to be held the next year and bidding method or methods proposed to be used;

(C) Cost-benefit analysis associated with each method;

(D) Reasons why a bidding method was selected;

(E) The reasons why more than 50% of the area leased in the upcoming year is to be leased under one particular bidding method;

(HR 1614, the House OCS bill, requires that sliding scale royalty, net profits and work commitment bidding methods be used not less than 20% nor more than 50% of the time.

This provision applies for 5 years, but can be waived by the Secretary. S9 requires, for five years, that bonus bidding not be used more than 50% of the time in areas where there has been "no development" prior to October 1, 1975. The Secretary determines these areas.)

(c) HB 854 requires that all lands will be first offered competitively. Only one bid variable will be used in any bidding method. Bids will be sealed, or other methods can be used. The state's royalty share will be free of all lease or unit expenses, including separation, cleaning, etc. costs.

Following a pre-sale analysis, the commissioner may choose at least one of the following leasing methods (which are all included in HR 1614 or S9):

(1) Bonus bidding

(A) Cash bonus bid with a fixed royalty - this is the present competitive method

(B) Cash bonus bid with a sliding scale royalty (see B. Wondzell's Memo dated 3/1/73 attached)

(2) Royalty bidding

(A) Fixed bonus with royalty as the bid variable

(B) Fixed bonus with sliding royalty as the bid variable

(3) Net profit bidding

(A) Cash bonus bid, fixed royalty, not less than 30% net profit (in OCS legislation 30% net profits equates to 12½% royalty)

(B) Fixed bonus, bid net profit--this is the only bidding method that does not require of royalty of not less than 12½%. "In kind" taking is protected by the state's right to purchase (v).

(C) Fixed bonus, fixed royalty, bid net profit

(D) Net profit share is "royalty" for Permanent Fund

(4) Work commitment bidding

Fixed bonus, or fixed royalty, or fixed sliding scale royalty, or fixed net profit, or any combination. Work commitment bid in dollars. 20% of the dollar amount bid in cash or performance bond required at the time of bid.

State may recover unperformed amount. Commissioner may terminate if work is unnecessary or cumulative. Regulations will permit the inclusion of all costs, except lessee's general overhead, toward work commitment. (S-9 requires 100% cash or performance bond. HR 1614 fixes a bonus at not less than $62 per hectare ($25/acre) and fixes the royalty at 12½% or 30% net profits.)

(d) Regulations allowing reduction of royalty during declining production, beginning two years after initial production. (HR 1614 allows the Secretary to eliminate any royalty at any time.)

(e) Commissioner may defer any part of the payment of the cash bonus up to five years.

(HR 1614 - same)

(f) Commissioner may withhold acreage from particular sale - this provision may be unnecessary unless legislature feels authority should be specified in order to withhold a tract from leasing block.

(g)(h) Regulations governing net profits and work commitments will be adopted. (Question: Should definition of allowable costs in net profits and work commitment be in the bill? Ad Hoc leasing committee thought not.)

(i) With consent of the leaseholder, state may store or trade its royalty. (HB 815 addresses this matter and appears to prohibit all storing; i.e. underlifting or overlifting.)

(j) Maximum size of lease is 5,760 acres, except subsec.(t). Presently, uplands 2,560 acres, offshore 5,760 (same as OCS).

Lease term 5 years, (except up to 10 years if environmental conditions severely restrict operations) or so long as produced in paying quantities (same as OCS). Unit or drilling will hold a lease. Commissioner must give

TO: LeRESCHE
FROM: RODERICK

reasonable time to place a shut-in well on producing status (same as existing law). Rental may be increased not to exceed 150% of the rental the preceding year for a lease held past the primary 5-year term. (Presently a minimum royalty of $1/acre is charged on shut-in leases). By regulation, commissioner may require the lessee to drill deeper or the deeper horizons revert to state for resale. (Perhaps this requirement to drill deeper can be accomplished by inserting stronger due diligence language in lease contract.)

(k) Freeze rental at abandonment or until royalty, net profit or work commitment exceeds rental for 3 consecutive years.

Rentals are: Year 1 = $1.00/acre
Year 2 = $1.50/acre
Year 3 = $2.00/acre
Year 4 = $2.50/acre
Year 5 = $3.00/acre

(present rentals - competitive $1/acre; noncompetitive .50¢/acre)

(l) May issue holder of a federal or private lease or state shorelands lease within its boundaries. Term may not exceed 5 years. (These are lands determined to be "navigable" during lease term.)

(m)(n) Unitization (existing law). No changes.

(p) Pooling for well spacing (existing law). No changes.

(q) Development or drilling contracts (existing law). State may share in the costs of exploration (new). These contracts have been authorized for years, but never used. We did not delete from HB 854 in order to allow the legislature to decide to eliminate or to keep. Work commitment and subsection(t) could replace these contracts. (S9, OCS, Federal government can share in exploration costs.)

(r) Subsurface storage (existing law). AMENDMENT. By error last line in existing law was not included. Should be added.

(s) Lessee's report on "local hire" (existing law). Provision required in lease (new).

(t) Tracts receiving no bids may be offered on flexible terms including noncompetitive. [illegible] include a sliding scale royalty. Rentals may be less than in subsec(k) and tracts may exceed 5,760 acres in size.

(u) Authority to restrict joint bidding by major or multi-national oil and gas companies to encourage competition.

(HR (HR 1614 restricts joing bidding to companies who have 1.6 million barrels or more per day production. Also, anti-trust review by the Attorney General and the Federal Trade Commission is required.)

AGO 547061

(v) State may purchase up to 16.66% of oil and 100% of gas production at the regulated price or fair market value. Purchased petroleum may be used as "in-kind" royalty.

(w) The commissioner is given the right to obtain "all data" obtained from exploration, development or production from the lease. This is simply the lessor's recognized right to have what information it deems necessary to intelligently manage its land. (Title 30, Section 251.12, Code of Federal Regulations gives the Secretary the right to inspect and select for at least one year any or all geological or geophysical data collected by the lessee. This includes geophysical data, processed geophysical information and reprocessed information. It does not include interpreted geological or geophysical information. Data must be kept confidential for ten years after the issuance of the permit, and, then, processed, reprocessed and interpreted geophysical information is released to the public. Geological data and analyzed and interpreted geological information obtained from deep strategraphic tests are released five years after completion of the test well or 60 calendar days after the issuance of the first Federal lease within 50 geographic miles of the test site, whichever is earlier.)
POSSIBLE AMENDMENT TO INCLUDE CONFIDENTIAL STATUTE AS 38.05.035

Section 2

Notice requirements of AS 38.05.135(b) retained for competitive sales; deleted for noncompetitive

Section 3

Upland acreage limitation reduced from 500,000 acres to 200,000 acres. Offshore maximum acreage remains at 500,000 acres. AS 38.05.140(c)

Section 4

The priority given a Federal oil and gas offer to a state noncompetitive lease is extinguished. AS 38.05.145(b) This provision now provides that if lands on which a federal oil and gas noncompetitive lease offer exists is classified as competitive by the state within 90 days of receipt of tentative approval from Interior, the priority given the Federal offeror to a state noncompetitive lease is extinguished. I believe an AMENDMENT to HB 854 will be necessary to specify that as of the effective date of the Act all state lands will be classified as competitive. Thus, any lands which subsequently are tentatively approved will not grant a priority to a noncompetitive offer. Approximately 80 Federal offers have earned a preference right and will be awarded state noncompetitive leases under the existing law. The amendment will need to protect these existing rights.

HB 654 will also need an AMENDMENT to AS 38.05.180 which will specify the extension rights of existing state noncompetitive leaseholders. Under AS 38.05.180(c) upon expiration of the initial five-year term of a noncompetitive lease the lessee is entitled to a five-year extension unless the lands are determined to be competitive in which case the lease is extended for only two years.

TO: LeRESCHE
FROM: RODERICK

The AMENDMENT should read:

"A noncompetitive lease existing at the affective date of this Act shall be extended for a period of two years and so long thereafter as oil and gas is produced in paying quantities. A noncompetitive lease extended under this paragraph is subject to the rules and regulations in force at the expiration of the initial five-year term of the lease. No extension may be granted, however, unless within a period of 90 days before the expiration date a.. application for extension is filed by the record title holder or an assignee whose assignment has been filed for approval, or an operator whose operating agreement has been filed for approval."

cc: J. P. Green

TESTIMONY ON

<u>ALASKA LEASING POLICY BILL</u>

(H.B. 854)

By
Rod L. Boane
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Exxon Company, U.S.A.

Before The
State of Alaska
House Resources Committee

Juneau, Alaska

March 17, 1978

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Mr. Chairman 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.

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- <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

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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 royalty 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.

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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.

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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

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

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 committment 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.

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(1) <u>AS38.05.180(v) Right to Purchase</u> - 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?

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(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

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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

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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.

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TESTIMONY ON H.B. 854

Mr. Chairman, members of the committee, my name is John Carson, and I appreciate the opportunity to comment on House Bill 854.

I've been a petroleum geologist for 22 years, 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. I've lived and worked in this state, and 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 five-year leasing program for Alaska. We believe the state should be encouraged in its effort to establish and maintain such a long-term program, with appropriate industry participation.

Members of the committee, the petroleum industry--as indicated by its response to your 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.

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I will say candidly that this legislation is untenable from our point of view. If enacted into law, H.B. 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.

The situation we face today reminds me of a quote I heard the other day attributed to an executive of Walt Disney Productions, which recently announced that it was abondoning its latest recreation complex because of excessive and oppressive regulation.

The Walt Disney executive blamed the end of the project on, and I quote: "An irresponsible proliferation of delays, the never-ending requests for more irrelevant information and studies, and bureaucratic sidetracking and meanderings into unreasonable alternatives."

I realize this is the first of many hearings on this legislation, but H.B. 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 before the legislature; 6) the Commissioner's right to ban joint bidding by major companies; and 7) reduced acreage chargeability on state uplands.

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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:

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.

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.

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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.

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 lessor 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.

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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 to Mississippi, 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.

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?

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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 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 tracts of the sale.

The second proposed bidding method we are concerned about is net profit bidding. This system has most of the disadvantages of royalty bidding plus two more: It requires a huge staff to administer and audit.

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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.

Work commitment bidding is the least onerous alternative to cash bonus bidding methods and would be beneficial, provided that it is enforceable. We view this method with some caution because of the uncertainty of the conditions under which it might be imposed.

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.

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

Second, it is the simplest and easiest 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.

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