

ALASKA LEGISLATURE COMMITTEE FILES 1985-1986 86/2

4269 SRES SB 309

2749

Chugach feels that the determination of royalty value should be based on long term contract price. A shift to prevailing market value will cause a rate increase for a very large number of consumers. Chugach also feels that the prevailing value method of determination injects uncertainty into power supply planning and and rate stabilization efforts. For these reasons, Chugach supports a change to state law to base royalty value on long term contract price. Proponents of the Alaska Natural Gas Pipeline also support changing the law because they feel the ability to secure financing for the pipeline would be impaired without the added price stability this change in statute would cause.

The Department of Natural Resources opposes any such change in the law. The Department feels that as land manager for the entire state, it is its responsibility to collect fair royalty value for all state leases and that failure to pursue collection of fair value on all leases would be selective enforcement. In addition to directly reducing state revenues, the Department of Law has advised that such actions could indirectly set precedents which would impair the state's ability to enforce the royalty provisions of North Slope leases. DNR feels that existing law provides a mechanism for long term royalty certainty.

In this packet are:

- 1 - the relevant paragraphs from lease form DL-1
- 2 - letters from the Resource Development Council and the Naknek Electric Association and a resolution by Alaska Rural Electric Cooperative Association in favor of valuation based on long term contract price.

3 - Department of Natural Resources Decision Memo No. 25, Royalty Gas Valuation -- Cook Inlet, November 6, 1984, (Note - Some of the issues mentioned in this memo have subsequently been decided by the courts. In addition, the figures mentioned in the memo have been revised. The memo remains, however, a valuable document in the understanding of this issue.)

4 - Cook Inlet Royalty Gas Valuation - An Overview by the Department of Natural Resources, February 6, 1986

5 - Impacts of State Royalty Gas Increase on Railbelt Consumers by Chugach Electric Asscciation

6 - Settlement offer letter by the Department of Law, January 6, 1986

7 - Chugach's response to the State of Alaska's January 6, 1986 settlement offer

Representatives of the Department of Natural Resources, Chugach Electric, and other interested parties will be present at the hearing to testify and answer questions.

STATE OF ALASKA
DEPARTMENT OF NATURAL RESOURCES
Division of Lands

LEASE NO. ADL _____

Competitive Oil and Gas Lease

11. **ROYALTY ON PRODUCTION.** Except for oil and gas used on said land for development and production or unavoidably lost, Lessee shall pay Lessor as royalty the following:

- (a) On oil.....per cent in amount or value of the oil produced and saved and removed or sold from said land.
- (b) On gas.....per cent in amount or value of the gas produced and saved and sold or used off said land or used for the extraction of natural gasline or other products therefrom.
- (c) On associated substances.....percent in amount or value of such substances produced and saved and

14. **ROYALTY IN KIND.** Whenever, at the option of Lessor, which may be exercised from time to time upon not less than six months notice to Lessee, Lessor elects to take its royalty in kind, Lessee shall deliver free of charge (on said land or at such place as Lessor and Lessee mutually agree upon) to Lessor or to such individual, firm, or corporation as Lessor may designate all royalty oil and/or gas produced and saved from said land. Such oil and/or gas shall be in good and merchantable condition. Lessee shall, if necessary, furnish storage for royalty oil free of charge for thirty days after the end of the calendar month in which the oil is produced from said land; provided, that Lessee shall not be held liable for loss or destruction of royalty oil and/or gas from causes beyond Lessee's reasonable control. Should Lessee dehydrate or clean the oil or gas produced from said land, Lessee shall be entitled to an allowance of the actual cost of dehydrating or cleaning said royalty oil or gas.

15. **ROYALTY IN VALUE.** At the option of Lessor, which may be exercised from time to time upon not less than six months' notice to Lessee, and in lieu of royalty in kind, Lessee shall pay to Lessor the field market price or value at the well of all royalty oil and/or gas. All royalty that may become payable in money to Lessor shall be paid on or before the last day of the calendar month following the month in which the oil or gas is produced. The payments shall be accompanied by copies of run tickets or other satisfactory evidence of sales, shipments, and amounts of gross production.

16. **PRICE.** The field market price or value of royalty oil or gas shall not be less than the highest of: (1) The price actually paid or agreed to be paid to Lessee at the well by the purchaser thereof, if any; or (2) The posted price of Lessee in the field for such oil or gas at the well, if any; or, (3) The prevailing price received by other producers in the field at the well for oil of like grade and gravity or gas of like kind and quality at the time such oil or gas is removed from said land or run into storage, or such gas is delivered to an extraction plant.



Resource Development Council

for Alaska, Inc.

SB 309
Bill File

807 "G" Street, Suite 200, Anchorage, Alaska 99501-3440
Box 108516, Anchorage, Alaska 99510-0516 - 907/276-0700

January 20, 1986

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Senator Arliss Sturgulewski
Alaska State Senate
Pouch V
Juneau, AK 99811

JAN 20 1986

re: SB 309, Royalty Gas Valuation legislation

Dear Arliss:

I want to take this opportunity to make you aware of our concerns regarding the merits of SB 309, the royalty gas valuation bill.

The Resource Development Council strongly supports SB 309. This bill will set forth a fair and stable royalty valuation policy for the state.

DNR recently changed its policy for valuing the royalty share of natural gas extracted from state leases in Cook Inlet. Previous to this change the state calculated its royalty at the price received by the producer. DNR's new position is to calculate its royalty share based on the current market value of the gas, not the price paid to the producer.

The old valuation policy, statutorily mandated by SB 309, is the better state position for the following reasons:

1) The first and most obvious is the fairness issue. Why should the state receive more value per unit than the producer? If the state is of the opinion that the producer is selling his product for an inappropriately low price, the state has the option to receive its royalty share in kind, as opposed to in value, and can sell it for whatever price it can obtain.

2) Another significant issue is stability. If DNR intends to change the value of its royalty share whenever the market price fluctuates, it will effectively doom a number of development projects with enormous potential for our state. The most obvious of these is the Trans-Alaska Gas Line.

The present state policy would make it almost impossible to finance the gas line because of the uncertain value of the state's royalty share. It is hard to imagine that a foreign buyer of North Slope gas will consider a purchase contract of sufficient length to gain adequate financing if the state can adjust the value of its royalty share at any given time. The gas line is essential to our future

Senator Arliss Sturgulewski
January 20, 1986
page 2

and we must not take any actions which would inhibit its development unnecessarily. Every other project in which the state holds a royalty interest could suffer the same fate.

3) The last significant concern is that the market price for natural gas could someday fall below the price set in a contract. In that case, using the rationale of the present administration, the state would make less money per unit than the producer. This scenario may seem unlikely now, but given the volatile nature of energy prices it is certainly not unforeseeable.

The old state policy, made law by SB 309, insures that the state receives one-eighth of the monetary value gained by the leaseholder from the resource.

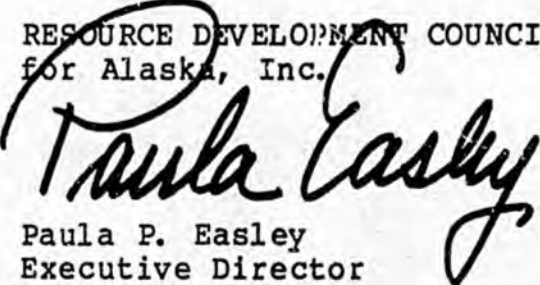
Despite the perception of some members of the administration that the issue is important only to the utilities or the leaseholders, it is in fact important to our entire economy which seems certain to rely on resource development on state lands for some time. As the owner of so much land and resources in Alaska, state government must behave in a manner which insures consistency and fairness as well as an equitable return on our resources.

We support your efforts to insure a timely review of this bill in the Senate Resources Committee. This is an issue which merits action by both the House and Senate in this session.

Please call on RDC if there is anything we can do to help you gain support for this legislation.

Sincerely,

RESOURCE DEVELOPMENT COUNCIL
for Alaska, Inc.



Paula P. Easley
Executive Director

cc: Members, Senate Resources Committee
Senator Jan Faiks
Phil Holdsworth



ALASKA RURAL ELECTRIC COOPERATIVE
ASSOCIATION, INC.

237 E. FIREWEED LANE • SUITE 301
ANCHORAGE, ALASKA 99503 • (907) 276-3235

ARECA

Resolution 85-19

Royalty Gas Revaluation

WHEREAS the Alaska Department of Natural Resource's recent decision to base the state's natural gas royalty on the highest value of gas rather than the contract price of gas; and

WHEREAS DNR's decision reversed a long-standing policy and was taken unilaterally without input from the public, the State Legislature, parties to existing gas contracts or other parties; and

WHEREAS DNR's royalty gas revaluation will cost consumers of Chugach Electric Association, Matanuska Electric Association and Homer Electric Association many millions of dollars; and

WHEREAS consumers of other cooperatives such as Golden Valley Electric Association and Copper Valley Electric Association would be adversely affected should those co-ops avail themselves of natural gas-fired generation,

BE IT THEREFORE RESOLVED that DNR reverse its royalty gas revaluation decision and any such future proposal be subject to timely, meaningful public and legislative input.

I hereby certify this to be a true and correct copy of Resolution 85-19 adopted at the Alaska Rural Electric Cooperative Association, Inc. Annual Meeting, August 10, 1985.

David Hutcheon

Executive Director

November 5, 1985

Date.



FEB 4 1986

NAKNEK ELECTRIC ASSOCIATION, INC.

POST OFFICE BOX 118 • NAKNEK, ALASKA 99633 • PHONE (907) 246-4261

January 30, 1986

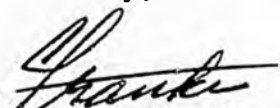
The Honorable Arliss Sturgulewski
Senate Resource Standing Committee
Alaska State Legislature
Pouch V (MS 3100)
Juneau, Alaska 99811

Dear Senator Sturgulewski:

We write with concern of S.B. 309 and the economic impact of rural consumers reduction of Power Cost Equalization (PCE), in the event of failure of S.B. 309.

As power costs of the "railbelt" elevate, PCE entitlement will decrease, consequently, we should like our concern made a part of the comment in the bill hearing. Thank you.

Sincerely,


Claude E. Franke
General Manager

cc: Senator Fred Zharoff

MEMORANDUM
DEPARTMENT OF NATURAL RESOURCES
DIVISION OF OIL AND GAS

State of Alaska

TO: Esther C. Wunnicke
Commissioner

DATE November 6, 1984

FILE NO:

TELEPHONE NO 265-4241

FROM: *duj*
for Kay Brown, Director
Division of Oil and Gas

SUBJECT Decision Memo No. 25
Royalty Gas Valua-
tion -- Cook Inlet

Statement of the issue: Should the state accept long-term gas contract prices as being determinative of royalty value where those prices have become significantly below current market prices because of escalating gas values?

Background: As a general matter, producers have calculated and paid their royalty as to each volume of gas based upon the contract price applicable to that volume of gas. As gas prices have escalated, the issue has arisen here, as it has in other jurisdictions, whether an older long-term contract price may control the royalty amount for gas produced and sold under that contract, even after the market value has escalated well above the contract price. Depending upon the particular jurisdiction and the governing language of particular leases, court cases have split on the issue. The issue has not been addressed by any court in the State of Alaska.

Considerations:

- o Legal analysis. Although court cases interpreting various other lease forms have gone each way in other jurisdictions, the Department of Law advises us that the proper construction of state oil and gas lease form DL-1 is that a long-term contract price should not control royalty valuation when current market price or value is higher.
- o Impact on oil and gas companies. Oil and gas companies have an obligation to diligently produce and market oil and gas. The companies believe it is unfair to have their royalty payments based upon high current market price values where (they argue) the only available means of marketing the gas in the past was by means of long-term contracts with either a fixed price or a defined escalation clause. Apparently in recognition of the possibility that the royalty value might be construed to be higher than the long-term contract price, however, the producers have mitigated, in large part, the impacts of escalating

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DIVISION OF OIL & GAS
ANCHORAGE, ALASKA

values by means of pass-through provisions in their sales contracts. These provisions make the gas purchaser liable for any additional royalty. Also, producers increasingly are insisting upon price re-openers for their long-term contracts. Such price re-openers allow the producers to benefit from escalating values on their share of the gas, while also protecting the producers against an increased royalty burden. Thus, as a general matter, the producers can protect themselves against the possibility of higher royalty obligations. However, there are possible exceptions. For instance, Union Oil Company has committed a large volume of gas for use in its own major urea processing plant. Union's royalty obligation will be higher on the gas committed to that plant if long-term contracts are considered inappropriate references in the computation of market price or value. Union may not be able to pass any increased cost through to its urea customers. However, if the application of the royalty term as written becomes too onerous, the lease provides a mechanism for seeking royalty reduction. See DL-1, ¶ 13. Thus, even those producers which cannot pass higher royalty obligations on to their customers have a limited remedy under the lease.

- o Impacts on gas purchasers. The principal long-term gas contracts in Cook Inlet which would be affected by this decision are between Chugach Electric and Chevron, ARCO and Shell (Beluga River Field), and between Enstar/Alaska Pipeline Company and Marathon and Union (Kenai Field). The long-term Chugach contract price is 21¢/Mcf, and the long-term Enstar/APC contract price is 61¢/Mcf. By contrast, prevailing current prices exceed \$2.00/Mcf. For instance, the recent long-term contracts for Cook Inlet gas have fluctuated between a high of \$2.32/Mcf and the present \$2.055/Mcf. Although seven-eighths of the gas sold under the 21¢/Mcf and 61¢/Mcf contracts would continue to be bound by those contract prices, the governing contracts permit the producers to pass on through to Enstar/APC and Chugach the burden of higher royalty rates on the one-eighth of the flow attributable to the state's royalty. It is uncertain whether Enstar and Chugach could, in turn, legally pass the charges through to their customers if the state collects additional royalties retroactively. Moreover, even if the

royalties were collected at the higher valuation rate only prospectively, the ability of the companies to pass the costs through to their consumers would be subject to Alaska Public Utilities Commission rate proceedings. Thus, the imposition of royalty valuation based upon current market prices or values could have adverse impacts upon Anchorage area utility companies.

- o Impacts on consumers of gas and gas-generated electricity. Ultimately, it is anticipated that the brunt of higher valuation on royalties attributable to long-term contract volumes will be borne by consumers of gas and electricity in the Anchorage area. It is estimated that this impact would probably be an increase over current rates of more than 10 percent, but less than 20 percent.
- o Impacts on state revenue. Obviously, the consequences of higher royalty valuation include increased royalty revenue to the state. It is estimated that eschewing long-term contract prices for current values would, under present conditions, result in additional royalty collections of approximately \$8.5 million per year from the state's Cook Inlet area leases. The impact upon North Slope gas royalty revenue is relatively insignificant at this time.
- o Uncertainty. The fluctuation of royalty value independently of the contract price under which gas is sold injects uncertainty into the long-term planning by oil companies and utilities. This uncertainty (and higher royalty rates) may reduce incentives to invest capital in oil and gas and utility enterprises, or affect the timing or structuring of such enterprises. For instance, the state's royalty treatment of long-term gas contracts might affect North Slope gas marketing.
- o Impacts on royalty collection by the United States and CIRI. The United States and CIRI are also lessors of oil and gas leases in the Cook Inlet area. The United States distributes 90 percent of the onshore royalties it collects to the state. CIRI shares its royalties with other ANCSA corporations under section 7(i) of ANCSA. Alaska has previously joined other states in encouraging the United States to ensure full royalty

collection through, among other things, using current prices or values in calculating the royalties due for gas sold under long-term sales contracts. By requiring royalty valuation according to current market values for state leases, the state would further its relations with the ANCSA corporations and other states, and would lend support to current federal royalty litigation, which, if successful, will result in greater distributions to the state under its 90 percent share.

Options:

(1) Accept long-term contract prices as determinative of market value for royalty purposes, even when those prices have been eclipsed by market transactions at higher values.

(2) Reject long-term contract prices as determinative of royalty valuation where they are below current market value. In implementing this option, the state could also:

(a) Give consideration to electing to take royalty gas attributable to long-term contracts in-kind, rather than in-value. A host of practical difficulties exist with this suboption. In particular, taking gas in-kind is difficult because of the limited and inflexible transportation and storage capacities for gas (the "deliverability" factor). Nonetheless, the state could explore the possibilities, including possible sales to Enstar, Chugach, and the proposed CIRI LNG plant; and

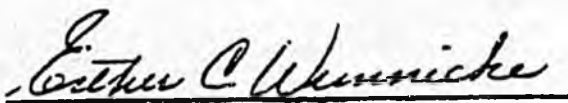
(b) Apply the decision only to prospective royalty valuations. This would ease a number of problems, including the difficulties attendant to retroactive pass-through charges to utility consumers.

Recommendation:

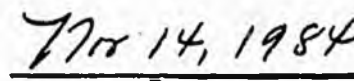
Option 2, with suboptions 2(a) and 2(b).

Decision:

I concur with the recommendations:



Esther C. Wunnicke
Commissioner



Date

Recommend Concurrence:

Timmi D. Arnold
Bob Arnold
Deputy Commissioner

11/15/84
Date

James K. Barnett
James K. Barnett
Deputy Commissioner

11-19-84
Date

COOK INLET ROYALTY GAS VALUATION:
An Overview

Esther C. Wunnicke, Commissioner
Alaska Department of Natural Resources

Kay Brown, Director
Division of Oil and Gas
Alaska Department of Natural Resources

Bill Van Dyke, Petroleum Manager
Division of Oil and Gas
Alaska Department of Natural Resources

February 6, 1986

2/5/86

COOK INLET GAS SUMMARY

Lease interpretation: Under the terms of its oil and gas lease contracts with the oil companies, the state is entitled to royalty payments determined by the higher of the price received by an oil company under its sales contract, or the value of the gas at the time of production. This means that the price received under a long-term gas sales contract does not control royalty valuation in those instances where inflation and market forces have caused the current value of the gas to be higher than the contract price.

DNR policy:

(1) As land manager for the citizens of the entire state, it is DNR's responsibility to obtain fair value for the state's oil and gas resources by collecting the full royalties to which the state is entitled under its oil and gas leases.

(2) DNR should not selectively abdicate its responsibility to enforce the royalty terms of the Cook Inlet gas leases just because utility companies have agreed as part of their gas purchase contracts to reimburse the oil companies for royalty collections made by the state. Any consumer subsidy should be the result of an affirmative, direct subsidy by the legislature as part of a comprehensive energy policy.

(3) DNR should not divert from uniform enforcement of the oil and gas leases, since such action could, in addition to directly reducing revenues from any leases from which royalties are not fully collected, also indirectly cause a much larger reduction in state revenues by impairing the state's ability to enforce the royalty provisions of the North Slope leases.

The potential consumer impact result from actions by Chugach, not the state. The risk that gas values might escalate to values in excess of the long-term gas sales price was a circumstance foreseen by the parties to those sales contracts. This is demonstrated by the fact that the contracts between the oil company lessees and Chugach Electric Association, Inc. (Chugach) specifically assign to Chugach the risk of any rise in royalty obligations. The state was not a party to those sales contracts. The contract price, the absence of an adequate price escalator or price reopener, and the assignment to Chugach of the risk of increased royalty obligations were all conditions established by contract between Chugach and the lessees without state participation.

Existing law provides an adequate mechanism for long-term royalty certainty: DNR is sympathetic to the desirability of long-term certainty in royalty matters. However, new statutory authorities are not necessary in order to provide such certainty. Royalty certainty can be attained by negotiation of long-term in kind gas sales contracts which parallel the contracts between the state's

lessees and their gas purchasers. This would allow an opportunity for DNR, the royalty board, and the legislature to evaluate the adequacy of the royalty over the life of the contract. This is preferable to being locked into a long-term royalty value set by prices established by lessees without any notice to or participation from the state.

Litigation: Last March DNR notified the Cook Inlet lessees of its determination to enforce the leases. The notices asserted that the most recent (December 1982) major contracts from the Kenai and Beluga River fields (the "APL II contracts") established the current value. These contracts had a base contract price of \$2.05 per mcf in 1985. The state subsequently indicated its readiness to accept a lower royalty value if presented with evidence that the current value of gas in Cook Inlet is less than the price established under the APL II contracts. Union, Marathon, ARCO, Chevron and Shell responded to the notices by suing the state.

Recent Cook Inlet Gas Sales Contracts:

<u>Date of Contract</u>	<u>Purchaser</u>	<u>Field</u>	<u>Starting Base Price</u>
1982	APL (Enstar)	Beluga	\$2.32
1982	APL (Enstar)	Kenai, Beaver Creek or McArthur River	\$2.32
1983	Chugach	Cannery Loop	\$1.80
1984	APL (Enstar)	Lewis River	\$1.80
1985	Tesoro	Kenai, Beaver Creek or McArthur River	\$2.01

Settlements achieved: In the last two months of 1985 DNR's royalty enforcement actions achieved significant success. Settlements relating to gas royalties due on production from the Kenai Field, and involving Marathon, Union, Alaska Pipeline Company (Enstar), CIRI, the U.S. Department of the Interior and the state, yielded the state about \$4 million in retroactive royalties, and will bring in excess of \$6.5 million per year more than the amounts which would have been paid under the lessees' prior reporting practices (including those increases attributable to the state's 90% interest in federal onshore royalties). Under the lessees' theory, the royalties would have been variously between \$0.21 and \$0.61 per mcf; under the settlement, the lessees will pay \$1.95 per mcf during 1986. The \$1.95 is squarely within the gas values established by recent Cook Inlet gas sales contracts, as well as the values established by Enstar's pending rates (\$2.1854 for Schedule C purchasers - "Large Commercial Service", and from \$1.6480 to \$2.0158 for sales to power plants). The settlements confirm the soundness of the royalty enforcement action taken last spring.

Remaining disputes: The major remaining dispute relates to the Beluga River field, the primary source of gas for Chugach.

Settlement negotiations during the last six months have failed to produce any resolution. Options explored have included underlifting the state's royalty share, thus delaying the royalty into the future; an in kind sale to Enstar or Chugach; and an in value settlement. The lessees (ARCO, Chevron and Shell) assert that they should not be required to contribute any monies to any settlement, since their sales contract with Chugach requires Chugach to reimburse the lessees for any additional royalty amount the state collects. Chugach, in turn, has been unwilling to agree to an acceptable value, and has indicated that it will seek legislative relief. Recently, the state made a formal offer to its lessees to settle the dispute for \$1.50 per mcf. This offer was rejected, but settlement efforts and discussions continue.

Consumer impact. Chugach estimates that a royalty rate of \$2.05 per mcf on state leases would increase retail consumer rates only about 2.38%, assuming the lessees were successful in asserting that their contracts with Chugach permitted them to pass the royalty burden on to Chugach, and further assuming that the APUC permitted Chugach to pass the burden on to its consumers. DNR estimates that a \$2.05 royalty would increase state revenues by about \$2.8 million per year. Under the \$1.50 per mcf settlement offer, the increase in royalty income would fall to about \$2 million per year, and the magnitude of retail consumer impact would be correspondingly reduced to less than 2%. (A two per cent increase on a monthly bill of \$30 would be only \$0.60).

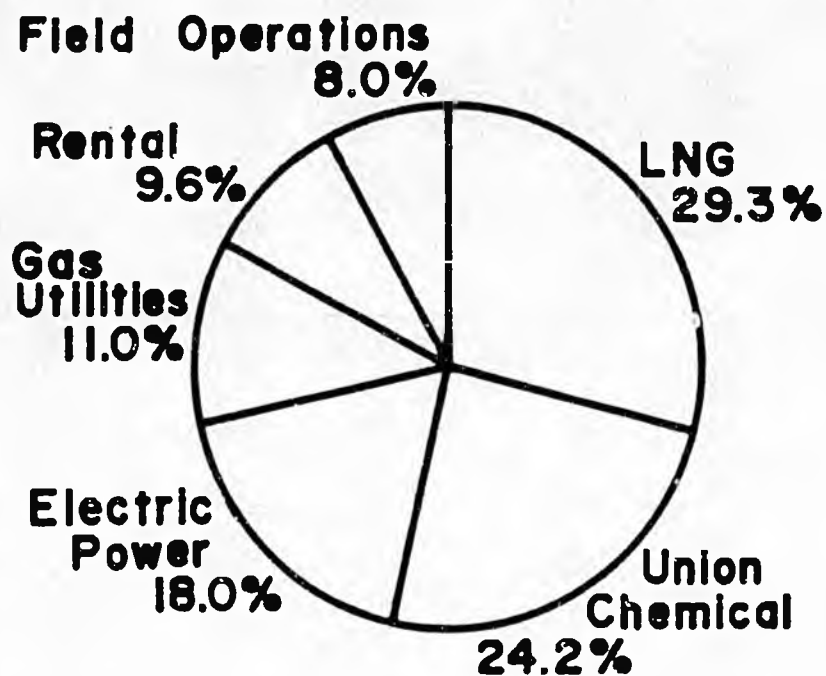
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COOK INLET GAS ROYALTY SETTLEMENTS
(State leases and State share of federal royalties)

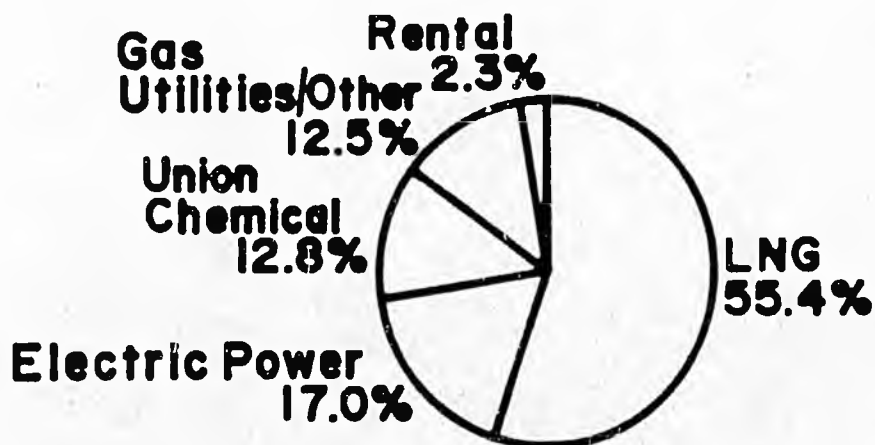
Lessee	Scope of Settlement	Retro- active Payment (millions)	Current Monthly Value Under Settlement (per Mcf)	Estimated Additional Royalties per year (millions)
Phillips	North Cook Inlet Field gas sold as LNG in Japan	\$36.3	\$2.32	\$12.00
Marathon	Kenai field gas sold as LNG in Japan	\$ 4.3	\$2.32	\$ 0.75
Union and Marathon	All of Union's Kenai field gas disposition (including the following: urea/ammonia plant, rental gas, Enstar), plus Marathon's dispositions to Enstar under Enstar's 1975 contract	\$ 4.1	\$1.95	6.90
Total		<u>\$44.7</u>		<u>\$19.65</u>

COOK INLET

Total Sales

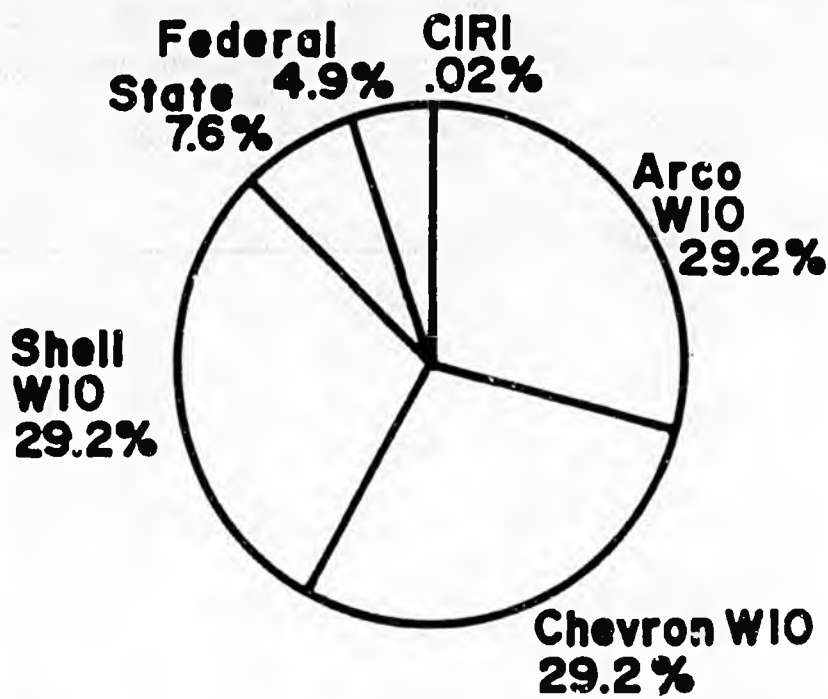


State Royalty Disposition



BELUGA FIELD

Royalty And Working Interest Ownership

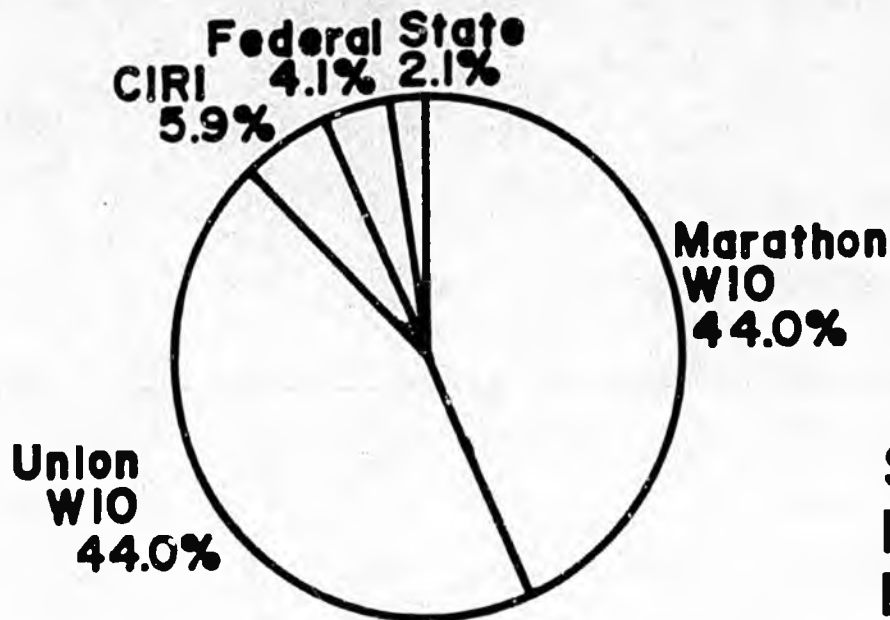


State Royalty Disposition

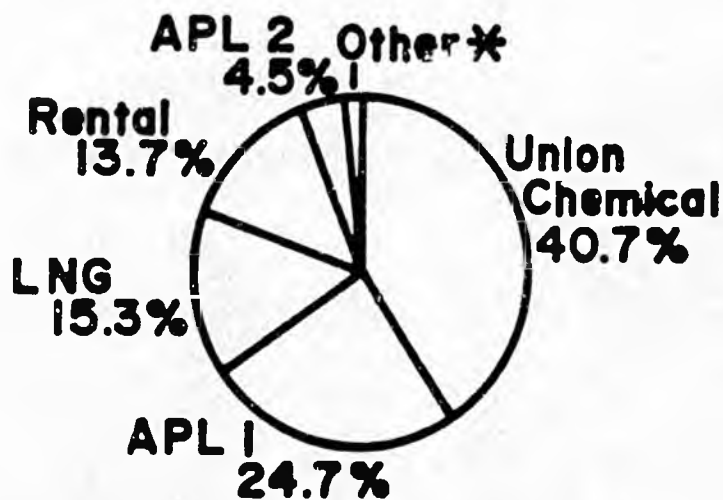


KENAI FIELD

Royalty And Working Interest Ownership



State Royalty Disposition



* APL-Nikiski 0.4%
 Union-Chevron Exchange 0.2%
 City Of Kenai 0.5%

COOK INLET GAS PRODUCTION
(For 1984)

	Total MMCF/Month	State Royalty MMCF/Month
Beluga River Field		
For: Chugach	1673	125
Enstar	<u>121</u>	<u>9</u>
Total	1794	134
Kenai Field		
For: APL 1	2029	42
APL 2	369	8
APL Nikiski	31	1
APL Kenai	41	1
Union Chevron Ex	16	1
Rental gas	741	15
Rental gas extra	389	8
Ammonia-Urea	3352	67
LNG	<u>1261</u>	<u>25</u>
Total	8229	168
McArthur River Field		
For: Rental gas and ammonia-urea	355	44
Beaver Creek Field		
For: APL 2	789	0
Lewis River Field		
For: APL 2	153	19
North Cook Inlet Field		
For: LNG	<u>3932</u>	<u>491</u>
GRAND TOTAL	15,250	856

Excerpts from Lease Form DL-1
Pertaining to the Pricing of Royalty Products

11. ROYALTY ON PRODUCTION. Except for oil and gas used on said land for development and production or unavoidably lost, Lessee shall pay Lessor as royalty the following:

(a) On oil 12-1/2 percent in amount or value of the oil produced and saved and removed or sold from said land.

(b) On gas 12-1/2 percent in amount or value of the gas produced and saved and sold or used off said land or used for the extraction of natural gasoline or other products therefrom.

(c) On associated substances 12-1/2 percent in amount or value of such substances produced and saved and removed or sold from said lands.

15. ROYALTY IN VALUE. At the option of Lessor, which may be exercised from time to time upon not less than six months' notice to Lessee, and in lieu of royalty in kind, Lessee shall pay to Lessor the field market price or value at the well of all royalty oil and/or gas. All royalty that may become payable in money to Lessor shall be paid on or before the last day of the calendar month following the month in which the oil or gas is produced. The payments shall be accompanied by copies of run tickets or other satisfactory evidence of sales, shipments, and amounts or gross production.

16. PRICE. The field market price or value of royalty oil or gas shall not be less than the highest of: (1) The price actually paid or agreed to be paid to Lessee at the well by the purchaser thereof, if any; or (2) The posted price of Lessee in the field for such oil or gas at the well, if any; or, (3) The prevailing price received by other producers in the field at the well for oil of like grade and gravity or gas of like kind and quality at the time such oil or gas is removed from said land or run into storage, or such gas is delivered to an extraction plant.

RECENT CONTRACTS AND PURCHASE AGREEMENTS

	<u>Purchaser</u>	<u>Field or Seller</u>	<u>Starting Base Price</u>
1977	Pac Alaska	Cook Inlet	\$1.46 per mcf
1982	Enstar	Beluga River	\$2.32
1982	Enstar	Beaver Creek Field	\$2.32
1982-83	Chugach	Beluga River	\$1.40-1.60
	(Peaking Gas)		
1983	Chugach	Cannery Loop	\$1.80
1984	Enstar	Lewis River	\$1.80
1985	Tesoro	Marathon	\$2.01
1985	AEG&T	Enstar	\$2.04
	(Homer Electric)		
1985	HL&P	Enstar	\$1.60
	(Anchorage)		

ALLOCATION OF GAS SOLD FOR CONSUMER USE
(Assuming the State Prevails in the Pricing Dispute)

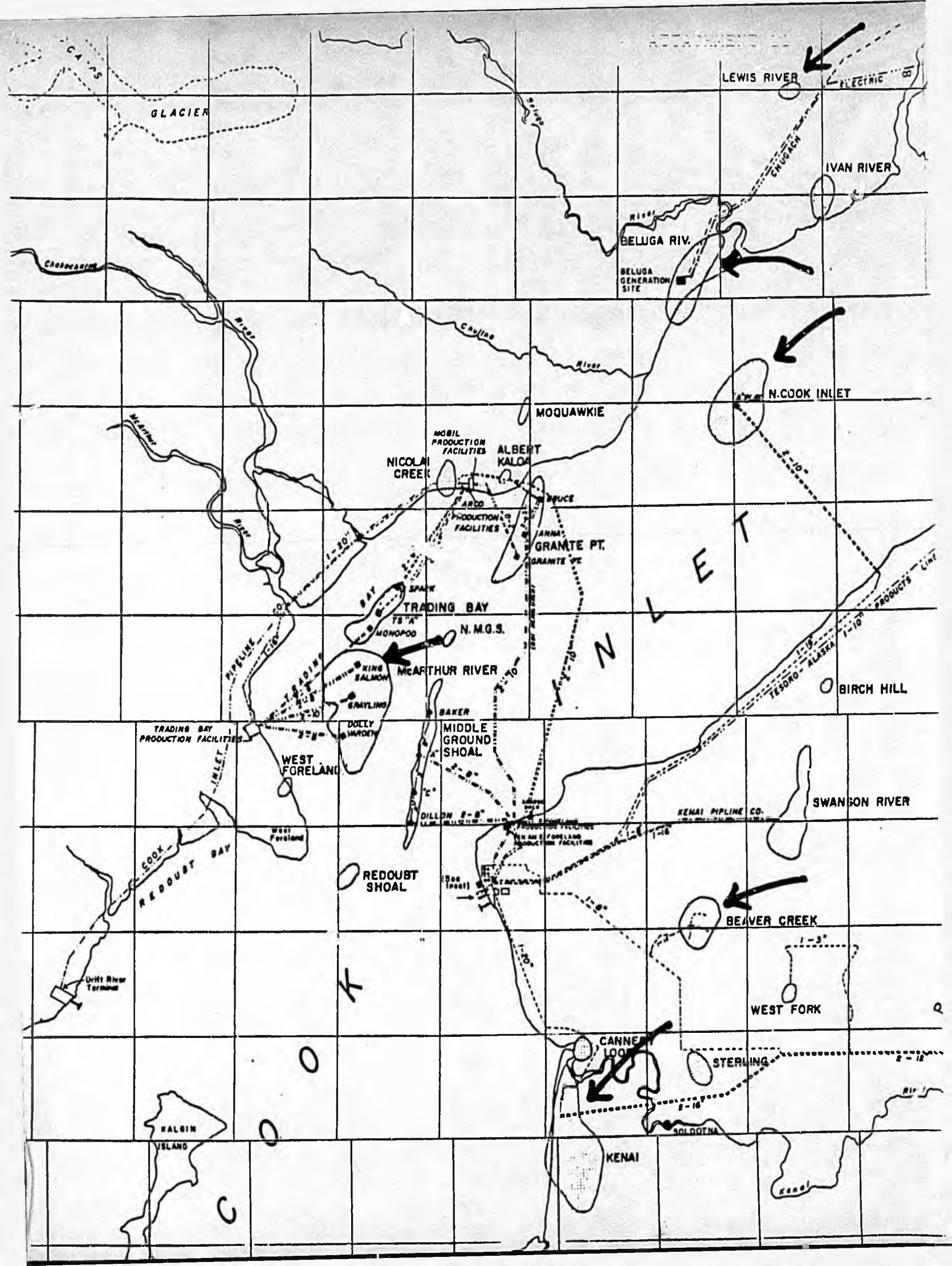
	<u>TOTAL MMCF/MONTH</u>	<u>STATE ROYALTY SHARE MMCF/MONTH</u>
Beluga River Field		
Chugach - low priced	1548	0
- high priced	125	125
Enstar - high priced	121	9
Kenai Field		
Enstar (APL 1) - low priced	1776	0
- high priced	254	42
Enstar (APL 2) - high priced	368	8
Enstar (Nikiski) - low priced	32	1
Enstar (City of Kenai) - low priced	41	1
Beaver Creek Field		
Enstar - high priced	789	0
Lewis River Field		
Enstar - high priced	153	19
Subtotal - low priced	3397	2
Subtotal - high priced	1810	203
GRAND TOTAL - all prices	5207	205

2/5/86

COOK INLET GAS ROYALTY CHRONOLOG

<u>Month</u>	<u>Year</u>	<u>Description of Event</u>
March	1964	<u>Foster v. Atlantic Refining Company</u> , 329 F.2d 485 (5th Cir. 1964) holds that long-term contract price does not control royalty valuation when market value rises, even if this is burdensome on the lessee.
May	1965	Chugach Electric Association, Inc. enters into 20 year contracts with ARCO, Chevron and Shell for Beluga River gas, with an initial price of 15.2 cents per mcf, subject to a volume limit.
January	1973	Chugach renegotiates its 1965 contracts, extending the term to 1998 (unless the new, higher volume limit is reached earlier). The 1986 base price under those contracts is about 21 cents per mcf.
November	1982	Chugach obtains supplemental gas deliveries under the 1973 contract at a base price of \$1.48 per Mmbtu (approximately equivalent to \$1.48 per mcf).
December	1982	Alaska Pipeline Company (Enstar) signs contracts for gas deliveries from Beluga River (with Shell) and Kenai (with Marathon) at a price of \$2.32 per mcf, with annual adjustments based upon fuel price fluctuations (the "APL-II" contracts). This is the first totally new contract for Beluga River gas subsequent to the 1973 Chugach contract under which there were any deliveries.
March	1984	<u>Piney Woods County Life School v. Shell Oil Company</u> , 726 F.2d 225 (5th Cir. 1984), reh. den. 750 F.2d 69, cert. den. 105 S.Ct. 1868 (1985) reaffirms the soundness and continued validity of the rule in <u>Foster</u> , above.
May	1984	The state and Phillips settle their dispute concerning the valuation of Cook Inlet gas from state leases which is sold as LNG in Japan, using a formula which initially yields a royalty of \$2.40 per mcf.
May	1984	The federal government informs Union that virtually all gas royalties from the Kenai field, including gas sold under below-current-market, long-term contracts with Enstar, must be valued in accordance with the price under the APL-II contracts.
November	1984	DNR determines, in consultation with the Department of Law, to enforce the Cook Inlet lease terms requiring payment of gas royalty on the basis of current value.

February	1985	U.S. District Judge Fitzgerald rules that Marathon must pay royalties on Kenai Field gas sold as LNG in Japan based upon the Japan sales price, less costs of transportation. Marathon calculates the netback value under the order to be about \$3.00 per mcf, while the federal government calculates the value to be about \$3.60 per mcf. The accounting remains in dispute in District Court, while the District Court's February 1985 decision is under appeal to the Ninth Circuit.
March	1985	By written notice, DNR informs its Cook Inlet lessees of its determination to enforce the royalty requirements of the leases.
May/June	1985	All Cook Inlet gas producers file separate lawsuits seeking judicial declaration of their royalty obligations under the leases.
July	1985	The state and Marathon settle their dispute concerning the royalty value of Kenai Field gas sold as LNG in Japan in accordance with the terms of the May 1984 Phillips settlement.
November	1985	The state, federal government and CIRI (all royalty owners in the Kenai field) settle most royalty issues for production from the Kenai field. Most significantly, royalty on gas used in Union's urea and ammonia plant and used to promote greater oil production from the Swanson River oil field, is set at \$1.85 per mcf for 1985 and \$1.95 per mcf for 1986, with annual adjustments thereafter based upon fluctuations in fuel oil prices.
November	1985	The Secretary of the Interior issues a definitive order holding that Cook Inlet gas sold by Union and Marathon to Enstar must be valued for royalty purposes according to current market values.
December	1985	The state, federal government and CIRI enter into a settlement agreement on the value of the royalty on Kenai gas sold to Enstar under long-term contracts. Under this settlement, the royalty owners receive \$1.85 per mcf for the part of 1985 at issue, and will receive \$1.95 per mcf for 1986 production, with annual adjustment thereafter based upon fluctuations in the oil prices.
January	1986	The state offers to the producers to settle the dispute concerning the royalty value of gas sold to Chugach. This \$1.50 per mcf offer is rejected by the producers, but settlement discussions continue.



IMPACTS OF STATE ROYALTY GAS INCREASE ON RAILBELT CONSUMERS

Alaskans from Fairbanks to Homer face utility bill increases as a result of the Alaska Department of Natural Resources' decision to drastically raise the price of royalty gas in Cook Inlet. For Chugach Electric Association consumers in the Anchorage area, the impacts will be nearly \$3 million a year.

DNR's action was taken with virtually no advance notice to the parties involved, to the public or to the State Legislature. Litigation was initiated by the three producers against DNR on the revaluation in April 1985. Chugach is also involved in the litigation.

There are two major aspects of this issue: The additional costs to utility consumers of DNR's actions and, perhaps more important, the fundamental policy question of how royalty valuation is established.

On March 18, 1985, the Department of Natural Resources (DNR) issued a formal notice to the three Beluga River gas field producers -- ARCO, Shell and Chevron -- informing them that DNR would no longer accept royalty payments based on long-term contract price but would require payments based on the "prevailing market value."

This value was initially determined by DNR to be \$2.05 per thousand cubic feet (mcf), based on a Shell-ENSTAR (APL II) contract signed in December 1982. By contrast, Chugach currently pays \$.26/mcf for its Beluga gas, under long-term contracts on which the DNR had based its royalty price for the past 17 years.

Based on the \$2.05/mcf figure, the annual increase to Chugach retail and wholesale consumers would be approximately \$2.8 million. Even under a recent settlement offer by the state which would value the royalty gas at \$1.50/mcf, the impact would be approximately \$1.9 million annually.

Chugach negotiated its Beluga contracts in good faith and at arms length in 1965, and renegotiated with the producers in 1973. The contracts extend to 1998 or whenever 373 billion cubic feet (bcf) of gas is used, whichever comes first. That means the overall impact of the Beluga royalty revaluation alone could total more than \$30 million to consumers.

Additional financial impacts on Chugach consumers have resulted or could result from actions similar to or related to the Beluga royalty revaluation. Those actions are:

- a possible revaluation, identical to the state's, by the other Beluga royalty gas owners (the federal government and Cook Inlet Region, Inc.);
- the recent \$8.5 million settlement by ENSTAR relative to royalty gas from the Kenai field (raising ENSTAR's Kenai royalty price from \$.66 to \$1.95, and including retroactive payments);
- an increase in the cost of power purchased from Anchorage Municipal Light & Power, which was substantially impacted by the ENSTAR increase, and
- a possible increase in state gas severance taxes based on the Beluga royalty gas revaluation.

If all these actions occur, the impact on Chugach consumers would be approximately \$6 million annually -- the equivalent of about a 6 percent rate increase. Attachment A details the impacts.

Financial impacts also will be felt in the Fairbanks area, because Chugach has been selling wholesale power to Golden Valley Electric Association and Fairbanks Municipal Utility System over the Anchorage-Fairbanks intertie. ML&P also is selling power to Golden Valley. Golden Valley has estimated that its consumers will save more than \$600,000 this winter alone through purchases of power from Chugach and ML&P.

Copper Valley Electric Association also is concerned, because the Glennallen-based cooperative wants its consumers from Glennallen to Valdez to be intertied with the Railbelt utilities and reap the benefits of less expensive power.

Approximately three quarters of the state's estimated 560,000 residents live in the Railbelt between Fairbanks and Homer. Chugach serves nearly half the state's population through sales to its own retail consumers and those of Matanuska Electric Association, Homer Electric Association and the City of Seward. Thus, residents of the Matanuska and Susitna Valleys and on the Kenai Peninsula are directly affected.

In addition to the cost increases associated with the existing gas contracts, there is another major -- and perhaps even more important -- impact of DNR's royalty revaluation decision.

This is what could be called the uncertainty factor. If DNR is ultimately successful in setting royalty prices on what it determines to be the prevailing market value of a resource, utilities, producers and other purchasing parties will have no assurance of what future royalty gas components will be. This injects a real measure of insecurity into long-term gas contracts and, for Chugach at least, into power supply planning and ratemaking.

The uncertainty factor is an important public policy question for the state and is one that may well eclipse the cost-increase aspect of any given royalty lease revaluation. It could be argued that settling the price dispute over a specific revaluation without first resolving the underlying policy question is getting the horse before the cart.

It is important to note that although DNR's gas and oil lease form has given rise to dispute and litigation in many instances over the years, DNR has failed to propose regulations defining important lease terms. Proposed regulations would at least allow for a public discussion of the policy questions.

To resolve the problem raised by the state's royalty gas revaluation, Chugach is supporting passage of S.B. 309, or similar bills H.B. 403 and H.B. 425. Each of these bills would require DNR to tie royalty valuation to long-term contract price, thereby resolving the underlying policy question. A copy of each of the bills is attached.

Uncertainty in long-term price for royalty gas raises problems for Chugach and other utilities both in terms of long-term financing for generation projects and in efforts to ensure electric rate stability. Tying royalty price to long-term contract price allows DNR to continue to manage the state's resources for maximum value, while recognizing that these resources do not have a value independent of long-term contracts. DNR would still be permitted, on only six months' written notice, to take its royalty share in kind and sell it directly to a willing purchaser.

ATTACHMENT A

CHUGACH ELECTRIC ASSOCIATION, INC.
 Rate Impacts Due to Market Valuation of Royalty Gas

January 10, 1986

	<u>Retail:</u> <u>Dollars</u>	<u>Retail:</u> <u>Percent</u>	<u>Wholesale:</u> <u>Dollars</u>	<u>Wholesale:</u> <u>Percent</u>	<u>Total:</u> <u>Dollars</u>	<u>Total:</u> <u>Percent</u>
Current revenues	\$63,200,000		\$35,800,000		\$99,000,000	
Impacts:						
The state's Beluga royalty revaluation from \$.26/mcf to \$2.05/mcf	1,501,164	2.38	1,278,769	3.57	2,779,933	2.81
Possible federal/CIRI Beluga revaluation (based on state's \$2.05/mcf figure)	1,000,776	1.58	852,513	2.38	1,853,289	1.87
ENSTAR settlement	420,853	0.67	358,505	1.00	779,358	0.79
ML&P rate increase (resulting from ENSTAR settlement)	337,500	0.53	287,500	0.80	625,000	0.63
Possible state gas severance tax increase (based on state's Beluga royalty revaluation)	<u>87,100</u>	<u>0.14</u>	<u>74,196</u>	<u>0.21</u>	<u>161,296</u>	<u>0.16</u>
	\$3,347,393	5.30	\$2,851,483	7.97	\$6,198,876	6.26

CASES ON ROYALTY VALUATION

(These cases are interpreting a variety of royalty valuation clauses. Both the actual lease terms and the facts of the particular case have an impact on the court's rulings.)

1. Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981)

The courts following Tara have reasoned that since the lessee has an obligation to develop the lease and market the gas, long-term contracts are essential to resource development. Establishing a royalty value higher than an arms-length contract price penalizes the parties to those contracts. States following Tara:

- a. Oklahoma: Tara (1981)
- b. Louisiana: Henry v. Ballard & Cordell Corp.
418 So.2d 1334 (La. 1982)
- c. Arkansas: Hillard v. Stephens
637 S.W.2d 581 (Ark. 1982)

2. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968)

In this line of cases, courts have held that the market value of royalty gas is to be established by reference to comparable sales of gas. States following Vela:

- a. Texas: Vela (1968)
- b. Montana: Montana Power Co. v. Kravik
586 P.2d 298 (Mont. 1978)
- c. North Dakota: West v. Alpar Resources, Inc.
298 N.W.2d 484 (N.D. 1980)
- d. Kansas: Lightcap v. Mobil Oil
562 P.2d 1 (Kan. 1977)

3. Does an NGPA ceiling price establish "market value?"

The question addressed here is whether or not market value can exceed a price ceiling established by government regulation.

NGPA sets ceiling price: Texas: First National Bank v. Exxon Corp.
622 S.W.2d 80 (Tex. 1981)
Bowers v. Phillips Petroleum
692 F.2d 1015 (5th Cir. 1982)

NGPA does not set ceiling price: Kansas: Lightcap v. Mobil Oil
586 P.2d 1 (Kan. 1977)

BILL SHEFFIELD, GOVERNOR

REPLY TO:

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DEPARTMENT OF LAW

OFFICE OF THE ATTORNEY GENERAL

January 14, 1986

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Beluga River gas royalty
litigation: Chevron U.S.A., Inc.
v. State, 3AN 85-7617 Civ.;
ARCO Alaska Inc. v. State,
3AN 85-6218 Civ.; and Shell
Western E & P, Inc. v. State,
3AN 85-7633 Civ.

Gentlemen:

This letter contains a settlement offer from the State of Alaska, Department of Natural Resources concerning the dispute regarding royalty production from state lessee in the Beluga River unit. As you know, the major portion of that dispute relates to the valuation for royalty purposes of gas sold under long-term contracts to Chugach Electric Association, Inc. ("Chugach"). The dispute for those royalties relates to the period commencing April 15, 1985 and into the future so long as gas is produced and disposed of under the long-term Chugach contracts. For the reasons stated below, the state is prepared to resolve this aspect of the dispute by valuing the royalty portion of the gas production attributed to the Chugach contracts at \$1.50 per mcf, to be adjusted annually in accordance with some objective measure of local energy values, such as the posted price for Tesoro Number 2 fuel oil. The balance of this letter will set forth the circumstances which have led us to conclude that this settlement would be fair to all parties to this dispute.

Stephen M. Ellis, Esq.
William Rozell, Esq.
James D. Linxwiler, Esq.

January 14, 1985
Page 3

Later, starting November 1982, Chugach began entering into annual amendments to its 1973 contracts with Shell, ARCO and Chevron. These annual amendments allowed supplemental deliveries under the total volume commitment of the 1973 contract. The prices of gas under these supplemental agreements were, like the Pac LNG contracts, several times the price under the 1973 amendments to the 1985 Chugach contracts. Thus, the deliveries under the November 1982 and January 1983 contract supplements were at a base price of \$1.48 per million btu's (mmbtu) of heating value; $\frac{1}{2}$ and the deliveries under the December 1983 supplements were at a base price of \$1.60 per mmbtu. Significantly, Chugach continued to reap the benefits of its bargain 20 cent per mcf gas on the large majority of the deliveries under the 1973 contract amendments, and only paid the 8-times higher price for the supplemental deliveries under the annual contract amendments.

With the exception of the Chugach contracts, the only gas sales contract for gas from the Beluga River unit which resulted in any delivery occurred on December 20, 1982. On that date Shell executed a contract with the Alaska Pipeline Company ("APL"), a wholly owned subsidiary of Enstar Natural Gas Company ("Enstar") for the sale of gas from the Beluga River field. (This contract will hereafter be referred to as the "APL II" contract). The APL II contract called for an initial base contract price of \$2.32 per mcf. Because the base price fluctuates with fuel oil prices, the 1986 base contract price under the APL II contract is \$2.03 per mcf, almost ten times the base price under the Chugach contract. Moreover, as you know, the base contract price does not reflect the entire amount of the consideration under the APL II contract. In particular, Shell is reimbursed for the oil and gas production taxes applicable to the gas sold under the contract. We estimate that the tax reimbursement feature of the contract is worth about 10 cents per mcf. This raises the total contract price under the APL II contract to about \$2.13 per mcf. Further, if certain conditions are met, a special deliverability fee of \$0.35 per mcf would also be received by Shell. This would raise the total consideration under APL II to approximately \$2.48 per mcf.

$\frac{1}{2}$ One mcf of Cook Inlet gas yields, as you know, approximately one mmbtu of heating value.

Stephen M. Ellis, Esq.
William Rozell, Esq.
James D. Linxwiler, Esq.

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recovery from the Swanson River, and for gas it uses as feedstock for its urea and ammonia plant at Nikiski, Alaska. The reported royalties for this gas ranged between \$0.21 and \$0.62 prior to the settlement. Thus, recent gas sales contracts, Enstar's commercial service rates, and recent settlements all reflect a current gas value of between \$1.80 and \$2.32 per mcf.

Pertinent provisions of the lease

As you know, most of the state's royalty interest in Beluga River Unit production is under leases issued by the state under what is generally referred to as the state's competitive oil and gas lease form "DL-1." At the time the DL-1 leases were issued, the governing statute, AS 38.05.180(a), provided that the state's royalty share of gas production could "not be less than twelve and one-half percent in amount or value of the production removed or sold from the lease."

Several provisions of the lease form DL-1 give effect to the statutory provision calling for a minimum royalty of twelve and one-half percent of the value of the gas. Paragraph 11 provides for a royalty on gas production at the rate of twelve and one-half percent "in ... value of gas produced and saved and sold or used off said land...." Paragraph 15 of DL-1 expands upon that standard by specifying that the royalty value that lessee must pay is "field market price or value at the well." Paragraph 16 of DL-1 sets forth three nonexclusive valuation standards, and provides that the value of the gas for royalty purposes cannot be less (but could be higher) than the highest value obtained by applying the three alternative methodologies. The three paragraph 16 nonexclusive alternative minimum floor values are: (1) the price actually paid or agreed to be paid, if any; (2) the posted price in the field, if any; or (3) the prevailing price received by other producers in the field.

ARCO, Chevron, Shell and Chugach have contended that the royalty obligation under DL-1 for gas sold under long-term contracts with Chugach is properly calculated based solely upon the prices established in those contracts. This construction flies in the face of the unambiguous terms of the DL-1 lease form. The price actually received is but one of three, nonexclusive alternative floor value standards set forth in paragraph 16 of DL-1. When DL-1 was drafted, it was well-known and understood that one option was to create a "proceeds" lease form. As you know, a "proceeds" lease is one under which the royalty amount is determined solely on the basis of the amount received or realized by the lessee. Instead of a proceeds lease form, the state consciously chose a lease form which provided

Stephen M. Ellis, Esq.
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January 14, 1985
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prices being discussed may be somewhat lower than most of the recent contracts which have been negotiated in the Cook Inlet area. We are also aware that there is limited additional demand for gas in the Cook Inlet area, and that energy prices, and particularly gas prices, have fallen internationally within the last two years. These factors would indicate that the current market value of the gas may be lower than the recent contracts. We believe these factors support this settlement offer.

Third, the settlement figure proposed by the state includes some recognition of litigation risk. Although we are confident of the strength of our legal position, we understand the need to compromise from the higher value we might achieve in litigation in order to avoid the risks, costs and delays of litigation.

The settlement offer contained in this letter will remain open for a period of two weeks. Obviously, this letter does not comprehensively deal with all issues which must be dealt with in order to effect a comprehensive settlement. However, we believe it is most fruitful to agree first on the major issue, and then to work out the other details.

Thank you for your consideration of this offer.

Sincerely,

HAROLD M. BROWN
ATTORNEY GENERAL

By: 

Mark P. Worcester
Assistant Attorney General

MPW/ma

cc: Esther C. Wunnicke, Commissioner
Department of Natural Resources

Lee G. Post
Chevron, U.S.A., Inc.

Julie Simon, General Counsel
Chugach Electric Association, Inc.

Daniel Rodgers
ARCO Alaska, Inc.

D. Warren Hoff
Legal Department
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Chugach ELECTRIC ASSOCIATION, INC.

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TELEX: CHUGACH AHG
(090) 25 265

FEB 4
1986

January 28, 1986

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James D. Linxwiler, Esq.
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Re: Beluga River Gas Royalty Litigation
Chevron U.S.A., Inc. v. State, 3AN-85-7617 Civil
ARCO Alaska, Inc. v. State, 3AN-85-6218 Civil
Shell Western E&P, Inc. v. State, 3AN-85-7633 Civil

Gentlemen:

In his letter of January 14, 1986, Assistant Attorney General Mark Worcester asserts that the State is entitled, by application of the "unambiguous" terms of the DL-1 lease form, to collect royalties on Beluga River gas at a "prevailing" price received by other producers, if this price is higher than actual contract or posted price. As explained below, this assertion is legally and factually inaccurate. Additionally, it raises serious policy concerns based on the State's recent actions.

For the reasons stated more specifically below, the settlement proposed by the State is not an acceptable resolution of the current litigation. First, while the settlement offer would lead one to believe that the State's legal position is firmly grounded, this is anything but the case. Second, even if it would be advantageous to settle the matter, the State's offer is far from being a suitable resolution of the matter. Therefore, Chugach would reject the offer and strongly encourage you to do the same. In any event, a settlement should not be concluded without Chugach's involvement.

Specifically, as you know, the DL-1 lease form contains several sections concerning royalty valuations. Contrary to Mr. Worcester's assertion that these provisions are unambiguous, virtually identical provisions have already given rise to dispute and litigation in other oil and gas fields. As evidence of this,

Stephen M. Ellis
William Rozell
James D. Linxwiler

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January 28, 1986

it should be noted that Chugach views the terms of the lease as equally unambiguous in our favor.

Looking to the narrower language first, in contrast to the State's position that the three standards in Paragraph 16 of the leases are not exclusive in their applicability, both case law and existing industry practices at the time DL-1 lease form was drafted mandate that the three alternative price standards contained in Paragraph 16 of DL-1 were intended to cover different factual circumstances. The first standard, based on proceeds, would apply when there is, as in Chugach's case, an arm's-length sale "at the well." The second and third standards are keyed to indicia of value separate and apart from contract proceeds. These would be applicable only when there is no sale at the well by the lessee, or when that sale is a non-arm's-length transaction.

For instance, the second standard clearly is not applicable on its face; it looks to posted prices in the field, of which there are none. The third price standard, which the State is seeking to apply here, requires sales by "other producers." In its argument, the State is transposing "other sales" for "other producers," as there are no producers making sales from the Beluga field other than those selling to Chugach. Even if there were "other producers," the third standard still would not apply; it is designed to protect the State's interest when non-arm's-length sales are made. Such protection would be afforded by looking to sales by unaffiliated producers in order to determine royalty values. Here, Chugach and the producers entered into an arm's-length contract; there is no issue of affiliation.

In the more general royalty valuation clause (Paragraph 15) applicable, as here, when the State takes its royalty in value, the lessee is obligated to pay "the field market price or value." Although the line of cases following Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968), holds that market value should be determined based on sales contemporaneous with production, that line of cases is inapplicable here. In Vela, the lessee drafted the lease, providing adequate opportunity to protect himself. The DL-1 lease was drafted by the State, the lessor.

Additionally, the Vela case was decided subsequent to the creation of the DL-1 lease, which included the then-standard royalty valuation method: that proceeds would determine value unless the contracts were unreasonable when they were entered into or entered into at less than arm's-length, as is not the case here. When both the original and the 1973 Beluga gas contracts were entered into, they included escalator clauses that were comparable to the

Stephen M. Ellis
William Rozell
James D. Linxwiler

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January 28, 1986

industry standard at the time; hence, the contracts were not unreasonable. Finally, a majority of the Vela jurisdictions limit the royalty value to proceeds when there is a Natural Gas Policy Act ceiling on the price the producers may collect, as there is here.

A more recent and better reasoned line of cases is set forth in Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981). This line of cases adopts arm's-length contracts as determinative of value for royalty purposes. Tara, and the cases which follow, are based on the proposition that the lessee is obligated to develop the lease, and thus, must market the gas. Because large quantities of gas cannot be marketed absent long-term commitment of supply, proceeds from an arm's-length contract should be respected as determinative of value. The Tara line of cases is better law and is also the line of cases most often followed by courts deciding the issue in the recent past.

It is also important to note here that, should the State at any time believe its gas to have a higher value than current contract price, it may, on only six months' notice, elect to take its royalty share in-kind and sell it directly to a willing purchaser.

Additionally, as a matter of long-term policy, the State's injection of a measure of uncertainty into long-term contracts raises serious concerns. The State's action here opens the door for revaluations in the future. This uncertainty factor is unacceptable to Chugach, both in terms of access to long-term financing for generation projects and for our ability to ensure rate stability for our members.

Ironically, the desirability of long-term stability to ensure resource development was a recognized priority of the State when the DL-1 leases were developed. Additionally, Chugach's need for stable royalty prices was addressed by the State, Chugach and the Producers prior to making the commitment to construct the Beluga power facilities, without which the Beluga gas field might still lie undeveloped. At that time, you made a firm commitment to resist efforts to increase royalty prices above contract price.

Disregarding for the moment the legal reasons that the State's settlement position is unacceptable, the terms of the settlement themselves raise grave concerns. First, the price is out of line with market realities. A \$1.50/Mcf price for Beluga gas is a multiple of the price that consultants engaged by Chugach have placed on the value of the remaining reserves in the field. It is also just marginally below the price presently being offered

Stephen M. Ellis
William Rozell
James D. Linxwiler

-4-

January 28, 1986

in areas of the lower 48 where there is access to existing integrated pipeline transmission systems. ENSTAR's willingness to pay a higher price for Beluga gas does not establish a market price.

Second, resolution of the price question still leaves open the uncertainty of future royalty revaluations. At this time, the State is unwilling to commit to negotiate a contract with substantially similar terms and conditions to one which Chugach may negotiate with the producers for additional gas. This again leaves the future price of royalty gas to Chugach in doubt, something that is as unacceptable now as it was when the Beluga contracts were initially executed.

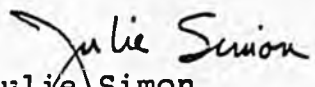
Moreover, the offer to peg future gas prices to No. 2 oil prices cannot be accepted. Unlike oil, which can be shipped to many markets in existing tankers for which there is presently a great oversupply, Beluga gas cannot presently be marketed in world markets without the construction of costly new LNG facilities. The failure of a prior attempt to market Beluga gas in such a manner attests to the problems inherent in that proposition. Additionally, Chugach is committed to rate stability, and oil, with its potential price fluctuations, is an inadequate measure for our gas prices. Chugach would insist on an index not directly tied to oil prices, such as the GNP price deflator, with a cap on annual escalation.

Although Chugach stands willing to negotiate a satisfactory resolution of pending litigation to avoid the costs, delays and risks of litigation, we do not believe, for the reasons discussed above, that the present settlement offer is acceptable.

Should you have further questions, please feel free to call to discuss this further.

Sincerely,

CHUGACH ELECTRIC ASSOCIATION, INC.


Julie Simon
General Counsel

cc: D. Warren Hoff
Lee Post
Daniel Rodgers

012186/445-LTRS/jag



Official Business

Alaska State Legislature

Senate

Pouch V
State Capitol
Juneau, Alaska 99811

TO: ALL MEMBERS OF THE SENATE

FROM: SENATOR TIM KELLY
CHAIRMAN
RULES COMMITTEE

THE SENATE RULES COMMITTEE WILL MEET AT 10:30 A.M.,
FRIDAY, FEBRUARY 28, 1986.

SB 309, "An Act relating to royalty gas contracts;
and providing for an effective date", will be on
the Committee Agenda.

No. Scope Gas v Pipelines. =
Doesn't get into union/etc contracts - }

In November of 1984, the administration reevaluated the method which they used to value Cook Inlet Royalty gas. At that time they said this was the only fair and legally proper method of valuing the gas and that use of any other method would set dangerous legal precedents. At the end of last session, when the impact of this decision had become obvious to the public, a number of bills were introduced on the subject.

When SB 309 came before the Senate Resources Committee, we worked very hard in the limited amount of time available. We dealt with the issues before us in a responsible manner. With the active cooperation of all the involved parties, the committee achieved a compromise that protected the state's interests while providing long-term price stability for southcentral and railbelt electric consumers.

Based on the Senate Resource Committee Substitute, Chugach Electric and the State signed a settlement based on the passage of this bill. At the time, the committee was advised by the administration that any widening of the language would establish dangerous legal precedents, be bad public policy, and would be adamantly opposed.

After this bill passed out of Resources, I continued my involvement at the request of the interested parties and the administration. A new draft, which included state regulated private utilities and extended the bill's benefits to gas consumers, was worked out and the administration found that this draft was good public policy and did not set any dangerous legal precedents.

The administration again gave dire warnings that further widening of the language would be bad public policy and endanger other oil and gas litigation in which the state is involved. This morning the administration was still strongly opposing any widening of the language on grounds of public policy and legal precedent. However, once again at the last minute, new compromise language has emerged which the administration suddenly supports.

I am strongly in support of a gas pipeline. I am very glad we have been able to achieve solutions in this bill that will benefit utility consumers. I am deeply disturbed, however, by the shifting sands of the administration's position on this issue and more importantly by the shifting legal advice on how our actions may be affecting other important oil and gas litigation.

Page 3

If the proposed amendments can help a pipeline become a reality, without endangering existing oil and gas litigation, I want to help make that come true. I am disturbed, however, that we are considering voting on a major and complex piece of legislation and major amendments are surfacing just hours before the vote. I would strongly urge that we delay this item until Monday, so we may have time to analyze the effects of the offered language.

STATE OF ALASKA

DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

BILL SHEFFIELD, GOVERNOR

POUCH M
JUNEAU, ALASKA 99811
PHONE: 907-485-2400

February 28, 1986

The Honorable Tim Kelly
Chair, Rules Committee
Alaska State Senate
P.O. Box V
Juneau, AK 99811

Dear Senator Kelly:

I am writing with regard to an amendment to CSSB 309 (Res) proposed in the Rules Committee yesterday by Senator Coghill.

The Sheffield Administration is strongly committed to the development of our North Slope gas resources. We are willing to work with the Legislature and all interested groups in enhancing the development of our North Slope gas resources. The most recent estimates indicate that there are about 36 trillion cubic feet of gas known to exist under state lands on the North Slope. The state's royalty share of this gas is estimated to be about 4.5 trillion cubic feet.

It would be an enormous achievement to bring this gas to markets somewhere in the world, and the state has worked closely with lessees and transportation entities to see this accomplished.

The amendment before you, however, would not accomplish this purpose only. It has several major problems:

- the amendment is not limited to arms'-length contracts;
- only the language regarding findings restricts the amendment to North Slope gas, and, therefore, the amendment might affect other state gas royalties;
- the amendment does not allow the state to assess the adequacy of the royalty value of a tremendously valuable public resource;

February 28, 1986

- there is no assurance in the amendment that a contract would be structured to reflect the true value of the gas and of the royalty share; and
- the amendment does not assure that the citizens of the state will receive maximum benefits from the agreement to use the contract value.

With these questions and issues remaining, it is my recommendation to the Rules Committee and to other members of the Senate that such an amendment not be included in this bill, which has been crafted painstakingly to address the concerns of railbelt energy consumers.

While I would prefer to see the issues raised by Senator Coghill addressed in a separate bill, I believe that the attached language drafted by our attorneys would be in the best interests of the state and could be added to SB 309.

Please contact me if you have questions or comments. I urge the Committee to pass out the draft Rules Committee Substitute for SB 309 including amendments relating to gas utility contracts, and to consider the language that I have attached to address the North Slope gas transportation issue.

Sincerely,



Esther C. Wunnicke
Commissioner

cc: Senator Faiks
Senator Coghill

Attachment

POSSIBLE AMENDMENT TO CS FOR SB 309

Add to section (1)(b) the following language at the end of the paragraph:

The legislature finds it is in the state's best interest to facilitate the financing and construction of a pipeline and increased gas production from the Alaska North Slope gas fields by establishing a procedure by which the state could commit itself to a royalty valuation methodology for so long as the state took its royalty share of gas production in value.

Add to section 2 a new subsection (bb):

In the event of a contract between parties which are unrelated in management, ownership, or other aspect for the sale of gas from Alaska's North Slope gas leases by means of delivery through a pipeline for export out of Alaska, within ninety days after the written request of a lessee of a lease issued under this section, unless the Commissioner makes a written finding that the contract price does not assure the maximum benefits to the people of Alaska in return for the state's gas resources, the Commissioner shall enter into an agreement with the lessee to use the price for the gas established in the gas sales contract as the value of the state's royalty share of gas production sold by the lessee under the contract. The lessee shall have the burden of providing all information necessary for the Commissioner to make an informed finding, and must

provide clear and convincing evidence that the value of the gas is reflected in the contract price rather than being attributed to transportation, marketing, or other profit or cost centers. For the purpose of this subsection, the term "price for gas established in the gas sales contract" includes tax reimbursement amounts, deliverability and other charges, and other forms of consideration received by the lessee under the contract.

PRELIMINARY SETTLEMENT AGREEMENT

The State of Alaska, Department of Natural Resources (DNR) and Chugach Electric Association, Inc. (Chugach) enter into the following conditional agreement concerning pending disputes and litigation concerning the valuation of the State's royalty share of gas:

(1) DNR and Chugach will vigorously support passage of the CS for SB 309 Resources (a copy of which is attached) (the Legislation), subject to mutually agreed-to amendments;

(2) DNR and Chugach agree to resolve the disputes at issue in ARCO Alaska, Inc. v. State of Alaska, Department of Natural Resources, and Chugach Electric Association, Inc., Case No. 3AN-85-6218 Civil, Chevron U.S.A. Inc. v. State of Alaska, Department of Natural Resources, and Chugach Electric Association, Inc., Case No. 3AN-85-7617 Civil, and Shell Western E&P, Inc. v. State of Alaska, Department of Natural Resources, Case No. 3AN-85-7633 Civil (collectively, the "Beluga River gas royalty litigation") concerning the royalty valuation of gas sold under Chugach's 1973 contracts with ARCO Alaska, Inc. (ARCO). Chevron U.S.A. Inc. (Chevron) and Shell Western E&P, Inc. (SWEPI) in accordance with the following terms:

(a) Supplemental gas for peak supply periods: the contract price, including all forms of consideration;

(b) Non-supplemental gas volumes for gas produced on or after April 15, 1985: 75 cents per mcf during 1985 and 1986, subject to annual adjustment on the first day of each January in

proportion to the amount of increase or decrease in the United States of America GNP price deflator over the previous year. Payments for royalties from April 15, 1985 until the date of final settlement will be paid over three years plus interest subject to APUC approval;

(c) The dispute concerning royalty liability on tax reimbursement amounts on gas for the period prior to April 15, 1985: will be resolved in good faith negotiations between the DNR, Chugach and the Beluga River lessees (ARCO, Chevron and SWEPI);

(3) These agreements concerning settlement of the Beluga River gas royalty litigation are conditioned upon the following events:

- (a) Approval by the Chugach Board of Directors;
- (b) Passage of the Legislation;
- (c) Agreement with the Beluga River lessees (with regard to the post-April 15, 1985 royalty issues);
- (d) Court approval of the settlement; and

(4) Any remaining issues or disputes not specifically identified will be resolved by good faith negotiations.

CHUGACH ELECTRIC ASSOCIATION, INC.

Dated: 2/19/86

Joyce Murphy
By: Joyce Murphy

President of the Board

ALASKA DEPARTMENT OF NATURAL RESOURCES

Dated: Feb 19, 1986

Esther C Wunnicke

By: Esther C. Wunnicke

Commissioner

2-24-86 2:00pm

IN THE LEGISLATURE OF THE STATE OF ALASKA
FOURTEENTH LEGISLATURE - SECOND SESSION
A BILL

TITLE: For an Act entitled: "An Act relating to royalty gas contracts; and providing for an effective date."

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

* Section 1. FINDINGS. (a) The legislature finds that the best interest of the state will be served if the commissioner of natural resources is authorized to establish the in value [FOR] royalty for gas [TAKEN IN VALUE BY THE STATE AND] sold to a [NONPROFIT] gas or electric utility by using the contract price between the lessee of the state and the [NONPROFIT] gas or electric utility, whether or not the [ROYALTY] gas lease [WITH THE STATE] establishes a different standard for the valuation and if the lessee and the [NONPROFIT] gas or electric utility are not related to each other. The legislature finds that this authorization should apply prospectively and does not intend the authorization to apply to the valuation for [OF] royalty purposes of gas [THAT IS] sold by a lessee [OF THE STATE] under a gas sales contract entered into

Ferry ?

[before the effective date of this Act [WITH A NONPROFIT ELECTRIC UTILITY]].

(b) The legislature finds that it is also in the best interest of the state to give the commissioner explicit discretionary authority to sell royalty gas received in kind by the state to [NONPROFIT] gas or electric utilities at a price that is below market value.

(c) The legislature finds that the proper exercise of the discretion conferred [BY THIS ACT] on the commissioner by this Act would support and complement the other programs that assist the citizens of the state with their long-term gas and electrical needs, including the power cost equalization program under AS 44.83.162 - 44.83.165 and hydroelectric and other programs for the generation of electricity.

(d) The legislature finds that the state should adopt a policy for the sale of royalty gas to [NONPROFIT] gas or electric utilities for in-state consumer use and in-state generation of electricity that is fundamentally different from the policies of the state for the sale of royalty oil and for the sale of royalty gas for export from the state or for uses other than in-state consumer use and in-state generation of electricity.

* Sec. 2. AS 38.05.180 is amended by adding a new subsection to read:

(aa) Within 90 days after the written request of a lessee of a lease issued under this section, unless the commissioner makes a written finding based on clear and convincing evidence that the contract price is unreasonably low and that a prospective reduction in royalty receipts would not be balanced by increased benefits to in-state gas and electric consumers, the commissioner shall enter into an agreement with the lessee to use the price for the gas established in the contract between the lessee and a gas or [NONPROFIT] electric utility, if the lessee and the utility are not related in management, ownership, or other aspect, as the value of the state's royalty share of gas production sold by the [A] lessee [OF THE STATE TO A NONPROFIT ELECTRIC UTILITY] under the contract. In this subsection

(1) "[NONPROFIT] gas or electric utility" includes an electric cooperative organized under AS 10.25 [AND] a municipal utility, and any gas or electric utility regulated under AS 42.05; and

(2) "price for the gas established in the contract" includes tax reimbursement amounts, deliverability and other charges, and other forms of

consideration paid by the [NONPROFIT] gas or electric utility under the contract.

* Sec. 3. AS 38.05.183(h) is amended by adding a new subsection to read:

(h) The commissioner may enter into a contract to sell royalty gas taken in kind by the state to a [NONPROFIT] gas or electric utility at less than the market value of the royalty gas if the commissioner, after considering the ~~[residential]~~ consumer benefits, other benefits, and detriments of the sale, makes a written finding that the sale is in the best interest of the state. In this subsection, "[NONPROFIT] gas or electric utility" includes an electric cooperative organized under AS 10.25 [AND], a municipal utility, and any gas or electric utility regulated under AS 42.05.

[* SEC. 4. AS 38.05.810(A) IS AMENDED TO READ:

(A) EXCEPT AS OTHERWISE PROVIDED IN AS 38.05.183(H), THE LEASE, SALE OR OTHER DISPOSAL OF STATE LAND OR RESOURCES MAY BE MADE TO A STATE OR FEDERAL AGENCY OR POLITICAL SUBDIVISION, OR THE LEASE, SALE, OR DISPOSAL OF COAL DEPOSITS SUITABLE FOR MINING MAY BE MADE TO A UTILITY OWNED AND OPERATED BY A GOVERNMENT AGENCY OR NONPROFIT COOPERATIVE ASSOCIATION ORGANIZED TO PARTICIPATE UNDER THE FEDERAL RURAL ELECTRIFICATION ACT FOR THE PURPOSE OF GENERATING

ELECTRIC POWER AND ENERGY OR THE PRODUCTION OF PROCESS STEAM, OR BOTH, FOR LESS THAN THE APPRAISED VALUE AS DETERMINED BY THE DIRECTOR AND APPROVED BY THE COMMISSIONER TO BE FAIR AND PROPER AND IN THE BEST INTERESTS OF THE PUBLIC, WITH DUE CONSIDERATION GIVEN TO THE NATURE OF THE PUBLIC SERVICES OR FUNCTION RENDERED BY THE AGENCY, SUBDIVISION, OR UTILITY MAKING APPLICATION, AND OF THE TERMS OF THE GRANT UNDER WHICH THE LAND WAS ACQUIRED BY THE STATE.]

* Sec. [5]4. Section 2 of this Act applies to agreements to establish the in value royalties on gas production under a lease issued under AS 38.05.180 which is sold under a contract^(s) entered into on or after the effective date of this Act between the state's lessee and [WITH] a gas or electric utility. [TO SELL TO NONPROFIT ELECTRIC UTILITIES GAS PRODUCED UNDER A LEASE ISSUED UNDER AS 38.05.180.

* SEC. 6. SECTION 3 OF THIS ACT APPLIES TO CONTRACTS ENTERED INTO BY THE STATE ON OR AFTER THE EFFECTIVE DATE OF THIS ACT TO SELL NEW QUANTITIES OF ROYALTY GAS TO NONPROFIT ELECTRIC UTILITIES.]

* Sec. [7]5. This Act takes effect immediately in accordance with AS 01.10.070(c).

The legislature further finds that proper exercise of the discretion conferred by this bill would support and complement other programs providing for the long-term electricity needs of the citizens of the state, including the power cost equalization program and hydro-electric and other electricity generation programs.

The legislature further finds that it should adopt a royalty policy for natural gas sold to electric utilities or cooperatives for instate electricity generation which is fundamentally different from the royalty policies for oil and for gas sold for export or for other instate uses.

Section 1. AS 38.05.180 is amended by adding a new subsection to read:

(aa) For the purpose of establishing the value of the state's royalty share of gas production sold by a state oil and gas lessee to an instate nonprofit electric utilities or cooperative, the commissioner may [enter into an agreement with the lessee to] use the arm's-length contract price, inclusive of tax reimbursement, deliverability and other charges, reimbursements or forms of consideration. This subsection applies only to the establishment of in value royalties for gas sold under contracts which are executed after ~~February 15, 1986~~. (for totally new quantities of gas).
effective date of this bill

Section 3. AS 38.05.183 is amended by adding a new subsection to read:

Ned ^{from} -ECW

2/18/86

→ Kie Campbell
Sen Sturgis's ofc.
5th Floor

CS for Senate Bill 309 (Resources)

For an Act entitled: "An act relating to the royalty value of natural gas under a state oil and gas lease, and royalty gas sales at less than market value; and providing for an effective date."

Section 1. Findings.

The legislature finds that the state's interest will be served if the commissioner is authorized to agree to value the state's royalty share of natural gas sold by the state's oil and gas lessees to instate nonprofit electric utilities or cooperatives based upon the arm's-length gas sales contract price, regardless of whether the pertinent lease terms set forth a different valuation standard. The legislature adopts this policy prospectively, and does not intend in any way to establish or affect the gas royalty value for gas sold by the state's oil and gas lessees under contracts entered into before February 15, 1986. [or for gas sold under existing contracts renegotiated after February 15, 1986.]

The legislature further finds that it is in the state's interest to give explicitly the commissioner the discretionary authority to sell in kind royalty gas to instate nonprofit electric utilities or cooperatives at a price which is below market value.

(g) The commissioner may enter into a contract for the sale of in kind royalty gas to an instate nonprofit electric utilities or cooperative at less than market value if the commissioner makes written finding that the sale is in the best interest of the state, with due consideration to the consumer benefits and other benefits and detriments of the sale.

Section 4. This Act shall take effect July 1, 1986.

Senators
Vii Fisher
276-7626

Wasted
time

2/14/86 Joyce
3/15-15/15

CS for Senate Bill 309 (Resources)

For an Act entitled: "An act relating to the royalty value of natural gas under a state oil and gas lease, and royalty gas sales at less than market value; and providing for an effective date."

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The legislature further finds that it is in the state's interest to explicitly give the commissioner the discretionary authority to sell in kind royalty gas to nonprofit electric cooperatives at a price which is below market value.*

The legislature further finds that proper exercise of the discretion conferred by this bill would support and complement other programs providing for the long-term electricity needs of the citizens of the state, including the power cost equalization program and hydroelectric and other electricity generation programs.

The legislature further finds that it should adopt a royalty policy for natural gas sold to electric cooperatives for instate electricity generation which is fundamentally different from

entirety of law

* current market value provided that price is not below the long term contract value for the gas in question

the royalty policies for oil and for gas sold for export or for other instate uses.

Section 1. AS 38.05.180 is amended by adding a new subsection to read:

(aa) For the purpose of establishing the value of the state's royalty share of gas production sold by a state oil and gas lessee to a nonprofit electric cooperative, the commissioner may enter into an agreement with the lessee to use the arm's-length contract price, inclusive of tax reimbursement, deliverability and other charges, reimbursements or forms of consideration. This subsection applies only to the establishment of in value royalties for gas sold under contracts which are executed after February 15, 1986 for totally new quantities of gas.

Section 3. AS 38.05.183 is amended by adding a new subsection to read:

(g) The commissioner may enter into a contract for the sale of in kind royalty gas to a nonprofit electric cooperative at less than market value if the commissioner makes written finding that the sale is in the best interest of the state, with due consideration to the consumer benefits and other benefits and detriments of the sale.

Section 4. This Act shall take effect July 1, 1986.

Ned ~~XXXXXXXXXX~~

2/18/86

→ Kie Campbell
Sen Sturgis's ofc.
5^m Floor

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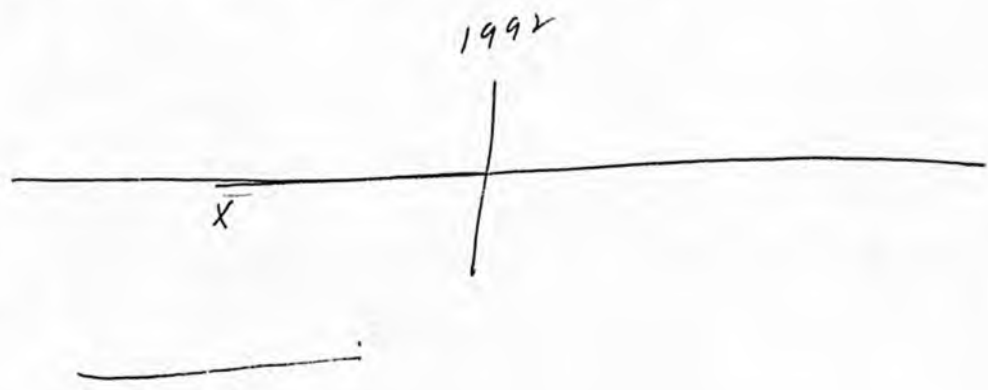
The legislature further finds that it is in the state's interest to give explicitly the commissioner the discretionary authority to sell in kind royalty gas to instate nonprofit electric utilities or cooperatives at a price which is below market value.

most other reasonable solutions
local needs - state-wide conduct
anything harder - just won't get any plan
w/ Esther's help shared be possible
& more. w/o Esther's support

Esther ret of Board

Inform - Consumers

Mrs Paulina Z Vie - more explicit -



The legislature further finds that proper exercise of the discretion conferred by this bill would support and complement other programs providing for the long-term electricity needs of the citizens of the state, including the power cost equalization program and hydro-electric and other electricity generation programs.

The legislature further finds that it should adopt a royalty policy for natural gas sold to electric utilities or cooperatives for instate electricity generation which is fundamentally different from the royalty policies for oil and for gas sold for export or for other instate uses.

Section 1. AS 38.05.180 is amended by adding a new subsection to read:

(aa) For the purpose of establishing the value of the state's royalty share of gas production sold by a state oil and gas lessee to an instate nonprofit electric utilities or cooperative, the commissioner may [enter into an agreement with the lessee to] use the arm's-length contract price, inclusive of tax reimbursement, deliverability and other charges, reimbursements or forms of consideration. This subsection applies only to the establishment of in value royalties for gas sold under contracts which are executed after February 15, 1986. (for totally new quantities of gas).

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(g) The commissioner may enter into a contract for the sale of in kind royalty gas to an instate nonprofit electric utilities or cooperative at less than market value if the commissioner makes written finding that the sale is in the best interest of the state, with due consideration to the consumer benefits and other benefits and detriments of the sale.

Section 4. This Act shall take effect July 1, 1986.

① Inappropriateness of policy
Sanctity of contracts

② Excludes Endors

③ Patched effect on law

State Resources Committee
2/19/86

ORIGINAL

R.D.C. → original drafted

CS for SB 309 (Resources)

For an Act entitled: "An Act relating to the royalty value of natural gas under a state oil and gas lease, and royalty gas sales at less than market value; and providing for an effective date."

Section 1. FINDINGS. The legislature finds that the state's interest will be served if the commissioner is authorized to value the state's royalty share of natural gas sold by the state's oil and gas lessees to instate nonprofit or government-owned utilities or cooperatives based upon the arms-length gas sales contract price, regardless of whether the pertinent lease terms set forth a different valuation standard. The legislature adopts this policy prospectively, and does not intend in any way to establish or affect the gas royalty value for gas sold by the state's oil and gas lessees under contracts entered into before the effective date of this Act.

The legislature further finds that it is in the state's interest explicitly to give the commissioner discretionary authority to sell in kind royalty gas to instate nonprofit or government-owned utilities or cooperatives at a price which is below market value.

The legislature further finds that proper exercise of the discretion conferred by this bill would support and

eliminate hidden subsidies - then compensate.

complement other programs providing for the long-term electricity needs of the citizens of the state, including the power cost equalization program and other electricity generation programs.

The legislature further finds that it should adopt a royalty policy for natural gas sold to nonprofit or government-owned electric utilities or electric cooperatives for instate electricity generation which is fundamentally different from the royalty policies for oil and for gas sold for export or for other instate uses.

Sec. 2. AS 38.05.180 is amended by adding a new subsection to read:

(aa) Upon the written request of a lessee, the commissioner shall within 90 days after the request enter into an agreement to use the contract price, inclusive of tax reimbursement amounts, deliverability charges and other forms of consideration, as establishing the in value royalty value during the life of the contract for the state's share of gas production sold under an arm's-length contract to an instate nonprofit or government-owned electric utility or ^{electric} cooperative, unless the commissioner makes a written finding based upon clear and convincing evidence that the contract price is unreasonably low and that any prospective reduction in royalty receipts would not be balanced by

increased benefits to electric consumers. This subsection applies only to the establishment of in value royalties for gas sold under contracts executed after the effective date of this Act for ~~total~~ new quantities of gas.

Sec. 3. AS 38.05.183 is amended by adding a new subsection to read:

(g) The commissioner may enter into a contract for the sale of in kind royalty gas to an instate nonprofit or government-owned electric utility or electric cooperative at less than market value if the commissioner makes a written finding that the sale is in the best interest of the state, with due consideration to the consumer benefits and other benefits and detriments of the sale.

Sec. 4. This Act shall take effect immediately.



Legislative
Information and
Teleconference Networks

SIGN-IN SHEET

Date:

Site/Location:

Sponsor/Subject:

Joyce Murphy
Com. Unconite

Name/Representing	Address	Phone	Here to Testify	Here to Observe
<i>Anchorage</i>				
<i>OK Mike Abbott</i>	<i>Resource Council</i>			
<i>OK Dale Teal</i>	<i>En Star</i>			
<i>Fairbanks</i>				
<i>OK Vayle Volonell</i>	<i>Mike Kelly - Golden Valley</i>			
<i>OK Vayle Palaspic</i>	<i>FHS Muni System</i>			
<i>Kodiak</i>				
<i>OK David Neese</i>	<i>Kodiak Electric</i>			

2/14/86

CS for Senate Bill 309 (Resources)

For an Act entitled: "An act relating to the royalty value of natural gas under a state oil and gas lease, and royalty gas sales at less than market value; and providing for an effective date."

Section 1. Findings.

The legislature finds that the state's interest will be served if the commissioner is authorized to agree to value the state's royalty share of natural gas sold by the state's oil and gas lessees to nonprofit electric cooperatives based upon the arm's-length gas sales contract price, regardless of whether the pertinent lease terms set forth a different valuation standard. The legislature adopts this policy prospectively, and does not intend in any way to establish or affect the gas royalty value for gas sold by the state's oil and gas lessees under contracts entered into before February 15, 1986, ~~for for gas sold under existing contracts renegotiated after February 15, 1986.~~

The legislature further finds that it is in the state's interest to explicitly give the commissioner the discretionary authority to sell in kind royalty gas to nonprofit electric cooperatives at a price which is below market value.

The legislature further finds that proper exercise of the discretion conferred by this bill would support and complement other programs providing for the long-term electricity needs of the citizens of the state, including the power cost equalization program and hydroelectric and other electricity generation programs.

The legislature further finds that it should adopt a royalty policy for natural gas sold to ^{non profit} electric ^{utilities or} cooperatives for instate electricity generation which is fundamentally different from

the royalty policies for oil and for gas sold for export or for other instance uses.

Section 1. AS 38.05.180 is amended by adding a new subsection to read:

(aa) For the purpose of establishing the value of the state's royalty share of gas production sold by a state oil and gas lessee to a nonprofit electric cooperative, the commissioner may ~~enter into an agreement with the lessee to~~ use the arm's-length contract price, inclusive of tax reimbursement, deliverability and other charges, reimbursements or forms of consideration. This subsection applies only to the establishment of in value royalties for gas sold under contracts which are executed after February 15, 1986 [for totally new quantities of gas].

Section 3. AS 38.05.183 is amended by adding a new subsection to read:

(g) The commissioner may enter into a contract for the sale of in kind royalty gas to a nonprofit electric cooperative at less than market value if the commissioner makes written finding that the sale is in the best interest of the state, with due consideration to the consumer benefits and other benefits and detriments of the sale.

Section 4. This Act shall take effect July 1, 1986.

DELIVER TO: <u>Lay Brown</u>	LOCATION: <u>OKH - Akub</u>
FROM: <u>Mark Wakester</u>	LOCATION: <u>Jan 0</u>
TELEPHONE/TELECOPIER # _____	TOTAL NUMBER OF PAGES: <u>3</u>
TRANSMITTING ON/SPEED _____	DATE: <u>9/12</u> TIME: <u>3:25PM</u>
PHONE FOR PROBLEMS-NAME/NUMBER: <u>Marcia 465-2400</u>	
COMMENTS _____	

CS for Senate Bill 309 (Resources)

For an Act entitled: "An act relating to the royalty value of a natural gas lease on state land, and royalty gas sales at less than market value; and providing for an effective date."

Section 1. Findings.

The legislature finds that the state's interest will be served if ~~[the commissioner is authorized to agree to value]~~ the state's in value royalty share of the natural gas sold by the state's lessees to nonprofit electric utilities and cooperatives ^{is} based upon the contract price, regardless of whether the pertinent lease terms set forth a different valuation standard. The legislature adopts this policy prospectively, and does not intend in any way to establish or affect the in value gas royalty value for gas sold by the state's oil and gas lessees under contracts entered into before February 15, 1986 ~~[or for gas sold under preexisting contracts renegotiated after February 15, 1986.]~~

~~[The legislature further finds that it is in the state's best interest to explicitly provide for the discretionary authority of the commissioner to sell in kind royalty gas to nonprofit electric utilities or cooperatives at a price which is below market value.]~~

The legislature further finds that this bill will support and complement the other programs of the state, including its electric power cost assistance program and

DNR points
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hydroelectric and other electrical generation programs, to provide for the long-term electrical needs of all the citizens of the state.

The legislature adopts these findings recognizing that the policy for royalty valuation of natural gas sold to nonprofit electric utilities and cooperatives for instate electric generation is fundamentally different from the policy for royalty valuation of oil or for gas sold for export or for other instate uses.

Section 2. AS 38.05.180 is amended by adding a new subsection to read:

(aa) For the purpose of establishing the value of the state's in value royalty share of gas production sold by a lessee to a nonprofit electric utility or cooperative, ^{for instate use} the commissioner ^{shall} ~~may~~ ^{or} enter into an agreement with the lessee to use the arms'-length contract price, inclusive of tax reimbursement, deliverability and other charges or forms of consideration. This act applies only for establishment of in value royalties for gas sold under ~~new~~ ^{new} contracts ^{for} ~~totally new supplies of gas which are~~ executed after February 15, 1986.

~~Section 3. AS 38.05.183 is amended by adding a new subsection to read:~~

~~(g) The commissioner may enter into a contract for the sale of in kind royalty gas to a nonprofit electric utility or cooperative at less than market value, if the commissioner makes a written finding that the sale is in the~~

best interest of the state, with due consideration to the
consumer and other benefits of the sale.]

Effective Date . . .