

ALASKA LEGISLATURE COMMITTEE FILES 1995-1996 8672

8984 SENATE RESOURCES

In 1978, the court articulated a unified equal protection analysis that avoids distinguishing between suspect and nonsuspect classifications by using a sliding scale to weigh the interests involved in any classification. State v. Erickson, 574 P.2d 1 (Alaska 1978). The court applies a single test that is flexible and dependent on the importance of the rights involved. The more fundamental the right involved, the more compelling the interest the state must have for preferring one classmember over another. Commercial Fisheries Entry Commission v. Apokedak, 606 P.2d 1255 (Alaska 1980).

There has not been a case involving the local or special legislation prohibition since the unified equal protection test was adopted by the court. It remains to be seen how the court will apply an equal protection analysis to a statute claimed to violate section 19.

According to the department, there are approximately 39 leases carrying net profit share provisions. It is possible that other leaseholders will claim discrimination if they are not also given relief from a corresponding net profit share provision. We doubt that a leaseholder would prevail in a claim that a statute permitting the reduction of a leaseholder's net profit share interest implicates a fundamental right. It is not a foregone conclusion that the other leaseholders are similarly situated to the Northstar leaseholder. We doubt there is a class of similarly situated leaseholders who would be discriminated against by a bill that only applies to the Northstar leases. The effect of a net profit share on a specific field will be subject to different economic assumptions (except price).

The state's interest advanced by the proposed statute is to bring the Northstar leases into production in a way that also encourages other employment and economic activity in the state. The state depends on petroleum revenues for approximately 85 percent of its general fund revenues. For this reason, a statute specifically directed to the Northstar leases can be said to have statewide significance. The reduction in net profit sharing is tied to promises of local manufacture and assembly of facilities to develop the leases. This will lead to substantial economic activity in the railbelt region of the state in which over half of the population of the state resides. There will be a direct economic benefit to the North Slope Borough derived from increased tax revenues. Production from the Northstar Unit will decrease the TAPS tariff for all existing North Slope fields and will likely extend the life of TAPS thereby making it more likely that fields not currently in production can be brought into production.

It will be the department's responsibility to carefully articulate the state's interest during legislative hearings on the bill proposing the net profit share reduction. This must be done with the goal in mind of establishing a detailed legislative history supporting the interests of the state. The legislative history will be important because the ultimate decision "whether a general act can be made applicable" rests with the Alaska Supreme Court.

3. Public Purpose.

The proposed reduction in the net profits share provisions of the Northstar leases raises the question of whether there might be an expenditure of future state revenues without a valid public purpose. It is debatable how much revenue, if any, would be foregone if the reduction in net profit share takes effect. The amount is dependent on when the leases go into production, the value of oil and other production from the lease, and when the leases become profitable under 11 A.A.C. 83.210 - .295.

The Alaska Constitution requires that state money be expended only for public purposes. Alaska Const. art. IX, sec. 6. To satisfy the public purpose doctrine, the benefit to the public must be the direct and primary purpose of an expenditure. It is permissible if the expenditure also has an indirect private benefit. However, the reverse (direct private benefit with only secondary, indirect public benefit) constitutes violation of the public purpose doctrine.

The analysis is similar to a determination whether there is adequate consideration to support a contract. If there is valuable consideration received by both the state and the leaseholder, the benefit to the state may be characterized as direct. In the case of the Northstar leases, there is a trade-off between expedited development of the leases and the loss of uncertain future revenue. The expedited development comes combined with in-state manufacture and assembly of production facilities. The magnitude of the loss in revenue is highly speculative because the value of production from the leases depends on the whims of the marketplace.

Because the State leased the oil rights at the Northstar field pursuant to the constitutional mandate to obtain the maximum public benefit, an effort to expedite production vitally affects the public interest. See Swindel v. Kelly, 499 P.2d 291, 298 n.27 (Alaska 1972) (ruling that State Constitution recognizes value of all public lands); Alaska Ski Corp. v. Holdsworth, 426 P.2d 1006, 1011 (Alaska 1967) (ruling that "our constitution reflects . . . the importance of our land resources and of the concomitant necessity for observance of legal safeguards in the disposal or leasing of state lands.") See also Trustees For Alaska v. State, 736 P.2d 324, 335 (Alaska 1987) (finding that State was granted large land holdings under the Statehood Act to "ensure the economic and social well-being of the new state.") Given the public's vital interest in deriving the maximum benefit from the leasing of state lands, the court would likely liberally construe the proposed net profit share reduction provisions in the State's favor. See State v. Moncrief, 720 P.2d 470, 475 (Wyo. 1986) (stating that if a governmental mineral lease is ambiguous, a court must then recognize that the government officials' duty "to realize the largest possible proceeds is a surrounding circumstance which must be considered when interpreting these leases.")

The Alaska Supreme Court tends to give a certain amount of deference to the judgment of the legislature concerning whether and how state resources may be expended for a particular purpose. See DeArmond v. Alaska State Development Corporation, 376 P.2d 717, 721

(Alaska 1962)(court will not set aside finding of public purpose unless it clearly appears that such finding is arbitrary and without any reasonable basis in fact). To be sure, there will be some uncertainty if this question is litigated. The Alaska Supreme Court has stated that the phrase "public purpose" represents a concept which is not capable of precise definition. DeArmond, 376 P.2d at 721; Walker v. Alaska State Mortgage Association, 416 P.2d 245 (Alaska 1966). The concept is an evolving one for which "it would be a disservice to future generations for [the Supreme Court] to attempt to define . . ." Id. The court will examine the "entire factual and governmental context to determine whether a particular plan of action serves a public purpose." Wright v. City of Palmer, 468 P.2d 326, 330 (Alaska 1970)(citation omitted). In essence, a determination of public purpose must be made in each case on the basis of the particular facts and circumstances. DeArmond, 376 P.2d at 721.

We believe that a compelling case can be made that there is adequate consideration to support a finding of a direct and substantial public benefit flowing from the reduction of the net profit share. We assign a low probability to the possibility of a successful challenge based on the public purpose doctrine.

4. Competitive Bidding Principles

It may be possible to consider a net profit share to be a contract right of the leaseholder. A public contract can be amended by the contracting parties. The power to amend a public contract is a necessary element of contract administration. It is not certain that judicial constructions of the ability of an administrative officer to amend a public contract will apply to the power to amend a contract right conveyed along with an oil and gas lease.

The power of amendment has its limits. The ability to amend is greatly restricted if the contract was awarded through the competitive bidding process. The reason for this is the premise that a material change in a competitively bid contract amounts to a new contract. McKinnon v. ALPETCO, 633 P.2d 281, 287 (Alaska 1981). A new contract can only be awarded through another round of competitive bids. Id.

The rule against material amendments was applied in Kenai Lumber Co., Inc. v. LeReache, 646 P.2d 215 (Alaska 1982). In Kenai Lumber, the Alaska Supreme Court offered factors for determining when an amendment is material. These factors include:

- (1) the legitimacy of the reasons for the change;
- (2) whether the reasons for the change were unforeseen at the time the contract was made;
- (3) the timing of the change;

- (4) whether the contract contains clauses authorizing modifications; and
- (5) the extent of the change relative to the original contract.

646 P.2d at 221.

It may be possible to formulate an argument that the reasons for amending the Northstar leases are legitimate and were unforeseen at lease formation. The timing of the change is sufficiently distant from formation of the leases to negate any claim that it is a pretext to avoid resolicitation of the leases. However, the extent of the change is substantial enough to raise serious questions as to whether factor (5) above can be satisfied. Other persons who competed for the leases may claim that since the net profit share was the sole variable in the lease sale, it is such a material term that a change cannot be made without violating the competitive bidding statute. Uncertainty concerning the state's prospects for prevailing in any litigation on this issue gives an additional basis for our advice that the department seek independent statutory authority for the Northstar transaction. The Alaska Supreme Court has held that competitive bidding is not necessary unless "required by constitution, statute, ordinance or regulation." McKinnon, 633 P.2d at 287. If the legislature were to directly authorize the amendments to the Northstar leases, that authorization would take precedence over any other statute requiring competitive bids, just as section 180(j) takes precedence over any other competitive bidding statute.

We hope that the foregoing memorandum adequately addresses the reasons why it would be prudent to seek specific authority from the legislature to reduce the net profit share provisions applicable to the Northstar leases. We are prepared to assist the Department of Natural Resources in seeking passage of a bill to accomplish this purpose.

JLB/clh



Alaska State Legislature

Official Business

State Capitol
Juneau AK 99801

COVER MEMO

TO: Senate Majority Members

THROUGH: Senate President Drue Pearce *Drue Pearce*
Resources Committee Chairman, Senator Loren Leman

FROM: Senate Resources Committee Staff *fk* *Loren Leman*

DATE: March 26, 1996

RE: Northstar Lease Agreement and Copies of Leases

Attached are copies of the Northstar Lease Agreement between the Department of Natural Resources and BP Exploration (Alaska), Inc. The agreement contains appendices B, C and appendix D which appears to be proposed legislation.

Also attached are copies of two of the leases referred to in the agreement. It is necessary to refer to the leases to understand the new, proposed agreement. All 1980 state leases in the Northstar unit were constructed the same, so only one example is given that is ADL #312798. The 1983 lease is ADL 355001.

FIRST AMENDMENT TO THE NORTHSTAR UNIT LEASES BETWEEN THE STATE
OF ALASKA AND BP EXPLORATION (ALASKA) INC.

The State of Alaska ("State") and BP Exploration (Alaska) Inc. ("BPXA") are parties to the following leases in the Northstar Unit: ADL 312798, effective February 1, 1980; ADL 312799, effective February 1, 1980; ADL 312808, effective February 1, 1980; and ADL 312809, effective February 1, 1980 (collectively the "1980 Leases"); as well as ADL 355001, effective August 1, 1983 (the "1983 Lease"). The parties agree to amend the 1980 Leases and the 1983 Lease as set forth in this first amendment to the Northstar Unit leases.

1980 Leases

- 1) Paragraph 6(b) is replaced in its entirety as follows:

(b) Annual rental paid in advance is a credit on the royalty or supplemental royalty due under this lease for that year.

- 2) Paragraph 7 is replaced in its entirety as follows:

7. SUPPLEMENTAL ROYALTY. (a) In addition to the royalty paid and computed under paragraphs 8, 10, and 11 below, Lessee shall pay to the State a supplemental royalty ("supplemental royalty"). Lessee shall pay the supplemental royalty, if owed, upon the same production volume for which royalty is paid ("production volume"). The supplemental royalty payment for a given month equals the supplemental royalty value times the supplemental royalty percentage rate ("percentage rate") times the production volume for that month. The percentage rate shall be calculated monthly by reference to: (1) an ANS West Coast spot price ("spot price"); and (2) a supplemental royalty trigger price ("trigger price"). If the spot price is equal to or less than the trigger price, then the percentage rate equals zero. If the spot price is greater than the trigger price, then the percentage rate equals [the spot price per barrel minus the

trigger price per barrel] times 1.5 per cent per dollar per barrel. The percentage rate may never exceed 7.5 per cent.

(b) The spot price is the price per barrel calculated in Article 3.3 of and Exhibit 4 to the ANS Royalty Litigation Settlement Agreement ("ANS Agreement"), dated December 31, 1991, between the State and BPXA, for the crude oil referred to as "ANS (USWC)" in the ANS Agreement. The trigger price is \$17.35 per barrel through April 30, 1997. On May 1, 1997, and each May 1 thereafter, the trigger price shall be adjusted by an inflation factor equal to fifty percent of the "inflation rate" defined as the Producer Price Index for Industrial Commodities ("PPI") for December of the previous year, as reported by April 30 of the current year, divided by the PPI for December of 1995, as reported by April 30, 1996. The supplemental royalty value for oil, gas, natural gas liquids and associated substances is defined in paragraphs 10 and 11 below. Exhibit B is a sample calculation to demonstrate the method of calculating supplemental royalty for oil.

3) Paragraph 9 is replaced in its entirety as follows:

9. REDUCTION OF ROYALTY. Except as provided in paragraph 7 above, Lessee shall not be entitled to any reduction of royalty paid under paragraph 8 above or supplemental royalty paid under paragraph 7 above based on any current or future agreement, State statute, or State regulation.

4) Paragraph 10 is replaced in its entirety as follows:

10. ROYALTY IN VALUE. Unless the State elects to receive all or a portion of its royalty or supplemental royalty in kind as provided in paragraph 12 below, Lessee shall pay to the State the value of all royalty and supplemental royalty oil, gas and associated substances as determined under paragraph 11 below. Royalty and supplemental royalty paid in value shall be free and clear of all lease expenses (and any portion of such expenses which is incurred away from the leased area), including, but not limited to, expenses for separation, cleaning, dehydration, gathering, saltwater disposal, and preparing the oil, gas or associated substances for transportation off the leased area. All royalty and supplemental royalty that may become payable in money to the State shall be paid on or before the last day of the calendar month following the month in which the oil, gas or associated substances are produced. Royalty and supplemental royalty payments shall be accompanied by copies of run tickets or such other information relating to valuation of royalty and supplemental royalty as the State may require, which may include, but is not limited to, evidence of sales, shipments, and amounts of gross oil, gas and associated substances produced.

- 5) Paragraph 11 is replaced in its entirety as follows:

11. VALUE. For purposes of computing supplemental royalty due under this lease, the value of supplemental royalty oil, gas, natural gas liquids and associated substances shall be the value used in computing royalty on said substances.

(a) To compute the value of oil for royalty and supplemental royalty purposes, this lease shall be deemed an "ANS Lease" under the terms of the ANS Agreement, irrespective of any provision(s) of such agreement which would otherwise exclude this lease therefrom.

(b) To compute the value of gas and natural gas liquids for royalty and supplemental royalty purposes, this lease shall be deemed a "Lease" under the terms of the 1995 ANS Gas Royalty Litigation Settlement Agreement between BPXA and the State dated as of April 1, 1995, irrespective of any provision(s) of such agreement which would otherwise exclude this lease therefrom.

(c) To compute the value of associated substances (which shall be deemed to exclude oil, gas, and natural gas liquids) for royalty and supplemental royalty purposes, the value of such associated substances shall not be less than the highest of:

(1) the field price actually received by Lessee for such associated substances;

(2) Lessee's posted price in the field for such associated substances;

(3) the volume weighted average field price actually received by other producers in the same field or area for associated substances of like kind and quality at the time such associated substances are removed from the leased or unit area; or

(4) the volume weighted average posted price in the field of other producers in the same field or area for associated substances of like kind and quality at the time such associated substances are removed from the leased or unit area.

If associated substances are sold away from the leased or unit area, the term "field price" above shall be the actual price for such associated substances received from the purchaser thereof less the actual cost of transportation away from the leased or unit area to the point of delivery.

Minimum Value Determinations. The State may establish minimum values for purposes of computing royalties on associated substances obtained from this lease, with consideration being given to the price actually received by Lessee, to the price or prices paid in the same field or area for production of like quality, to posted prices, to prices received by Lessee and/or other producers from

sales occurring away from the leased area, and to other relevant matters. Each such determination will be made only after Lessee has been given notice and a reasonable opportunity to be heard. Under this provision, it is expressly agreed that the minimum value of royalty associated substances under this lease may not necessarily equal the price of such associated substances.

6) The following provision shall be added to the end of paragraph 12:

(e) Supplemental royalty under paragraph 7 above may be taken in kind under the same terms and conditions as royalty may be taken in kind under this paragraph 12.

7) Paragraph 14 is replaced in its entirety as follows:

14. APPORTIONMENT OF ROYALTY FROM APPROVED UNIT. The landowner's royalty and supplemental royalty share of the unit production allocated to each separately owned tract shall be regarded as royalty to be distributed to and among, or the proceeds of it paid to, the landowners, free and clear of all unit expense and free of any lien for it. Under this provision, the State's royalty and supplemental royalty share of any unit production allocated to the leased area shall be regarded as royalty to be distributed to, or the proceeds of it paid to, the State, free and clear of all unit expenses (and any portion of such expenses which is incurred away from the unit area), including, but not limited to, expenses for separation, cleaning, dehydration, gathering, saltwater disposal, and preparing oil, gas or associated substances for transportation off the unit area, and free of any lien for it.

8) Paragraph 28 (c) is added as follows:

(c) Notwithstanding any other provisions of this lease, the Northstar Unit Agreement, State statute, or State regulation, this lease shall terminate automatically without notice, an opportunity to be heard, or judicial proceeding, if the Lessee fails to comply with the project schedule set forth in Exhibit C ("project schedule"), attached and incorporated by reference. Automatic termination shall occur whether or not there is a well on the leased area capable of producing oil or gas in paying quantities, the lease is committed to a unit agreement, or the Lessee is drilling or conducting reworking operations, on the date performance under the schedule is due. Furthermore, upon termination BPXA shall promptly file of record appropriate lease relinquishments. The automatic termination shall occur at 11:59 P.M., Alaska Time, on the day performance of an obligation under the project schedule is due. The State may waive performance of an obligation required under the project schedule by prior written consent. The performance of any obligation

required under the project schedule is subject to the provisions of paragraph 32.

- 9) Paragraph 32 is replaced in its entirety as follows:

32. **FORCE MAJEURE.** If the State determines that Lessee has been prevented, after diligent efforts made in good faith, from complying with any express or implied promise, term, condition or covenant of this lease, from conducting drilling operations, or from producing or marketing oil or gas from the leased area, by reason of war, riots, acts of God, unusually severe weather, or any other cause beyond Lessee's reasonable ability to foresee or control (including delays caused by judicial decision or lack thereof or inability to obtain local, State, or federal permits or environmental impact statements), whether similar to those enumerated or not, Lessee's obligation to comply with such provision shall be suspended, but not voided, and Lessee shall not be liable for damages for failure to comply therewith. If Lessee's obligations to conduct drilling or reworking operations are suspended under this paragraph and the continuation of such operations without suspension would have had the effect of preventing the expiration or termination of this lease, this lease shall not terminate during the period which the obligation to perform such operations is suspended. Nothing in this paragraph shall be construed to suspend the obligation to pay rentals, or to suspend the obligation to pay royalties, supplemental royalties or other production payments from operations on the lease area which are not suspended or from operations which are not affected by any such suspension, to the State.

- 10) Paragraph 41 is replaced in its entirety as follows:

41. **EMPLOYMENT OF ALASKAN RESIDENTS.** Lessee shall comply with all valid federal, State and local laws in hiring Alaska residents and contractors and shall not discriminate against Alaska residents or contractors. Within the constraints of law, Lessee shall employ Alaska residents and contractors to the extent they are available and qualified. Subject to the foregoing:

Lessee voluntarily agrees to adopt a program to hire residents of Alaska. Lessee shall advertise for available positions locally and use Alaska job service organizations to notify the Alaskan public. For work in connection with this lease, Lessee shall use best efforts to contract with Alaska firms and fabricate modules in Alaska, whenever feasible. Lessee shall encourage its contractors to employ and train, when necessary, residents of Alaska. In determining feasibility, Lessee shall consider commercial, health, safety, and environmental conditions and requirements to ensure maintenance of Lessee's operational standards. Lessee shall submit annually to the Director, Division of Oil and Gas, for transmission to the Department of

Labor, a report that details the specific measures Lessee and its contractors and subcontractors have taken or are planning to take to recruit qualified Alaska residents for available jobs, describes on-the-job training opportunities, and describes Lessee's efforts to hire Alaska firms for work in connection to this lease. Lessee shall furnish the Department of Labor a quarterly report regarding the employment of Alaska residents on the leased area in compliance with regulations by the Commissioner of Labor. The report must also include statistical data concerning the number of resident personnel hired within the past year for this lease.

1983 Lease

- 1) Paragraph 4(f) and paragraph 34(7) are deleted and replaced in their entirety with the following paragraph 4(f):

(f) FORCE MAJEURE. If the state determines that lessee has been prevented, after diligent efforts made in good faith, from complying with any express or implied promise, term, condition or covenant of this lease, from conducting drilling operations, or from producing or marketing oil or gas from the leased area, by reason of war, riots, acts of God, unusually severe weather, or any other cause beyond lessee's reasonable ability to foresee or control (including delays caused by judicial decision or lack thereof or inability to obtain local, state, or federal permits or environmental impact statements), whether similar to those enumerated or not, lessee's obligation to comply with such provision shall be suspended, but not voided, and lessee shall not be liable for damages for failure to comply therewith. If lessee's obligations to conduct drilling or reworking operations are suspended under this paragraph and the continuation of such operations without suspension would have had the effect of preventing the expiration or termination of this lease, this lease shall not terminate during the period which the obligation to perform such operations is suspended. Nothing in this paragraph shall be construed to suspend the obligation to pay rentals, or to suspend the obligation to pay royalties, supplemental royalties or other production payments from operations on the lease area which are not suspended or from operations which are not affected by any such suspension, to the state.

- 2) Paragraph 5(b) is replaced in its entirety as follows:

(b) Annual rental paid in advance is a credit on the royalty or supplemental royalty due under this lease for that year.

- 3) Paragraph 7 is replaced in its entirety as follows:

7. APPORTIONMENT OF ROYALTY FROM APPROVED UNIT. The state's royalty and supplemental royalty share of the unit production allocated to each separately owned tract must be regarded as royalty to be distributed to or among, or the proceeds of it paid to, the state, free and clear of all unit expenses and free of any lien for them. Under this provision, the state's royalty and supplemental royalty share of any unit production allocated to the leased area will be regarded as royalty to be distributed to, or the proceeds of it paid to, the state, free and clear of all unit expenses (and any portion of those expenses incurred away from the unit area), including, but not limited to, expenses for separating, cleaning, dehydration, gathering, saltwater disposal, and preparing oil, gas, or associated substances for transportation off the unit area, and free of any lien for them.

- 4) A new paragraph 20(c) is added as follows:

(c) Notwithstanding any other provisions of this lease, the Northstar Unit Agreement, state statute, or state regulation, this lease shall terminate automatically without notice, an opportunity to be heard, or judicial proceeding, if the lessee fails to comply with the project schedule set forth in Exhibit C ("project schedule"), attached and incorporated by reference. Automatic termination shall occur whether or not there is a well on the leased area capable of producing oil or gas in paying quantities, the lease is committed to a unit agreement, or the lessee is drilling or conducting reworking operations, on the date performance under the schedule is due. Furthermore, upon termination BPXA shall promptly file of record appropriate lease relinquishments. The automatic termination shall occur at 11:59 P.M., Alaska Time, on the day performance of an obligation under the project schedule is due. The state may waive performance of an obligation required under the project schedule by prior written consent. The performance of any obligation required under the project schedule is subject to the provisions of paragraph 4(f).

- 5) Paragraph 31 is replaced in its entirety as follows:

31. EMPLOYMENT OF ALASKAN RESIDENTS. Lessee shall comply with all valid federal, state and local laws in hiring Alaska residents and contractors and shall not discriminate against Alaska residents or contractors. Within the constraints of law, lessee shall employ Alaska residents and contractors to the extent they are available and qualified. Subject to the foregoing:

Lessee voluntarily agrees to adopt a program to hire residents of Alaska. Lessee shall advertise for available positions locally and use Alaska job

service organizations to notify the Alaskan public. For work in connection with this lease, lessee shall use best efforts to contract with Alaska firms and fabricate modules in Alaska, whenever feasible. Lessee shall encourage its contractors to employ and train, when necessary, residents of Alaska. In determining feasibility, lessee shall consider commercial, health, safety, and environmental conditions and requirements to ensure maintenance of lessee's operational standards. Lessee shall submit annually to the Director, Division of Oil and Gas, for transmission to the Department of Labor, a report that details the specific measures lessee and its contractors and subcontractors have taken or are planning to take to recruit qualified Alaska residents for available jobs, describes on-the-job training opportunities, and describes lessee's efforts to hire Alaska firms for work in connection to this lease. Lessee shall furnish the Department of Labor a quarterly report regarding the employment of Alaska residents on the leased area in compliance with regulations by the Commissioner of Labor. The report must also include statistical data concerning the number of resident personnel hired within the past year for this lease.

- 6) Paragraph 35 is replaced in its entirety as follows:

35. ROYALTY ON PRODUCTION. Except for oil, gas, and associated substances used on the leased area for development and production or unavoidably lost, the lessee shall pay to the state as a royalty 20 percent in amount or value of the oil, gas, and associated substances saved, removed, or sold from the leased area and of the gas used on the leased area for extraction of natural gasoline or other products from the leased area.

- 7) Paragraph 36 is replaced in its entirety as follows:

36. VALUE. For purposes of computing supplemental royalty due under this lease, the value of supplemental royalty oil, gas, natural gas liquids, and associated substances shall be the value used in computing royalty on said substances.

(a) To compute the value of oil for royalty and supplemental royalty purposes, this lease shall be deemed an "ANS Lease" under the terms of the ANS Agreement, irrespective of any provision(s) of such agreement which would otherwise exclude this lease therefrom.

(b) To compute value of gas and natural gas liquids for royalty and supplemental royalty purposes, this lease shall be deemed a "Lease" under the terms of the 1995 ANS Gas Royalty Litigation Settlement Agreement between BPXA and the State dated as of April 1, 1995, irrespective of any provision(s) of such agreement which would otherwise exclude this lease therefrom.

(c) To compute the value of associated substances (which shall be deemed to exclude oil, gas, and natural gas liquids) for royalty and supplemental royalty purposes, the value of such associated substances shall not be less than the highest of:

- (1) the field price actually received by lessee for such associated substances;
- (2) Lessee's posted price in the field for such associated substances;
- (3) the volume weighted average field price actually received by other producers in the same field or area for associated substances of like kind and quality at the time such associated substances are removed from the leased or unit area; or
- (4) the volume weighted average posted price in the field of other producers in the same field or area for associated substances of like kind and quality at the time such associated substances are removed from the leased or unit area.

If associated substances are sold away from the leased or unit area, the term "field price" above shall be the actual price for such associated substances received from the purchaser thereof less the actual cost of transportation away from the leased or unit area to the point of delivery.

Minimum Value Determinations. The state may establish minimum values for purposes of computing royalties on associated substances obtained from this lease, with consideration being given to the price actually received by lessee, to the price or prices paid in the same field or area for production of like quality, to posted prices, to prices received by lessee and/or other producers from sales occurring away from the leased area, and to other relevant matters. Each such determination will be made only after lessee has been given notice and a reasonable opportunity to be heard. Under this provision, it is expressly agreed that the minimum value of royalty associated substances under this lease may not necessarily equal the price of such associated substances.

- 8) Paragraph 37 is replaced in its entirety as follows:

37. ROYALTY IN VALUE. Unless the state elects to receive all or a portion of its royalty or supplemental royalty in kind as provided in paragraph 38, lessee shall pay to the state the value of all royalty and supplemental royalty oil, gas and associated substances as determined under paragraph 36. Royalty and supplemental royalty paid in value shall be free and clear of all lease expenses (and any portion of such expenses which is incurred away from the leased area), including, but not limited to, expenses for separation, cleaning

dehydration, gathering, saltwater disposal, and preparing the oil, gas or associated substances for transportation off the leased area. All royalty and supplemental royalty that may become payable in money to the state shall be paid on or before the last day of the calendar month following the month in which the oil, gas or associated substances are produced. Royalty and supplemental royalty payments shall be accompanied by copies of run tickets or such other information relating to valuation of royalty and supplemental royalty as the state may require, which may include, but is not limited to, evidence of sales, shipments, and amounts of gross oil, gas and associated substances produced.

- 9) The following provision shall be added to the end of paragraph 38:

(f) Supplemental royalty under this lease may be taken in kind under the same terms and conditions as royalty may be taken in kind under this paragraph 38.

- 10) Paragraph 39 is replaced in its entirety as follows:

39. REDUCTION OF ROYALTY. Except as provided in paragraph 40 below, lessee shall not be entitled to any reduction of royalty paid under paragraph 35 above or supplemental royalty paid under paragraph 40 below based on any current or future agreement, state statute, or state regulation.

- 11) Paragraph 40 is replaced in its entirety as follows:

40. SUPPLEMENTAL ROYALTY. (a) In addition to the royalty paid and computed under paragraph 35, 36, 37 above, lessee shall pay to the state a supplemental royalty ("supplemental royalty"). Lessee shall pay the supplemental royalty, if owed, upon the same production volume for which royalty is paid ("production volume"). The supplemental royalty payment for a given month equals the supplemental royalty value times the supplemental royalty percentage rate ("percentage rate") times the production volume for that month. The percentage rate shall be calculated monthly by reference to: (1) an ANS West Coast spot price ("spot price"); and (2) a supplemental royalty trigger price ("trigger price"). If the spot price is equal to or less than the trigger price, then the percentage rate equals zero. If the spot price is greater than the trigger price, then the percentage rate equals [the spot price per barrel minus the trigger price per barrel] times 1.5 per cent per dollar per barrel. The percentage rate may never exceed 7.5 per cent.

(b) The spot price is the price per barrel calculated in Article 3.3 of and Exhibit 4 to the ANS Royalty Litigation Settlement Agreement ("ANS Agreement"), dated December 31, 1991, between the State and BPXA, for the crude oil referred to

as "ANS (USWC)" in the ANS Agreement. The trigger price is \$17.35 per barrel through April 30, 1997. On May 1, 1997, and each May 1 thereafter, the trigger price shall be adjusted by an inflation factor equal to fifty percent of the "inflation rate" defined as the Producer Price Index for Industrial Commodities ("PPI") for December of the previous year, as reported by April 30 of the current year, divided by the PPI for December of 1995, as reported by April 30, 1996. The supplemental royalty value for oil, gas, natural gas liquids and associated substances is defined in paragraphs 36 and 37 above. Exhibit B is a sample calculation to demonstrate the method of calculating supplemental royalty for oil.

These amendments do not affect: (1) any future agreements which may be reached for the handling of outside substances as that term is used in the Northstar Unit Agreement effective January 24, 1990 or (2) the current valuation methodology for royalty for any other Alaska Net Profit Share leases between the State and BPXA or any affiliates or any future agreements which may be reached regarding a future valuation methodology for Alaska Net Profit Share leases. These amendments take effect when and if an Act(s) substantially similar to the act, attached as Exhibit D and incorporated by reference, takes effect. This amendment is dated for reference purposes as of March 22, 1986.

LESSEE:

BP EXPLORATION (ALASKA), INC.



E. M. Luttrell, Vice President

LESSOR:

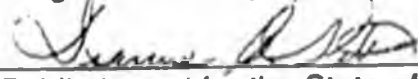
STATE OF ALASKA



John T. Shively, Commissioner
Department of Natural Resources

STATE OF ALASKA)
) ss.
Third Judicial District)

On March 22, 1996, before me appeared John T. Shively, Commissioner, State of Alaska, Department of Natural Resources, and who executed this lease and acknowledged voluntarily signing it on behalf of the State of Alaska, as lessor.




Notary Public in and for the State of Alaska
My Commission Expires: 1/16/99



STATE OF ALASKA)
) ss.
Third Judicial District)

On March 22, 1996, before me appeared E. M. Lutrell, Vice President of BP Exploration (Alaska), Inc., and who executed this lease and acknowledged voluntarily signing it on behalf of the BP Exploration (Alaska), Inc., as lessee.



Notary Public in and for the State of Alaska
My Commission Expires: 1/16/99



Exhibit B
Calculation of the Supplemental Royalty Payment for Oil

1) The calculation of the ANS West Coast spot price is derived from Platt's "Oilgram Price Report" Spot Crude Price Assessments:

Date	Platt's Reported Daily Assessment (\$/barrel)		ANSWC Daily Average	ANSWC Daily Average (After Rounding) ¹
	ANSWC Low	ANSWC High		
01/02/96	\$17.97	\$18.06	\$18.015	\$18.02
01/03/96	\$17.94	\$18.03	\$17.985	\$17.98
01/04/96	\$17.96	\$18.03	\$17.995	\$18.00
01/05/96	\$18.60	\$18.64	\$18.620	\$18.62
01/09/96	\$18.23	\$18.29	\$18.260	\$18.26
01/10/96	\$17.99	\$18.05	\$18.020	\$18.02
01/11/96	\$17.10	\$17.17	\$18.135	\$17.14
01/12/96	\$16.64	\$16.71	\$18.675	\$16.68
01/15/96	\$16.75	\$16.83	\$16.690	\$16.79
01/16/96	\$16.60	\$16.66	\$16.730	\$16.63
01/17/96	\$16.91	\$16.97	\$16.940	\$16.94
01/18/96	\$17.46	\$17.54	\$17.500	\$17.50
01/19/96	\$17.28	\$17.37	\$17.325	\$17.32
01/22/96	\$17.02	\$17.08	\$17.050	\$17.05
01/23/96	\$17.10	\$17.16	\$17.150	\$17.13
01/24/96	\$17.35	\$17.41	\$17.380	\$17.38
01/25/96	\$16.76	\$16.81	\$17.785	\$16.78
01/26/96	\$16.43	\$16.53	\$17.480	\$16.48
01/29/96	\$16.16	\$16.24	\$16.200	\$16.20
01/30/96	\$16.30	\$16.38	\$16.340	\$16.34
01/31/96	\$16.46	\$16.56	\$16.510	\$16.51

Monthly Average calculated from ANSWC Daily Average (After Rounding) = \$17.2271 per barrel

ANS West Coast spot price for the January 1996 month of production = \$17.23 per barrel

2) The inflation factor shall be calculated as follows: Assume that by April 30, 1996, the U.S. Department of Labor reports a PPI for December 1995 as 126.2. Assume that by April 30, 1998, the PPI for December 1997 is 134.2. The inflation factor for 1998 is calculated according to the following formula:

¹ All source and calculated numbers shall be rounded as required in the ANS Agreement.

Inflation Factor for May 1, 1998 through April 30, 1999

$$= [(PPI \text{ December of the previous year} + PPI \text{ December 1995}) - 1] \times 0.5$$

$$= [(134.2 + 126.2) - 1] \times 0.5 = 0.0317 = 3.17 \text{ percent}$$

3) The trigger price for May 1, 1998 through April 30, 1999 is calculated by adjusting \$17.35 per barrel by the inflation factor as follows:

$$\begin{aligned} \text{Trigger price for the current year} &= \$17.35 \text{ per barrel} \times (1 + \text{inflation factor}) \\ &= \$17.35 \text{ per barrel} \times (1 + 3.17 \text{ percent}) \\ &= \$17.35 \times 1.0317 \\ &= \$17.90 \text{ per barrel} \end{aligned}$$

4) Assuming the current month ANSWC spot price is \$21.40, the supplemental royalty percentage rate is calculated as:

$$\begin{aligned} \text{Supplemental royalty percentage rate} &= (\text{ANSWC spot price} - \text{trigger price for the current year}) \\ &\quad \times (1.5 \text{ percent per dollar per barrel}) \\ &= (\$21.40 \text{ per barrel} - \$17.90 \text{ per barrel}) \times 1.5 \text{ percent per dollar per barrel} \\ &= (21.40 - 17.90) \times 0.015 \\ &= 0.05250 = 5.25 \text{ percent} \end{aligned}$$

5) The calculation of the supplemental royalty payment for the current month is the product of the production volume times the royalty value and the supplemental royalty percentage rate. Assume that 1,550,000 barrels of oil were produced in the Northstar unit in the current month and that the royalty value is \$17.71. The supplemental royalty is:

$$\begin{aligned} \text{Supplemental royalty payment} &= \text{production volume} \times \text{royalty value} \times \text{supplemental royalty} \\ &\quad \text{percentage rate} \\ &= 1,550,000 \text{ barrels} \times \$17.71 \text{ per barrel} \times 5.25 \text{ percent} \\ &= \$1,441,151.25 \end{aligned}$$

EXHIBIT C
PROJECT SCHEDULE

The Northstar Development Project ("the Project") is described in the document titled "Northstar Development Project, Conceptual Engineering Report" dated February 1996. BPXA shall comply with the following schedule for the Project and shall provide satisfactory evidence of compliance within fifteen days of the date performance is due under the schedule:

BPXA shall receive Project sanction within twelve (12) months after passage by the legislature of an Act approving the First Amendments to the Northstar Unit Leases for the Project. "Project sanction" means approval in writing by the highest appropriate authority in BPXA or its parent entity necessary for the total amount of expenditures required for the Project. Satisfactory evidence of receipt of sanction shall be tendered to the State in the form of the sanctioning entity's documents approving the expenditure of funds for the Project. If Project sanction is withdrawn for any reason whatsoever, BPXA shall notify the State within three working days by letter from an authorized officer and BPXA shall be deemed to have failed to comply with this schedule.

EXHIBIT D

ACT

____ BILL NO. .

IN THE LEGISLATURE OF THE STATE OF ALASKA

NINETEENTH LEGISLATURE - SECOND SESSION

BY THE ____ RULES COMMITTEE BY REQUEST OF THE GOVERNOR

Introduced
Referred

A BILL

FOR AN ACT ENTITLED

1 "An Act authorizing, approving, and ratifying the amendment of Northstar Unit
2 oil and gas leases between the State of Alaska and BP Exploration (Alaska)
3 Inc., and providing for an effective date."

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

5 * Section 1. The legislature finds that

6 (1) the production of oil and gas from state land is a matter of statewide
7 interest and effect because it is an important source of revenue to the state and job
8 opportunities for the people of the state;

9 (2) BP Exploration (Alaska) Inc. holds state oil and gas leases in the Northstar
10 Unit that include net profit share provisions;

11 (3) with the current and projected price of oil, BP Exploration (Alaska) Inc.
12 maintains that the net profit share provisions of the Northstar Unit leases prevent the timely
13 development of the unit;

14 (4) existing law set out in AS 38.05 does not provide the commensurate of the

1 Department of Natural Resources with sufficient express authority to amend the net profit
2 share provisions of the Northstar Unit leases held by BP Exploration (Alaska) Inc.;

3 (5) unless the net profit share provisions of the Northstar Unit leases are
4 amended, production of oil and gas from the well is unlikely to begin until the year 2002;

5 (6) the Department of Revenue currently forecasts that production will not
6 begin from the unit until the year 2002;

7 (7) if the net profit share provisions of the Northstar Unit leases are amended,
8 full production of oil and gas from the well may begin as early as the year 1999;

9 (8) amending the net profit share provisions of the Northstar Unit leases to
10 provide for a supplemental royalty will maximize the economic benefits of oil and gas
11 production to the people of the state by encouraging timely production from the well;

12 (9) the development of the well and the associated construction of well facilities
13 within the state will provide additional revenue to the state and increased job opportunities;

14 (10) BP Exploration (Alaska) Inc. has committed to use its best efforts to hire
15 Alaska residents and contractors and to fabricate modules for the well in Alaska;

16 (11) the timely development of the well may result in increased state revenue
17 in future lease sales;

18 (12) the timely development of the well may result in technological
19 breakthroughs and other cost savings that may make other development opportunities in
20 Alaska economically feasible; and

21 (13) the development of the well will include the first truly offshore Arctic
22 island construction and Arctic subsea pipeline for oil.

23 • Sec. 2. (a) The State of Alaska and BP Exploration (Alaska) Inc. are parties to the
24 following leases to the Northstar Unit:

25 (1) ADL 312798, effective February 1, 1980;

26 (2) ADL 312799, effective February 1, 1980;

27 (3) ADL 312808, effective February 1, 1980;

28 (4) ADL 312809, effective February 1, 1980; and

29 (5) ADL 335001, effective August 1, 1983.

30 (b) The commissioner of the Department of Natural Resources may amend the
31 Northstar Unit leases described in (a) of this section to the extent set out in the "First

DRAFT

DRAFT - DEPARTMENT OF LAW

DRAFT

1 Amendment to the Northstar Unit Leases Between the State of Alaska and BP Exploration
2 (Alaska) Inc.", dated March ____, 1996.

3 (c) Notwithstanding any other provision of law, the "First Amendment to the Northstar
4 Unit Leases Between the State of Alaska and BP Exploration (Alaska) Inc.", dated March __
5 __, 1996, is approved and ratified.

6 • Sec. 3. This Act takes effect immediately under AS 01.10.070(c).



STATE OF ALASKA
OFFICE OF THE GOVERNOR
JUNEAU

March 25, 1996

The Honorable Drue Pearce
President of the Senate
Alaska State Legislature
State Capitol
Juneau, AK 99801-1182

Dear President Pearce:

Under the authority of art. III, sec. 18, of the Alaska Constitution, I am transmitting a bill providing for legislative authorization, approval, and ratification of the "First Amendment to the Northstar Unit Leases Between the State of Alaska and BP Exploration (Alaska) Inc."

This project is the beginning of a new era in the development of Alaska's oil resources. It requires a new commitment to Alaska hire, expands opportunities for Alaskan companies, introduces efficient and safe technological innovations and brings new revenues to Alaskans.

The Northstar Unit leases currently require BP Exploration (Alaska) Inc. to make net profit share payments to the state which average about 88% of "net profits." BP Exploration (Alaska) Inc. maintains that it can not develop the Northstar Unit unless the net profit share requirements are eliminated from the leases. The Department of Natural Resources believes that 2002 is the earliest the state might achieve development of Northstar. The longer it takes to develop the leases, the less the state receives because of the development account provisions of the net profit share leases. The incentives provided in this amendment would bring the Northstar Unit into full production by 1999.

The amendment has three main components. First, it eliminates the net profit share payments. In place of the net profit provision a supplemental royalty is required, payable on a sliding scale based on the price of oil, partially adjusted for inflation. This supplemental royalty, which can be as much as 7½%, is in addition to the 20% base royalty required under the leases. Development of these leases will generate an estimated \$430 million or more to the state treasury from royalties and taxes, including an estimated \$37 million in supplemental royalties.

Second, the amendment commits BP Exploration (Alaska) Inc. to an ambitious project schedule that requires construction start-up by 1997. If BP Exploration (Alaska) Inc. fails to perform its obligations under the project schedule the leases terminate automatically, thereby allowing the state to lease the tracts to another company.

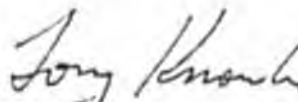
And third, the amendment replaces the current Alaska hire provisions in the leases with more forceful provisions that require BP Exploration (Alaska) Inc. to hire Alaskans, within the constraints of the law, and to contract with local construction and fabrication companies to build the project facilities. It is anticipated that enactment of this bill will generate 500 construction jobs and 50 permanent jobs in the state. It will result in Alaska companies fabricating production modules, including one or more of the first sealift modules ever constructed in Alaska.

I am requesting legislative approval of the Northstar amendment for two reasons. First, the terms of this amendment involve issues of statewide interest and impact that deserve a thorough and open public review and discussion.

Second, the bill would remove any legal cloud which may exist over the Administration's authorities in this matter by providing the commissioner of the Department of Natural Resources with sufficient express authority to amend the leases in the way we have amended them here. This will ensure that the project can proceed expeditiously and maximize the benefits to the state and the people of Alaska.

I urge your prompt and favorable action on the bill.

Sincerely,



Tony Knowles
Governor

STATE OF ALASKA
DEPARTMENT OF NATURAL RESOURCES
DIVISION OF MINERALS AND ENERGY MANAGEMENT

Competitive Oil and Gas Lease

ADL No.

312798

THIS LEASE is made by and between the State of Alaska, acting by and through the Commissioner of Natural Resources or his authorized agent, hereafter referred to as "the State," and

Amarada Hess Corporation

hereafter referred to as "Lessee," whether one or more.

In consideration of the cash payment heretofore made by Lessee to the State, which payment includes the first year's rental and any required cash bonus, and the promises, terms, conditions and covenants contained herein, including the Stipulation(s) numbered

1, 2, 3, 6, 7, 8, 9, 12, 13, 14, 17 and 5

attached hereto and by this reference incorporated herein, the State and Lessee agree as follows:

1. GRANT (s) Subject to the promises, terms, conditions and covenants contained herein, the State hereby grants and leases to Lessee, without warranty, the exclusive right to drill for, extract, remove, clean, process and dispose of oil, gas and associated substances in or under the following described tract of land:

Tract C30--46 (BF-46) is a portion of Blocks 470 and 514 as shown on the "Leasing and Nomination Map" for the Federal/State Beaufort Sea Oil and Gas Lease Sale, dated 1/30/79, more particularly described as follows:

Those lands located Easterly of the West boundary of T13N, and T14N, R13E U.M. Ak. being the North-South line intersecting the North and South boundary of Block 470, within the offshore three-mile arc lines listed as state area of Block 470 "Supplemental Official O.C.S. Block Diagram" approved 10/4/79, containing 690.35 Hectares, and those lands in Block 514 Easterly of the West boundary of T13N, R13E, U.M. Ak. (being identical with line 1-2 of Block 514) and lying Northerly of the South boundary of Sections 7 and 8 T13N, R13E U.M. Ak. (being identical with line 2-3 of Block 514) and that portion of Section 16 T13N, R13E U.M. Ak. within the N½S½ (being Easterly of line 3-4, of Block 514), being a portion of the listed state area of Block 514 on the "Supplemental Official O.C.S. Block Diagram" approved 12/9/79 containing 1087.37 Hectares.

(General Location: T14N, R13E; T13N, R13E; U.M., Ak.)

containing approximately 4392.82 acres, more or less (hereafter referred to as the "leased area"), the nonexclusive right to conduct within the leased area geological and geophysical exploration for oil, gas and associated substances, and the nonexclusive right to install pipelines and structures thereon to find, produce, save, store, treat, process, transport, take care of and market all such substances and to hire and board employees in its operations thereon.

(b) For the purpose of this lease, the leased area contains the legal subdivisions as shown on the attached plat marked Exhibit A.

(c) If the leased area is described above by protracted legal subdivisions and the State hereafter causes the leased area to be surveyed under the public land rectangular system, the boundaries of the leased area are those established by such survey, when approved, subject, however, to the provisions of applicable regulations relating to such surveys. If for any reason the leased area includes more acreage than the maximum permitted under applicable law (including the "rule of approximation" authorized in AS 38.05.148 and defined in AS 38.05.265(13)), this lease is not void and the acreage included in the leased area shall be reduced to the permitted maximum. If the State determines that this lease exceeds the permitted acreage and notifies Lessee in writing of the amount of acreage that must be eliminated, Lessee shall have sixty (60) days after such notice to surrender one or more legal subdivisions included in the leased area comprising at least the amount of acreage that must be eliminated. Any such subdivision(s) surrendered must be located on the perimeter of the leased area as originally described. If such a surrender is not filed within sixty (60) days, the State may terminate this lease as to the acreage that must be eliminated by mailing notice of such termination to Lessee describing the subdivision(s) eliminated.

(d) If the State's ownership interest in the oil, gas and associated substances in the leased area is less than an entire and undivided interest, the grant under this lease is effective only as to the State's interest in that oil, gas and associated substances, and the royalties and rentals herein provided shall be paid to the State in the proportion which the State's interest bears to the entire undivided fee.

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2. RESERVED RIGHTS. (a) The State, for itself and others, reserves all rights not expressly granted to Lessee by this lease. Without limiting the generality of the foregoing sentence, such reserved rights include:

- (1) the right to explore for oil, gas and associated substances by geological and/or geophysical means;
- (2) the right to explore for, develop and remove natural resources other than oil, gas and associated substances on or from the leased area;

(3) the right to establish or grant easements and rights-of-way for any lawful purpose, including without limitation for shafts and tunnels necessary or appropriate for the working of the leased area or other lands for natural resources other than oil, gas and associated substances;

(4) the right to dispose of land within the leased area for well sites and well bores of wells drilled from or through the leased area to explore for or produce oil, gas and associated substances in and from lands not within the leased area; and

(5) the right otherwise to manage and dispose of the surface of the leased area or interests therein by grant, lease, permit or otherwise to third parties.

(b) Rights reserved by the State may be exercised in any manner which does not unreasonably interfere with or endanger Lessee's operations under this lease.

3. TERM. This lease is issued for an initial primary term of ten (10) years from the effective date hereof, which term may be extended as provided in Paragraph 4 below. This lease may be extended beyond its primary term as provided in Paragraph 5 below.

4. EXTENSION OF PRIMARY TERM. (a) By Suspension of Operations. If, prior to the expiration of the primary term, the State directs or approves in writing suspension of all operations on or production from the leased area, the primary term shall be extended by adding the period of suspension to the primary term originally specified. For purposes of this subparagraph, any suspension of operations or production required by any stipulation made a part of this lease shall not be considered a suspension under any order by, or with the written consent of, the State.

(b) By Force Majeure. If the State determines that, prior to the expiration of the primary term, Lessee has been prevented by any of the conditions specified in Paragraph 32 from performing any act which would extend the lease beyond the primary term, the primary term shall be extended by adding the period of disability to the primary term originally specified.

or 5. EXTENSION BEYOND PRIMARY TERM. (a) By Production. This lease shall be extended automatically if and for so long as oil and gas is produced in paying quantities from the leased area.

(b) By Commitment to Approved Unit. This lease shall be extended automatically if it is committed to a unit agreement approved by the State, and shall remain in full force and effect as long as it remains committed to such a unit agreement.

(c) By Drilling. (1) If drilling has commenced as of the date on which this lease otherwise would expire and is continued with reasonable diligence, this lease shall continue in full force and effect until ninety (90) days after cessation of such drilling and for so long thereafter as oil or gas is produced in paying quantities from the leased area. (2) If oil or gas in paying quantities is produced from the leased area, and if such production ceases at any time, this lease shall not terminate if drilling or reworking operations are commenced on the leased area within (6) months after cessation of production and thereafter are prosecuted with reasonable diligence; if such drilling or reworking operations result in the production of oil or gas, this lease shall remain in full force and effect as long as oil or gas is produced in paying quantities from the leased area.

(d) By Shut-in Production. If there is a well capable of producing oil or gas in paying quantities on the leased area, this lease shall not expire because Lessee fails to produce the same unless the State gives notice to Lessee allowing a reasonable time, which shall not be less than six (6) months, after such notice to place the well on a producing status, and Lessee fails to do so. If producing status is established within the time allowed, this lease is extended only for so long thereafter as oil or gas is produced in paying quantities from the leased area.

(e) By Suspension of Operations or Production. This lease shall not expire because of any suspension of operations on or production from the leased area if the suspension is made under any order by, or with the written consent of, the State. Upon removal of such suspension, Lessee shall have a reasonable time, which shall not be less than six (6) months after notice that the suspension has been removed, to resume operations or production. For purposes of this subparagraph, any suspension of operations or production required by any stipulation made a part of this lease shall not be considered a suspension under any order by, or with the written consent of, the State.

(f) By Force Majeure. If the State determines that Lessee has been prevented by any of the conditions specified in Paragraph 32 from performing an act which would extend the lease beyond the primary term, this lease shall not expire during the term of disability plus a reasonable time thereafter, which shall not be less than sixty (60) days, for Lessee to resume operations or production.

6. RENTALS. (a) Lessee shall pay annual rental to the State in accordance with the following rental schedule:

- (1) For the first year, \$1.00 per acre or fraction thereof;
- (2) For the second year, \$1.50 per acre or fraction thereof;
- (3) For the third year, \$2.00 per acre or fraction thereof;
- (4) For the fourth year, \$2.50 per acre or fraction thereof;
- (5) For the fifth year and following years, \$3.00 per acre; provided that the State may increase the annual rental rate as provided by law upon extension of this lease beyond the primary term.

(b) Annual rental paid in advance is a credit on the royalty or net profit share due under this lease for that year.

(c) Lessee shall pay the annual rental to the State for any depository designated by the State with at least sixty (60) days' notice to Lessee in advance, on or before the annual anniversary date of this lease. The State is not required to give notice that rentals are due by billing Lessee, and no bill need be sent by the State to Lessee. If the State's (or depository's) office is not open for business on the annual anniversary date of this lease, the time for payment is extended to include the next day on which said office is open for business. If the annual rental is not paid timely, this lease automatically terminates as to both parties at 11:59 p.m., Alaska Standard Time, on the date by which the rental payment was to have been paid.

7. SHARE OF NET PROFIT. Lessee will pay to the State 93,20000% of the net profit derived by Lessee from this lease. For purposes of this Paragraph, calculation of the net profit shall be determined in accordance with 11 AAC 83.201 through 11 AAC 83.295 as those regulations exist on the effective date of this lease, copies of which are attached as Exhibits B and by this reference made a part of this lease. The amount of interest to be earned on the net profit share development account pursuant to 11 AAC 83.212 will be the average of the prime rates of the Citibank, NA New York; Chase Manhattan Bank, NA New York; and the Bank of America, NT and SA San Francisco, prevailing during the month.

8. ROYALTY ON PRODUCTION. (a) Except for oil, gas and associated substances used on the leased area for development and production or unavoidably lost, Lessee shall pay to the State as royalty the following:

(1) On oil, twenty (20) percent in amount or value of the oil saved, removed, or sold from the leased area.

(2) On gas, twenty (20) percent in amount or value of the gas saved, removed or sold from the leased area or used on the leased area for the extraction of natural gasoline or other products therefrom.

(3) On associated substances, twenty (20) percent in amount or value of the associated substances saved, removed, or sold from the leased area.

9. **REDUCTION OF ROYALTY.** After two (2) years' initial production from the field in which the leased area is located has occurred, the State, in its discretion, may reduce Lessee's obligations to pay royalty on all of the leased area or on any tract or portion thereof segregated for royalty purposes upon (1) request by Lessee, (2) a clear showing by Lessee that the revenue from all oil, gas and associated substances produced from the field is insufficient to produce a reasonable rate of return with respect to Lessee's total investment in the field, and (3) a clear showing by Lessee that a reduction in royalty will increase total production from the field.

10. **ROYALTY IN VALUE.** Unless the State elects to receive all or a portion of its royalty in kind as provided in Paragraph 12 below, Lessee shall pay to the State the value of all royalty oil, gas and associated substances as determined under Paragraph 11 below. Royalty paid in value shall be free and clear of all lease expenses (and any portion of such expenses which is incurred away from the leased area), including, but not limited to, expenses for separation, cleaning, dehydration, gathering, saltwater disposal, and preparing the oil, gas or associated substances for transportation off the leased area. All royalty that may become payable in money to the State shall be paid on or before the last day of the calendar month following the month in which the oil, gas or associated substances are produced. Royalty payments shall be accompanied by copies of run tickets or such other information relating to valuation of royalty as the State may require, which may include, but is not limited to, evidence of sales, shipments, and amounts of gross oil, gas and associated substances produced.

11. **VALUE.** (a) For purposes of computing royalties due under this lease, the value of royalty oil, gas or associated substances shall not be less than the highest of:

(1) the field price actually received by Lessee for such oil, gas or associated substances;

(2) Lessee's posted price in the field for such oil, gas or associated substances;

(3) the volume weighted average field price actually received by other producers in the same field or area for oil of like grade and gravity, gas of like kind and quality or associated substances of like kind and quality at the time such oil, gas or associated substances are removed from the leased or unit area or such gas is delivered to an extraction plant if such a plant is located on the leased or unit area; or

(4) the volume weighted average posted price in the field of other producers in the same field or area for oil of like grade and gravity, gas of like kind and quality or associated substances of like kind and quality at the time such oil, gas or associated substances are removed from the leased or unit area or such gas is delivered to an extraction plant if such a plant is located on the leased or unit area.

(b) If oil, gas or associated substances are sold away from the leased or unit area, the term "field price" in subparagraph (a) above shall be the actual price for such oil, gas or associated substances received from the purchaser thereof less the actual cost of transportation away from the leased or unit area to the point of delivery.

(c) **Minimum Value Determinations.** The State may establish minimum values for purposes of computing royalties on oil, gas or associated substances obtained from this lease, with consideration being given to the price actually received by Lessee, to the price or prices paid in the same field or area for production of like quality, to posted prices, to prices received by Lessee and/or other producers from sales occurring away from the leased area, and to other relevant matters. Each such determination will be made only after Lessee has been given notice and a reasonable opportunity to be heard. Under this provision, it is expressly agreed that the minimum value of royalty oil, gas or associated substances under this lease may not necessarily equal the price of such oil, gas or associated substances.

12. **ROYALTY IN KIND.** (a) At the State's option, which may be exercised from time to time upon not less than six (6) months' notice to Lessee, Lessee shall deliver all or a portion of the State's royalty oil, gas or associated substances produced from the leased area in kind. Delivery shall be on the leased area or at a place mutually agreed to by the State and Lessee, and shall be to the State or to any individual, firm or corporation designated by the State.

(b) Royalty oil, gas or associated substances delivered in kind shall be delivered in good and merchantable condition and be of pipeline quality, and shall be free and clear of all lease expenses (and any portion of such expenses which are incurred away from the leased area), including, but not limited to, expenses for separation, cleaning, dehydration, gathering, saltwater disposal, and preparing the oil, gas or associated substances for transportation off the leased area.

(c) After having given notice of its intention to take, or after having taken, its royalty oil, gas or associated substances in kind, the State, at its option and upon six (6) months' notice to Lessee, may elect to receive a different portion or none of its royalty in kind. If, under federal regulations, the Lessor's taking of royalty oil, gas or associated substances in value creates a supplier-purchaser relationship, Lessee hereby waives its right to continue to receive royalty oil, gas or associated substances under such a relationship, and further agrees that it will require any purchasers of the royalty oil, gas or associated substances to likewise waive any such rights.

(d) Lessee shall furnish storage for royalty oil and natural gas liquids produced from the leased or unit area to the same extent that Lessee provides storage for Lessee's share of oil and natural gas liquids. Lessee shall not be liable for the loss or destruction of stored royalty oil and natural gas liquids from causes beyond Lessee's reasonable control.

13. **RECORDS.** Lessee shall keep and have in its possession books and records showing the development and production (including records of development and production expenses) and disposition of all oil, gas and associated substances produced from the leased area. Lessee shall permit the State or its agents to examine such books and records at all reasonable times. Such books and records of development and production must employ methods and techniques that will ensure the most accurate figures reasonably available without requiring Lessee to provide separate tankage and/or meters for each well. Lessee shall use standard and consistent accounting procedures which are common to the industry.

14. **APPORTIONMENT OF ROYALTY FROM APPROVED UNIT.** The landowner's royalty share of the unit production allocated to each separately owned tract shall be regarded as royalty to be distributed to and among, or the proceeds of it paid to, the landowners, free and clear of all unit expense and free of any lien for it. Under this provision, the State's royalty share of any unit production allocated to the leased area shall be regarded as royalty to be distributed to, or the proceeds of it paid to, the State, free and clear of all unit expenses (and any portion of such expenses which is incurred away from the unit area), including, but not limited to, expenses for separation, cleaning, dehydration, gathering, saltwater disposal, and preparing oil, gas or associated substances for transportation off the unit area, and free of any lien for it.

15. **PAYMENTS.** All payments to the State under this lease shall be made payable to the State in the manner directed by the State, and shall be tendered to the State at

DEPARTMENT OF NATURAL RESOURCES
123 EAST FOURTH AVENUE
ANCHORAGE, ALASKA 99501

or to any depository designated by the State with at least sixty (60) days' notice to Lessee.

16. **PLAN OF OPERATIONS.** (a) No lease operations other than surface reconnaissance may be undertaken by Lessee, its agents or assigns, on the leased area, except in conformity with a plan of operations approved by the State. Lessee shall file with the State four (4) copies of its application for approval of its proposed plan of operations.

(b) The application shall set forth a detailed proposed plan of operations, including, but not limited to, surveys and maps or drawings setting forth each of the following: (1) the sequence and schedule of the operations proposed to be conducted on the leased area; (2) projected use requirements associated with the proposed operations, including, but not limited to, the location and design of well sites, material sites, water supplies, buildings, roads, utilities, airstrips and all other facilities necessary for exploration, development and production of the leased area; (3) plans for restoration of the leased area upon the completion of operations or phases thereof; and (4) a description of operating procedures designed to prevent or minimize adverse impacts upon other natural resources and other uses of the leased area and adjacent areas.

(c) Within sixty (60) days of Lessee's filing of complete application for approval of its proposed plan of operations, the State shall approve or deny the application. If the application is denied, the State shall state in writing its reasons for such denial and may propose modifications which, if accepted by Lessee, would qualify the plan for approval.

(d) Subsequent modification of an approved plan of operations may be proposed by Lessee. A modification of an approved plan of operations proposed by Lessee shall be considered under the same procedures used for review and approval of Lessee's original plan of operations.

(e) Approval by the State of a plan of operations or any modifications thereto signifies only that the State has no objection to the operations outlined in the plan from the standpoint of the lease administrator and does not relieve Lessee of its obligations to obtain approvals and permits required by other governmental agencies having regulatory authority over such operations.

(f) All of Lessee's operations on the lease area shall be in conformance with the approved plan of operations.

17. PLAN OF DEVELOPMENT. (a) Within six (6) months after certification of a well capable of producing oil, gas or associated substances in paying quantities, Lessee shall file two (2) copies of an application for approval by the State of an initial plan of development. The initial plan of development shall describe Lessee's plans for developing the leased area. No development of the leased area may occur until a plan of development has been approved by the State.

(b) Within sixty (60) days of Lessee's filing of a complete application for approval of its proposed initial plan of development, the State shall approve or deny the application. If the application is denied, the State shall state in writing its reason for such a denial and may propose modifications which, if accepted by Lessee, would qualify the plan for approval.

(c) The plan of development shall be revised, updated and submitted for the State's approval annually on the anniversary date of this lease or on such other date as may be mutually agreed to by Lessee and the State. If no changes from an approved plan are contemplated for the following year, a statement to that effect shall be filed in lieu of the required revision and updating.

18. EXCEPTION FOR LEASE INCLUDED IN AN APPROVED UNIT. If this lease is included in an approved unit, the Lessee shall not be required to submit a separate plan of operations or plan of development under Paragraphs 16 and 17 above.

19. LOGS AND OTHER RECORDS OF OPERATIONS. (a) Lessee shall file all logs and surveys taken, a description of all tests run for each well drilled on the leased area, together with a plat showing the exact location of each such well, with the State within thirty (30) days after each such well has been completed, suspended or abandoned.

(b) Any and all information filed by Lessee with the State in connection with this lease shall be available at all times for the confidential use of the State for the purpose of enforcing compliance with the promises, terms, conditions and covenants of this lease and the provisions of State law. Inspection of such information by any persons other than officers or employees of the State (and persons performing any function or work assigned to them by the State) shall be governed by applicable law.

20. DIRECTIONAL DRILLING. This lease may be maintained in force by directional wells drilled under the leased area from locations on other lands not covered by this lease. In such circumstances, drilling shall be considered to have commenced on the leased area when actual drilling is commenced on such other lands for the purpose of directionally drilling under the leased area. Production of oil or gas from the leased area through any directional well surfaced on such other lands or drilling or reworking of such directional well shall be considered production or drilling or reworking operations on the leased area for all purposes of this lease. Nothing contained in this Paragraph is intended or shall be construed as granting to Lessee any interest, license, easement or other right in or with respect to such lands in addition to any such interest, license, easement or other right which the Lessee may have lawfully acquired from the State or from others.

21. DILIGENCE AND PREVENTION OF WASTE. (a) Lessee shall exercise reasonable diligence in drilling, producing and operating wells on the leased area unless consent to suspend operations temporarily is granted by the State.

(b) Upon discovery of oil or gas on the leased area in quantities which would appear to a reasonable and prudent operator to be sufficient to recover ordinary costs of drilling, completing and producing an additional well in the same geologic structure at another location with a reasonable profit to the operator, Lessee shall drill such wells as a reasonably prudent operator would drill, having due regard for the interest of the State as well as the interest of the Lessee.

(c) Lessee shall carry on all operations under this lease in a good and workmanlike manner in accordance with the methods and practices set out in the approved plan of operations and plan of development with due regard for the prevention of waste of oil, gas and associated substances and the entrance of water to the oil and gas-bearing sands or strata to the destruction or injury of the same, and to the preservation and conservation of the property for future productive operations. Lessee shall carry out at Lessee's expense all orders and requirements of the State relative to the prevention of waste and the preservation of the leased area. If Lessee fails to carry out such orders, the State shall have the right, together with any other available legal recourse, to enter on the leased area to repair damage or prevent waste at Lessee's expense.

(d) Lessee shall securely plug in an approved manner any well before abandoning it.

22. OFFSET WELLS. Lessee shall drill such wells as a reasonably prudent operator would drill to protect the State adequately from loss by reason of drainage resulting from production on other land. Without limiting the generality of the foregoing sentence, if oil or gas should be produced in a well on other land not owned by the State or on which the State receives a lower rate of royalty than under this lease, and such well is within 500 feet in the case of an oil well or 1,500 feet in the case of a gas well of lands then subject to this lease, and such well produces oil or gas for a period of thirty (30) consecutive days in quantities which would appear to a reasonable and prudent operator to be sufficient to recover ordinary costs of drilling, completing and producing an additional well in the same geologic structure at an offset location with a reasonable profit to the operator, and if, after notice to Lessee and an opportunity to be heard, the State finds that production from such well is draining lands then subject to this lease, Lessee shall within thirty (30) days after written demand by the State begin in good faith and diligently prosecute drilling operations for an offset well on the leased area. In lieu of drilling any well required by this Paragraph, Lessee may, with the State's consent, compensate the State in full each month for the estimated loss of royalty through drainage in the amount determined by the State.

23. UNITIZATION. (a) Lessee may unitize with others, jointly or separately, in collectively adopting and operating under a cooperative or unit agreement for the exploration, development or operation of the pool or field or like area or part thereof which includes or underlies the leased area or any part thereof whenever a regulatory agency having appropriate jurisdiction determines and certifies that such an agreement is in the public interest for the purpose of property concerning the natural resources of any oil or gas pool, field or like area or any part thereof.

(b) Lessee agrees, within six (6) months after demand by the State, to subscribe to a reasonable cooperative or unit agreement which shall adequately protect all parties in interest, including the State. The State reserves the right to prescribe such an agreement.

(c) With the consent of Lessee, the State may establish, alter, change, or revoke drilling, producing, rental and royalty requirements of this lease if the leased area is committed to any such cooperative or unit agreement, and may adopt such regulations with reference to this lease in connection with the institution and operation of any such cooperative or unit agreement as the State determines are necessary and proper to secure the proper protection of the public interest.

(d) If a portion of the leased area or any separate and distinct zone or geological horizon is committed to an approved or prescribed unit agreement, the committed acreage or zone or horizon shall be segregated into a separate and distinct lease having the same effective date as this lease. Any portion of the leased area or any separate and distinct zones or geological horizons not committed to such a cooperative or unit agreement shall remain subject to the terms and conditions of this lease unaffected by the pooling or unitization of any other portion of the leased area or zone or horizon or by operations in any such unit.

24. INSPECTION. Lessee shall keep open at all reasonable times, for inspection by any duly authorized representative of the State, the leased area, all wells, improvements, machinery and fixtures thereon, and all reports and records relative to operations and surveys or investigations on or with regard to the leased area or under this lease.

25. SUSPENSION. The State may from time to time direct or approve in writing suspension of production or other operations under this lease.

26. ASSIGNMENT, PARTITION AND CONVERSION. This lease, or any undivided interest herein, may, with the approval of the State, be assigned, subleased or otherwise transferred as to the entire leased area or any one or more legal subdivisions included therein, or any separate and distinct zone or geological horizon underlying the leased area or such one or more legal subdivisions therein, to any person or persons qualified to hold a lease. No assignment, sublease or other transfer of an interest in this lease, including assignments of working or royalty interests and operating agreements and subleases, shall be binding upon the State unless approved by the State. Lessee shall remain liable for all obligations under this lease accruing prior to the approval by the State of any assignment, sublease or other transfer of an interest in this lease. All covenants, conditions and agreements contained in this lease shall extend to and be binding upon the heirs, administrators, successors, and assigns of the State and/or Lessee. Applications for approval of an assignment, sublease or other transfer shall comply with all applicable regulations and must be filed within ninety (90) days after the date of final execution of the instrument of transfer. Transfer of this lease or an interest therein shall be approved by the State unless (1) Lessee fails to comply with applicable statutes and regulations or (2) the State determines in writing that the best interests of the State justify a denial. Where an assignment, sublease or other transfer is made of all or a part of Lessee's interest in and to a portion of the leased area, that portion may, at the option of the State or upon request of the transferee and with the approval of the State, be segregated into a separate and distinct lease having the same effective date as this lease.

27. SURRENDER. Lessee at any time may make and file with the State a written surrender of all rights under this lease or any portion thereof comprising one or more legal subdivisions or, with the consent of the State, any separate and distinct zone or geological horizon underlying the leased area or one or more legal subdivisions thereof. Such a surrender shall be effective as of the date of filing, subject to the continued obligations of Lessee and his surety to make payment of all accrued royalties and to place all wells and surface facilities on the surrendered land or in the surrendered zones or horizons in condition satisfactory to the State for suspension or abandonment. Thereafter, Lessee shall be released from all obligations under this lease with respect to the surrendered lands, zones or horizons.

28. DEFAULT AND TERMINATION; CANCELLATION. (a) The failure of Lessee to perform timely its obligations under this lease, or its failure of Lessee otherwise to abide by all express and implied promises, terms, conditions and covenants of this lease, shall be deemed to be a default in Lessee's obligations hereunder. Whenever Lessee fails to comply with any of the provisions of this lease (other than a provision which, by its terms, provides for automatic termination) and fails within sixty (60) days after written notice of such default to commence to remedy and thereafter diligently prosecute operations to remedy such default, the State may terminate this lease if at that time there is no well on the leased area capable of producing oil or gas in paying quantities. If at that time there is a well on the leased area capable of producing oil or gas in paying quantities, this lease may be terminated by an appropriate judicial proceeding. In the event of any termination under this subparagraph, Lessee shall have the right to retain under this lease any and all drilling or producing wells as to which no default exists together with a parcel of land surrounding each well or wells and such rights-of-way through the leased area as are reasonably necessary to enable Lessee to drill, operate, and transport oil and/or gas from such retained well or wells.

(b) The State may cancel this lease at any time if the State determines, after Lessee has been given notice and a reasonable opportunity to be heard, that (1) continued operations pursuant to this lease probably will cause serious harm or damage to biologic resources, to property, to mineral resources or to the environment (including the human environment), (2) the threat of harm or damage will not disappear or decrease to an acceptable extent within a reasonable period of time, and (3) the advantages of cancellation outweigh the advantages of continuing this lease in force. Any cancellation under this subparagraph shall not occur unless and until operations under this lease have been under suspension or temporary prohibition by the State, with due extension of the term of this lease, continuously for a period of five (5) years or for a lesser period upon request of the Lessee. Any cancellation under this subparagraph will entitle Lessee to receive such compensation as Lessee demonstrates to the State is equal to the lesser of (1) the value of the cancelled rights as of the date of cancellation, with due consideration being given to both anticipated revenues from this lease and anticipated costs, including costs of compliance with all applicable regulations and stipulations, liability for clean-up costs or damages, or both, in the case of an oil spill, and all other costs reasonably anticipated under this lease, or (2) the excess, if any, over Lessee's revenues from this lease (plus interest thereon from the date of receipt to date of reimbursement) of all consideration paid for this lease and all direct expenditures made by Lessee after the effective date of this lease and in connection with exploration or development, or both, pursuant to this lease, plus interest on such consideration and such expenditures from the date of payment to the date of reimbursement.

29. RIGHTS UPON TERMINATION. Upon the expiration or earlier termination of this lease as to all or any portion of the leased area, Lessee will be directed in writing by the State and shall have the right at any time within a period of one (1) year thereafter, or such extension thereof as may be granted by the State, to remove from the leased area or portion thereof all machinery, equipment, tools, and materials. Upon the expiration of such period and at the option of the State, any machinery, equipment, tools, and materials which Lessee has not removed from the leased area or portion thereof become the property of the State or may be removed by the State at Lessee's expense. At the option of the State, all improvements such as roads, pads and wells shall either be abandoned and the sites restored by Lessee to the satisfaction of the State or be left intact and Lessee absolved of all further responsibility as to their maintenance, repairs and eventual abandonment and restoration. Subject to the foregoing, Lessee shall deliver up the leased area or such portion or portions thereof in good condition.

30. DAMAGES AND INDEMNIFICATION. (a) No rights under reservations contained in leases or grants of Alaska land may be exercised by the State or by its Lessee until provision has been made to pay the owner of the land upon which the reserved rights are sought to be exercised full payment for all damages sustained by the owner by reason of entering on the land. If the owner for any reason refuses or neglects to settle the damages, the State or its Lessee may enter upon the land after posting a surety bond determined by the State, after notice and an opportunity to be heard, to be sufficient as to form, amount, and security to secure to the owner payment for damages, and may institute legal proceedings in a court of competent jurisdiction where the land is located to determine the damages which the owner of the land may suffer. Lessee hereby agrees to pay any damages that may become payable under AS 38.05.130 and to indemnify the State and hold it harmless from and against any claims, demands, liabilities and expenses arising from or in connection with such damages. The furnishing of a bond in compliance with this Paragraph shall be regarded by the State as sufficient provision for the payment of all damages that may become payable under AS 38.05.130 by virtue of this lease.

(b) Lessee shall indemnify the State for, and hold it harmless from, any claim, including claims for loss or damage to property or injury to a person or persons caused by or resulting from any act or omission committed pursuant to this lease by or on behalf of Lessee. Lessee shall not be held responsible to the State under this subparagraph for any loss, damage or injury caused by or resulting from the sole negligence of the State.

(c) Lessee expressly waives any defense to an action for breach of a covenant of this lease or for damages resulting from an oil spill or other harm to the environment which is based on the fact that the act or omission complained of was committed by an independent contractor. Lessee expressly agrees to assume responsibility for all actions of its independent contractors.

31. **BONDS.** (a) If required by the State, Lessee shall furnish a bond prior to the issuance of this lease in an amount equal to at least \$5.00 per acre or fraction thereof contained in the leased area, but no less than \$10,000.00, and shall maintain said bond as long as required by the State.

(b) Before beginning drilling operations on the leased area, Lessee shall furnish a bond in the amount of at least \$100,000.00 and shall maintain said bond as long as required by the State.

(c) Lessee may, in lieu of the bond required under (a) above, furnish and maintain a Statewide bond in accordance with applicable regulations.

(d) The State may, after notice to Lessee and a reasonable opportunity to be heard, require a bond in a reasonable amount greater than the amount specified in (a) and (b) above where such greater amount is justified by the nature of the surface and its uses and the degree of risk involved in the types of operations being or to be carried out under this lease. A Statewide bond shall not satisfy any requirement of a bond imposed under this subparagraph, but shall be considered by the State in determining the need for and the amount of any additional bond under this subparagraph.

(e) If the leased area is committed in whole or in part to a cooperative or unit agreement approved or prescribed by the State and a unit bond is furnished, Lessee need not thereafter maintain any bond with respect to the portion of the leased area committed to such agreement.

32. **FORCE MAJEURE.** If the State determines that Lessee has been prevented, after efforts made in good faith, from complying with any express or implied promise, term, condition or covenant of this lease, from conducting drilling operations, or from producing or marketing oil or gas from the leased area, by reason of war, riots, acts of God, unusually severe weather, or any other cause beyond Lessee's reasonable ability to foresee or control (including delays caused by judicial decisions or lack thereof), whether similar to those enumerated or not, Lessee's obligation to comply with such provision shall be suspended, but not voided, and Lessee shall not be liable for damages for failure to comply therewith. If Lessee's obligations to conduct drilling or reworking operations are suspended under this Paragraph and the continuation of such operations without suspension would have had the effect of preventing the expiration or termination of this lease, this lease shall not terminate during the period which the obligation to perform such operations is suspended. Nothing in this Paragraph shall be construed to suspend the obligation to pay rentals, or to suspend the obligation to pay royalties or other production or profit-based payments from operations on the leased area which are not suspended or from operations which are not affected by any such suspension, to the State.

33. **AUTHORIZED REPRESENTATIVES.** The State Director of the Division of Minerals and Energy Management, Department of Natural Resources, and the person executing this lease on behalf of Lessee shall be the authorized representatives for their respective principals for purposes of administering this lease. The State or Lessee may change the designation of its authorized representative or the address to which notices to that representative are to be sent by a notice given in accord with Paragraph 34 below. Where activities pursuant to a plan of operations are underway, Lessee will also designate, pursuant to a notice under Paragraph 34 below, by name, job title and address, an agent who will be present in the State during all such activities.

34. **NOTICES.** Any notices required or permitted under this lease shall be by electronic media producing a permanent record or in writing and shall be given personally or by registered or certified mail, return receipt requested, addressed as follows:

TO THE STATE:

DIRECTOR, DIVISION OF MINERALS AND ENERGY MANAGEMENT
DEPARTMENT OF NATURAL RESOURCES
703 W. NORTHERN LIGHTS BOULEVARD
ANCHORAGE, ALASKA 99503

TO THE LESSEE:

Amerada Hess Corporation
C/o N. D. Bernard
P. O. Box 2040
Tulsa, Oklahoma 74102

Any such notice shall be effective when delivered to the foregoing authorized representative.

35. **STATUTES AND REGULATIONS.** This lease is subject to all State and Federal statutes and regulations in effect on the effective date hereof, and, insofar as is constitutionally permissible, to all statutes and regulations hereinafter placed in effect. This lease shall not be interpreted as a limitation upon the exercise by the State of Alaska or by the United States of America of the power to enact and enforce legislation or to promulgate and enforce regulations affecting, directly or indirectly, the activities of Lessee or its agents in connection with this lease or the value of the interests held under this lease.

36. **INTERPRETATION.** This lease is to be interpreted in accordance with the rules applicable to the interpretation of contracts made in the State of Alaska. The Paragraph headings are not part of this lease and are inserted only for convenience. The State and Lessee expressly covenant that the law of the State of Alaska shall apply in any judicial proceeding under this lease.

37. **INTEREST IN REAL PROPERTY.** It is the intention of the parties that the rights granted to Lessee by this lease constitute an interest in real property in the lease area.

38. **SEVERABILITY.** If it is finally determined in any judicial proceeding that any provision of this lease is invalid, the State and Lessee may jointly determine and agree by a written amendment to this lease that, in consideration of the promises, terms, conditions and covenants contained in that written amendment, the invalid portion of the lease will be treated as severed from the lease and that the remainder of the lease, as amended, will remain in effect.

39. **DEFINITIONS.** All words and phrases used in this lease are to be interpreted where possible in the manner required in respect to the interpretation of statutes by AS 01.10.040. However, the following words have the following meanings unless the context unambiguously requires otherwise:

(1) "oil" means crude petroleum oil and other hydrocarbons regardless of gravity which are produced in liquid form by ordinary production methods, including liquid hydrocarbons known as distillate or condensate recovered by separation from gas other than at a gas processing plant;

(2) "gas" means all natural gas (except helium gas) and all other hydrocarbons produced which are not defined herein as oil;

(3) "associated substances" means all substances except helium produced as an incident of production of oil or gas by ordinary production methods and not defined herein as oil or gas;

(4) "drilling" means the act of boring a hole to reach a proposed bottom hole location through which oil or gas may be produced if encountered in paying quantities, and includes re-drilling, sidetracking, deepening or other means necessary to reach the proposed bottom hole location, testing, logging, plugging and other operations necessary and incidental to the actual boring of the hole;

(5) "reworking operations" means all operations designed to secure, restore or improve production through some use of a hole previously drilled, including, but not limited to, mechanical or chemical treatment of any horizon, plugging back to test higher strata, etc; and

(6) "paying quantities" means quantities sufficient to yield a return in excess of operating costs even though drilling and equipment costs may never be repaid and the undertaking considered as a whole may ultimately result in a loss.

40. **CONDITIONAL LEASE.** If all or a part of the leased area is land that has been selected by the States under laws of the United States granting lands to the State, but such land has not been patented to the State by the United States, then this lease is a conditional lease as provided by law until such a patent becomes effective. If for any reason such a selection is not finally approved, or such a patent does not become effective, any rental, royalty or profit-based payments made to the State under this lease will not be refunded.

41. **EMPLOYMENT OF ALASKAN RESIDENTS.** Lessee shall comply with all valid and applicable laws and regulations with regard to the hiring of Alaska residents. Lessee will not discriminate against Alaska residents, as prohibited by applicable laws and regulations of the State of Alaska. Lessee will furnish the Alaska Department of Labor a quarterly report regarding the employment of Alaska residents on the leased area in compliance with regulations adopted by the Commissioner of Labor.
IN WITNESS WHEREOF the parties have executed this lease effective as of the 1st day of February, 19 80.

LESSEE
AMERADA HESS CORPORATION

STATE OF ALASKA

By [Signature]
V. M. Hebertson, Vice President, U.S.
Exploration & Offshore Joint Venture
Operations

By: Ethel H. Nelson
ETHEL H. NELSON
Title: Leasing Manager

THE UNITED STATES OF AMERICA)
STATE OF ALASKA) m.
)

Acknowledgment of Lessor

This certifies that on the 11th day of January, 19 80, before me, a notary public in and for the State of Alaska, duly commissioned and sworn, personally appeared ETHEL H. NELSON to me known to be the person who executed the foregoing lease on behalf of the State of Alaska, who, after being duly sworn according to law, stated to me under oath that he has authority pursuant to law to execute the foregoing lease on behalf of the State of Alaska, acting through the Division of Minerals and Energy Management, Department of Natural Resources and that he executed the same freely and voluntarily as the act and deed of the State of Alaska and for the Division of Minerals and Energy Management, Department of Natural Resources.

WITNESS my hand and official seal.

MARY K. WEISENBERGER
NOTARY PUBLIC
STATE OF ALASKA

Mary K. Weisenberger
Notary Public in and for Alaska
My Commission expires 3/29/83

RECEIVED
MAR 1 1980

U.S. DEPARTMENT OF THE INTERIOR
BUREAU OF LAND MANAGEMENT

STATE OF ALASKA
30th COMPETITIVE OIL AND GAS LEASE SALE
- BEAUFORT SEA -

LEASE STIPULATIONS

ADL 312798

State Stipulation No. 1 - Historic and Archaeologic Discoveries

In the event any site, structure, or object of historic or archaeological significance should be discovered during the conduct of any operations on the leased area, the lessee shall report immediately such findings to the Director, Division of Minerals and Energy Management, and make every reasonable effort to preserve and protect such site, structure, or object from damage until the Director has given directions as to its preservation.

Upon abandonment of the drilling platform or related facilities, such facilities will be removed to the extent that they no longer intrude on the historic or cultural scene or could otherwise adversely affect an archaeological, or historic site or area included in or eligible for inclusion in the National Register of Historic Places.

State Stipulation No. 2 - Environmental Training

The lessee shall include in any exploration and/or development plans a proposed environmental training program for all personnel involved in exploration or development activities (including personnel of the lessee's contractors and subcontractors) for review and approval by the Director, Division of Minerals and Energy Management. The program shall be designed to inform each person working on the project of specific types of environmental, social, and cultural concerns which relate to the individual's job. The program shall be formulated and implemented by qualified instructors experienced in each pertinent field of study and shall employ effective methods to ensure that personnel understand and use techniques necessary to preserve archaeological, geological, and biological resources. The program shall also be designed to increase the sensitivity and understanding of personnel to community values, customs, and lifestyles in areas in which such personnel will be operating.

The lessee shall also submit for review and approval a continuing technical environmental briefing program for supervisory and managerial personnel of the lessee and its agents, contractors, and subcontractors.

State Stipulation No. 3 - Site Restoration

After completion of the exploratory drilling phase, all structures will be removed from the lease and the lessee will restore the site to its original condition unless the structure or site will be used in the production phase or for additional exploratory drilling or unless it is not in the best interest of the public or the environment to require removal or restoration. Authorization to leave the structure in place must be obtained from the Director, Division of Minerals and Energy Management, after consultation with the Department of Fish and Game and the Department of Environmental Conservation.

~~State Stipulation No. 4 - Surface Entry~~

~~Surface entry by the lessee or subcontractors will be prohibited on Cross Island (State leasing unit BF-54) and Pole Island (State leasing units BF-81 and BF-82) during the period May 15 to August 15. Surface entry during other periods may be permitted by the Director, Division of Minerals and Energy Management, provided any structures, equipment, personnel, or supplies are removed before May 15.~~

State Stipulation No. 5 - Special Biological Resources

If biological populations or habitats which may require additional protection are identified by the Director, Division of Minerals and Energy Management, on any tracts in the leasing area, the Director will require the lessee to conduct environmental surveys, as approved by the Director, to determine the extent and composition of biological populations or habitats, and the effects of proposed or existing operations on the populations or habitats which might require additional protective measures. The Director shall provide written notice to the lessee of his decision to require such surveys. Such surveys will be required for the area known as the Boulder Patch, which applies to the following leasing units: BF-82, BF-70, BF-71, BF-76, BF-77, BF-78, BF-79, BF-82, BF-83, BF-88, and BF-116. For all other tracts within the lease area, the nature and extent of any surveys will be determined by the Director on a case-by-case basis.

Based on any surveys which the Director may require of the lessee, or other information available to the Director on special biological resources, the Director may require the lessee to: (1) locate the site of such operation so as not to adversely effect the resource identified; (2) establish to the satisfaction of the Director, on the basis of a site-specific survey, either that such operation will not have a significant adverse effect upon the resource identified or that a special biological resource does not exist; (3) operate during those periods of time that do not adversely effect the biological resources as established by the Director; and (4) modify operations in such a way as not to affect adversely the significant biological populations or habitats deserving protection.

The lessee agrees that, if any area of biological significance should be discovered during the conduct of any operations on the leased area, he shall immediately report such findings to the Director, and make every reasonable effort to preserve and protect the biological resource from damage until the Director has given the lessee directions with respect to its protection.

The lessee shall submit all data obtained in the course of such surveys to the Director, with the locational information for drilling or other activity. The lessee may take no action that might result in any effect on the biologic populations or habitats surveyed, until the Director provides written directions to the lessee, with regard to permissible actions.

Known special biological resources and their habitats include hard and rocky bottoms with kelp, bryozoans, sponges, coral, or other epibenthic communities.

State Stipulation No. 6 - Drilling Discharges

1. Discharge of produced waters into marine waters is prohibited, except that the Commissioner of the Department of Environmental Conservation may approve discharges in tracts greater than 10 meters of water on a case-by-case basis.
2. Discharge of drilling muds and cuttings into marine waters is prohibited, except that the Commissioner of the Department of Environmental Conservation may approve discharges (a) in tracts greater than 10 meters of water on a case-by-case basis and (b) in tracts of less than 10 meters of water on a case-by-case basis if effluents are shown to be non-toxic and can be adequately dispersed.

State Stipulation No. 7 - Pipelines

1. Pipelines will be required (a) if pipeline rights-of-way can be determined and obtained; (b) if laying such pipelines is technically feasible and environmentally preferable; and (c) if, in the opinion of the lessor, pipelines can be laid without net social loss, taking into account any incremental costs of pipelines over alternative methods of transportation and any incremental benefits in the form of increased environmental protection or reduced multiple-use conflicts. The lessor specifically reserves the right to require that any pipeline used for transporting production to shore be placed in certain designated management areas. In selecting the means of transportation, consideration will be given to any recommendation of the Beaufort Sea Coordination Committee. Where feasible, and environmentally preferable, all pipelines, including both flow lines and gathering lines for oil and gas, shall be designed and constructed to provide for adequate protection from water currents, storm and ice scouring, subfreezing conditions, and other hazards as determined on a case-by-case basis.
2. Following the completion of pipeline installation of sufficient capacity, no crude oil production will be transported by surface vessel from offshore production sites, except in the case of emergency. Determinations as to emergency conditions and appropriate responses to these conditions will be made by the Director, Division of Minerals and Energy Management.
3. Where the three criteria set forth in the first sentence of this stipulation are not met and surface transportation must be employed, all vessels used for carrying hydrocarbons to shore from the leased area will conform with all standards established for such vessels, pursuant to the Ports and Waterways Safety Act of 1972 (46 U.S.C. 391(a)).

State Stipulation No. 8 - Solid Waste

Solid waste disposal on natural or artificial islands or in marine waters within the lease area is prohibited.

State Stipulation No. 9 - Seasonal Operations

Exploratory drilling and testing, and other downhole exploratory activities from surface locations outside the barrier islands will be limited to the period November 1 through March 31, unless the Director, Division of Minerals and Energy Management, after consulting with the Oil and Gas Conservation Commission, determines that continued operations are necessary to prevent a loss of well control or to ensure human safety. This stipulation will remain in effect for two years following issuance of the lease.

Exploratory drilling and testing, and other downhole exploratory activities from surface locations inside the barrier islands will be limited to the period November 1 through March 31, except the Director, Division of Minerals and Energy Management after consultation with the Biological Task Force may allow drilling and downhole activities to continue no later than May 15 if the lessee demonstrates the ability to operate safely and ice conditions justify; provided, however, that the Director, Division of Minerals and Energy Management, after consultation with the Oil and Gas Conservation Commission may allow continued operations leading to shut down which are necessary to prevent loss of well control or to ensure human safety. This stipulation will remain in effect two years following issuance of the lease.

~~State Stipulation No. 10 - Operational Restrictions (Block 700)~~

~~Exploratory drilling operations, emplacement of structures (platforms) or seafloor wellheads for production or storage of oil or gas, and the emplacement of pipelines will not be allowed on the state-owned portion of lease block 700. All exploration for and development of oil and gas must be performed from locations outside of the state-owned portion of lease block 700.~~

State Stipulation No. 11 - Interim Agreement

This lease is subject to the "Agreement Between the United States and State of Alaska pursuant to Section 7 of the Outer Continental Shelf Lands Act, and Alaska Statutes 38.05.137" (Signed on October 26, 1979, and commonly referred to as the "Interim Agreement"), and the lessee hereby consents to every term of that agreement.

Any loss incurred or sustained by the lessee as a result of obtaining validation and recognition of this lease pursuant to the "Interim Agreement," and in particular any loss incurred or sustained by the lessee as a result of conforming this lease with any and all provisions of all applicable laws of the party prevailing in *United States of America v. State of Alaska*, United States Supreme Court No. 84, Original, shall be borne exclusively by the lessee.

No taxes payable to the State of Alaska will be required to be paid with respect to this lease until such time as ownership of or jurisdiction over the lands subject to this lease is resolved. In the event that the lands subject to this lease, or any portion of them, are judicially determined to be state lands, the lessee shall pay to the State a sum equivalent to the state taxes which would have been imposed under Alaska law if the lands, or portion thereof determined to be state lands, had been undisputed state lands from the date the lease was executed, plus interest at the rate of 10 percent per year accruing from the date the taxes would have become due under Alaska law. Such payment shall be in lieu of and in satisfaction of the actual state taxes.

State Stipulation No. 12 - Utilization Agreement

This lease is subject to the "Agreement Regarding Utilization for the Proposed Joint Federal/State Beaufort Sea Lease Sale" executed by the United States and State of Alaska on October 26, 1979, and the lessee is bound by the terms of that agreement.

STATE OF ALASKA
DEPARTMENT OF NATURAL RESOURCES

Competitive Oil and Gas Lease

ADL No. 355001

THIS LEASE is entered into August 1, 1983, between the State of Alaska, "the state," and
J. ANDREW BACHNER (30%), JAMES F. DIERINGER, JR. (15%), W.G. STROECKER (22.5%),
RICHARD E. WAGNER (32.5%)

"the lessee," whether one or more, whose sole address for purposes of notification under Paragraph 26 is:

J. Andrew Bachner et al
c/o Main Hurdman
1001 Noble Street, Fairbanks, AK 99701

in consideration of the cash payment made by the lessee to the state, which payment includes the first year's rental and any required cash bonus, and subject to the provisions of this lease, including applicable stipulation(s) and mitigating measures attached to this lease and by this reference incorporated in this lease, the state and the lessee agree as follows:

1. GRANT. (a) Subject to the provisions in this lease, the state grants and leases to the lessee, without warranty, the exclusive right to drill for, extract, remove, clean, process, and dispose of oil, gas, and associated substances in or under the following described tract of land:

TRACT 39-01

T. 13 N., R. 13 E., 1st 1st Meridian, Alaska

- Section 17, Protracted, All, 640.00 acres;
- Section 18, Protracted, All, 631.00 acres;
- Section 19, Protracted, All, 633.00 acres;
- Section 20, Protracted, All, 640.00 acres;
- Section 25, Protracted, All, 640.00 acres;
- Section 26, Protracted, All, 640.00 acres;
- Section 27, Protracted, All, 640.00 acres;
- Section 28, Protracted, All, 640.00 acres;
- Section 29, Protracted, All, 640.00 acres.

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DIVISION OF OIL & GAS
ANCHORAGE, ALASKA

containing approximately 5744.00 acres, more or less (referred to in this lease as the "leased area"); the nonexclusive right to conduct within the leased area geological and geophysical exploration for oil, gas, and associated substances; and the nonexclusive right to install pipelines and build structures on the leased area to find, produce, save, store, treat, process, transport, take care of, and market oil, gas, and associated substances and to house and board employees in its operations on the leased area. The rights granted by this lease are to be exercised in a manner which will not unreasonably interfere with the rights of any permittees, lessees or grantees of the state consistent with the principles of reasonable concurrent use as set out in article VIII, section B of the Alaska Constitution.

(b) For the purposes of this lease, the leased area contains the legal subdivisions as shown on the attached plat marked Exhibit A.

(c) If the leased area is described by protracted legal subdivisions and, after the effective date of this lease, the leased area is surveyed under the public land rectangular system, the boundaries of the leased area are those established by that survey, when approved, subject, however, to the provisions of applicable regulations relating to those surveys. If for any reason the leased area includes more acreage than the maximum permitted under applicable law (including the "rule of approximation" authorized in AS 38.05.145 and defined in AS 38.05.365(13)), this lease is not void and the acreage included in the leased area must be reduced to the permitted maximum, if the state determines that the leased area exceeds the permitted acreage and notifies the lessee in writing of the amount of acreage that must be eliminated, the lessee must have 60 days after that notice to surrender any or more legal subdivisions included in the leased area comprising at least the amount of acreage that must be eliminated. Any subdivision surrendered must be located on the perimeter of the leased area as originally described. If a surrender is not filed within 60 days, the state may terminate this lease as to the acreage that must be eliminated by mailing notice of the termination to the lessee describing the subdivision eliminated.

(d) If the State of Alaska's ownership interest in the oil, gas, and associated substances in the leased area is less than an entire and undivided interest, the grant under this lease is effective only as to the state's interest in that oil, gas, and associated substances, and the royalties and rentals provided in this lease must be paid to the state in the proportion that the state's interest bears to the entire undivided fee.

(e) The state makes no representations or warranties, express or implied, as to title, or access to, or quiet enjoyment of, the leased area. The state is not liable to the lessee for any deficiency in title to the leased area, nor is the lessee or any successor in interest to the lessee entitled to any refund due to deficiency in title for any rent's, bonuses, or royalties paid under this lease.

2. **RESERVED RIGHTS.** (a) The state, for itself and others, reserves all rights not expressly granted to the lessee by this lease. These reserved rights include, but are not limited to:

(1) the right to explore for oil, gas, and associated substances by geological and geophysical means;

(2) the right to explore for, develop, and remove natural resources other than oil, gas, and associated substances on or from the leased area;

(3) the right to establish or grant easements and rights-of-way for any lawful purpose, including without limitation for shafts and tunnels necessary or appropriate for the working of the leased area or other lands for natural resources other than oil, gas, and associated substances;

(4) the right to dispose of land within the leased area for well sites and well bores of wells drilled from or through the leased area to explore for or produce oil, gas, and associated substances in and from lands not within the leased area; and

(5) the right otherwise to manage and dispose of the surface of the leased area or interests in that land by grant, lease, permit, or otherwise to third parties.

(b) The rights reserved may be exercised by the state, or by any other person or entity acting under authority of the state, in any manner that does not unreasonably interfere with or endanger the lessee's operations under this lease.

3. **TERM.** This lease is issued for an initial primary term of 10 years from the effective date of this lease. The term may be extended as provided in Paragraph 4 below.

4. **EXTENSION.** (a) This lease will be extended automatically if and for so long as oil or gas is produced in paying quantities from the leased area.

(b) This lease will be extended automatically if it is committed to a unit agreement approved or prescribed by the state, and will remain in effect for so long as it remains committed to that unit agreement.

(c) (1) If the drilling of a well whose bottom hole location is in the leased area has commenced as of the date on which the lease otherwise would expire and is continued with reasonable diligence, this lease will continue in effect until 90 days after cessation of that drilling and for so long as oil or gas is produced in paying quantities from the leased area.

(2) If oil or gas in paying quantities is produced from the leased area, and if that production ceases at any time, this lease will not terminate if drilling or reworking operations are commenced on the leased area within six months after cessation of production and are prosecuted with reasonable diligence; if those drilling or reworking operations result in the production of oil or gas, this lease will remain in effect for so long as oil or gas is produced in paying quantities from the leased area.

(c) If there is a well capable of producing oil or gas in paying quantities on the leased area, this lease will not expire because the lessee fails to produce that oil or gas unless the state gives notice to the lessee, allowing a reasonable time, which will not be less than six months after notice, to place the well into production, and the lessee fails to do so. If production is established within the time allowed, this lease is extended only for so long as oil or gas is produced in paying quantities from the leased area.

(d) If the state directs or approves in writing a suspension of all operations on or production from the leased area (except for a suspension necessitated by the lessee's negligence), or if a suspension of all operations on or production from the leased area has been ordered under federal, state, or local law, the lessee's obligation to comply with any express or implied provision of this lease requiring operations or production will be suspended, but not voided, and the lessee shall not be liable for damages for failure to comply with that provision. If the suspension occurs before the expiration of the primary term, the primary term will be extended at the end of the period of the suspension by adding the period of time lost under the primary term because of the suspension. If the suspension occurs during an extension of the primary term under this paragraph, upon removal of that suspension, the lessee will have a reasonable time, which will not be less than six months after notice that the suspension has been removed, to resume operations or production. For the purposes of this subparagraph, any suspension of operations or production specifically required or imposed as a term of sale or by any stipulation made a part of this lease will not be considered a suspension ordered by law.

(e) If the state determines that the lessee has been prevented by force majeure, after efforts made in good faith, from performing any act that would extend the lease beyond the primary term, this lease will not expire during the period of force majeure. If the force majeure occurs before the expiration of the primary term, the primary term will be extended at the end of the period of force majeure by adding the period of time lost under the primary term because of the force majeure. If the force majeure occurs during an extension of the primary term under this paragraph, this lease will not expire during the period of force majeure plus a reasonable time after that period, which will not be less than 60 days, for the lessee to resume operations or production.

(f) Nothing in subparagraph (a) or (b) suspends the obligation to pay royalties or other production or profit-based payments to the state from operations on the leased area that are not affected by any suspension of force majeure, or suspends the obligation to pay rentals.

5. **RENTALS.** (a) The lessee shall pay annual rental to the state in accordance with the following rental schedule:

(1) For the first year, \$1.00 per acre or fraction of an acre.

(2) For the second year, \$1.50 per acre or fraction of an acre.

(3) For the third year, \$2.00 per acre or fraction of an acre.

(4) For the fourth year, \$2.50 per acre or fraction of an acre.

(5) For the fifth year and following years, \$3.00 per acre or fraction of an acre.

(b) Annual rental paid in advance is a credit on the royalty or net profit share due under this lease for that year.

(c) The lessee shall pay the annual rental to the State of Alaska to any depository designated by the state with at least 60 days notice in advance, on or before the annual anniversary date of this lease. The state is not required to give notice that rentals are due by billing the lessee. If the state's (or depository's) office is not open for business on the annual anniversary date of this lease, the time for payment is extended to include the next day on which that office is open for business. If the annual rental is not paid timely, this lease automatically terminates as to both parties at 11:59 p.m. Alaska Standard Time on the date by which the rental payment was to have been made.

(d) Nothing in subparagraph (a) or (b) suspends the obligation to pay royalties or other production or profit-based payments to the state from operations on the leased area that are not affected by any suspension of force majeure, or suspends the obligation to pay rentals.

6. RECORDS. The lessee shall keep and have in its possession books and records showing the development and production (including records of development and production expenses) and disposition (including records of sales prices, volumes, and purchasers) of oil, gas, and associated substances produced from the leased area. The lessee shall permit the State of Alaska or its agents to examine these books and records at all reasonable times. These books and records of development, production, and disposition must employ methods and techniques that will ensure a most accurate figures reasonably available without requiring the lessee to provide separate tanks or meters for each well. The lessee shall use standard and consistent accounting procedures.

7. APPORTIONMENT OF ROYALTY FROM APPROVED UNIT. The state's royalty share of the unit production allocated to each separately owned tract must be regarded as royalty to be distributed to and among, or the proceeds of it paid to, the state, free and clear of all unit expenses and free of any lien for them. Under this provision, the state's royalty share of any unit production allocated to the leased area will be regarded as royalty to be distributed to, or the proceeds of it paid to, the state, free and clear of all unit expenses (and any portion of those expenses incurred away from the unit area), including, but not limited to, expenses for separating, cleaning, dehydrating, gathering, saltwater disposal, and preparing oil, gas, or associated substances for transportation off the unit area, and free of any lien for them.

8. PAYMENTS. All payments to the State of Alaska under this lease must be made payable to the state in the manner directed by the state, and, unless otherwise specified, must be tendered to the state at

DEPARTMENT OF NATURAL RESOURCES

POUCH 7-006

ANCHORAGE, ALASKA 99510

ATTENTION: ACCOUNTING

or to any depository designated by the state with at least 60 days notice to the lessee.

9. PLAN OF OPERATIONS. (a) Except as provided in subparagraph (b) below, no lease operations may be undertaken on the leased area until a plan of operations has been approved by the state:

- (1) the State of Alaska owns all or part of the surface estate of the leased area;
- (2) the lessee reserves a net profit share to the State of Alaska; or
- (3) the State of Alaska owns all or part of the mineral estate, but the entire surface estate of the leased area is owned by a party other than the State of Alaska and a surface owner requests that a plan of operations be required by the state for the portion of the leased area owned by that surface owner.

(b) A lease plan of operations will not be required by the state for:

- (1) lease operations that would not require a land use permit under 11 AAC, or
- (2) lease operations undertaken under an approved unit plan of operations in accordance with 11 AAC.

(c) Before undertaking operations on the leased area, the lessee shall provide for full payment of all damages sustained by the owner of the surface estate as well as by the surface owner's lessee and permittees by reason of entering the land. If the surface estate is owned by a party other than the State of Alaska, the lessee shall also notify the surface owner of his opportunity to request that the state require a plan of operations before allowing lease operations to be undertaken on the portion of the leased area owned by the requesting surface owner.

(d) The lessee shall file with the state 10 copies of its proposed plan of operations if the proposed operations are within the coastal zone, and five copies if the proposed operations are not within the coastal zone.

(e) An application for approval of a plan of operations must contain sufficient information, based on data reasonably available at the time the plan is submitted for approval, for the state to determine the surface use requirements and impacts directly associated with the proposed operations. An application must include statements and maps or drawings setting out the following:

- (1) the sequence and schedule of the operations to be conducted on the leased area, including the date operations are proposed to begin and their proposed duration;
 - (2) projected use requirements directly associated with the proposed operations, including but not limited to the location and design of well sites, material sites, water supplies, solid waste sites, sumps, buildings, roads, utilities, airstrips, and all other facilities and equipment necessary to conduct the proposed operations;
 - (3) plans for rehabilitation of the affected leased area after completion of operations or phases of those operations; and
 - (4) a description of operating procedure designed to prevent or minimize adverse effects on other natural resource and other uses of the leased area and adjacent areas, including fish and wildlife habitats, historic and archeological sites, and public use areas.
- (f) In approving a lease or unit plan of operations, or an amendment of a plan, the state will require amendments if determines necessary to protect the state's interest, including the environment. The state will not require any amendment that would be inconsistent with the terms of sale under which the lease was obtained or with the terms of the lease itself, or would deprive the lessee of reasonable use of the leasehold interest.

(g) The lessee may, with the approval of the state, amend an approved plan of operations.

(h) Approval by the state of a plan of operations or any modifications of a plan of operations signifies only that the state has no objection to the operations outlined in the plan from the standpoint of the lease administrator and does not relieve the lessee of its obligation to obtain approvals and permits required by other governmental agencies having regulatory authority over those operations.

(i) All of the lessee's operations on the leased area must be in conformance with the approved plan of operations.

(j) Upon completion of operations, the lessee shall inspect the area of operations and submit a report indicating the completion date of operations and stating any non-compliance of which the lessee knows, or should reasonably know, with requirements imposed as a condition of approval of the plan.

10. PLAN OF DEVELOPMENT. (a) Except as provided in subparagraph (d) below, within 12 months after certification of a well capable of producing oil, gas, or associated substances in paying quantities, the lessee shall file two copies of an application for approval by the state of an initial plan of development that must describe the lessee's plans for developing the leased area. No development of the leased area may occur until a plan of development has been approved by the state.

(b) The plan of development must be revised, updated, and submitted to the state for approval annually before or on the anniversary date of the previously approved plan. If no changes from an approved plan are contemplated for the following year, a statement to that effect must be filed for approval in lieu of the required revision and update.

(c) The lessee may, with the approval of the state, subsequently modify an approved plan of development.

(d) If the leased area is included in an approved unit, the lessee will not be required to submit a separate lease plan of development for unit activities.

11. LOGS AND OTHER RECORDS OF OPERATIONS. (a) The lessee shall file with the state all logs, geological and geophysical surveys taken, a description of all tests run for each well drilled on the leased area, and a description of each well, within 30 days after each well or survey has been completed, suspended, or abandoned.

(b) Any information filed by the lessee with the state in connection with this lease will be available at all times for the use of the state and its agents, subject to the duty to keep the information confidential as provided in AS 38.05.035(a)(8), AS 31.06.086, and applicable regulations.

12. DIRECTIONAL DRILLING. This lease may be maintained in effect by directional wells whose bottom hole location is on the leased area but that are drilled from locations on other lands not covered by this lease. In these circumstances, drilling will be considered to have commenced on the leased area when actual drilling is commenced on those other lands for the purpose of directionally drilling into the leased area. Production of oil or gas from the leased area through any directional well surfaced on those other lands, or drilling or reworking of that directional well, will be considered production or drilling or reworking operations on the leased area for all purposes of this lease. Nothing contained in this paragraph is intended or will be construed as granting to the lessee any interest, license, easement, or other right in or with respect to those lands in addition to any interest, license, easement, or other right that the lessee may have lawfully acquired from the state or from others.

13. DILIGENCE AND PREVENTION OF WASTE. (a) The lessee shall exercise reasonable diligence in drilling, producing, and operating wells on the leased area unless consent to suspend operations temporarily is granted by the state.

(b) Upon discovery of oil or gas on the leased area in quantities that would appear to a reasonable and prudent operator to be sufficient to recover ordinary costs of drilling, completing, and producing an additional well in the same geologic structure at another location with a reasonable profit to the operator, the lessee must drill those wells as a reasonable and prudent operator would drill, having due regard for the interest of the state as well as the interest of the lessee.

(c) The lessee shall perform all operations under this lease in a good and workmanlike manner in accordance with the methods and practices set out in the approved plan of operations and plan of development, with due regard for the prevention of waste of oil, gas, and associated substances and the entrance of water to the oil and gas-bearing sands or strata to the destruction or injury of those sands or strata, and to the preservation and conservation of the property for future productive operations. The lessee shall carry out at the lessee's expense all orders and requirements of the State of Alaska relative to the prevention of waste and to the preservation of the leased area. If the lessee fails to carry out these orders, the state will have the right, together with any other available legal recourse, to enter the leased area to repair damage or prevent waste at the lessee's expense.

(d) The lessee shall securely plug in an approved manner any well before abandoning it.

14. OFFSET WELLS. The lessee shall drill such wells as a reasonable and prudent operator would drill to protect the state from loss by reason of drainage resulting from production on other land. Without limiting the generality of the foregoing sentence, if oil or gas is produced in a well on other land not owned by the State of Alaska or on which the State of Alaska receives a lower rate of royalty than under this lease, and that well is within 500 feet in the case of an oil well or 1,500 feet in the case of a gas well of lands then subject to this lease, and that well produces oil or gas for a period of 30 consecutive days in quantities that would appear to a reasonable and prudent operator to be sufficient to recover ordinary costs of drilling, completing, and producing an additional well in the same geological structure at an offset location with a reasonable profit to the operator, and if, after notice to the lessee and an opportunity to be heard, the state finds that production from that well is draining lands then subject to this lease, the lessee shall within 30 days after written demand by the state begin in good faith and diligently prosecute drilling operations for an offset well on the leased area. In lieu of drilling any well required by this paragraph, the lessee may, with the state's consent, compensate the state in full each month for the estimated loss of royalty through drainage in the amount determined by the state.

15. UNITIZATION. (a) The lessee may unite with others, jointly or separately, in collectively adopting and operating under a cooperative or unit agreement for the exploration, development, or operation of the pool, field, or like area or part of the pool, field, or like area that includes or underlies the leased area or any part of the leased area whenever the state determines and certifies that the cooperative or unit agreement is in the public interest.

(b) The lessee agrees, within six months after demand by the state, to subscribe to a reasonable cooperative or unit agreement that will adequately protect all parties in interest, including the state. The state reserves the right to prescribe such an agreement.

(c) With the consent of the lessee, and if the leased area is committed to a unit agreement approved by the state, the state may establish, alter, change, or revoke drilling, producing, and royalty requirements of this lease as the state determines necessary or proper to secure the proper protection of the public interest.

(d) Except as otherwise provided in this subparagraph, where only a portion of the leased area is committed to a unit agreement approved or prescribed by the state, that commitment constitutes a severance of this lease as to the unitized and nonunitized portions of the leased area. The portion of the leased area not committed to the unit will be treated as a separate and distinct lease having the same effective date and term as this lease and may be maintained only in accordance with the terms and conditions of this lease, statutes, and regulations. Any portion of the leased area not committed to the unit agreement will not be affected by the unitization or pooling of any other portion of the leased area, by operations in the unit, or by suspension approved or ordered for the unit. If the leased area has a well certified as capable of production in paying quantities on it before commitment to a unit agreement, this lease will not be severed. If any portion of this lease is included in a participating area formed under a unit agreement, the entire leased area will remain committed to the unit and this lease will not be severed.

16. INSPECTION. The lessee shall keep open at all reasonable times, for inspection by any duly authorized representative of the State of Alaska, the leased area, all wells, improvements, machinery, and fixtures on the leased area, and all reports and records relative to operations and surveys or investigations on or with regard to the leased area or under this lease. Upon request, the lessee shall furnish the State of Alaska with copies of and extracts from any such reports and records.

17. SUSPENSION. The state may from time to time direct or approve in writing suspension of production or other operations under this lease.

18. ASSIGNMENT, PARTITION, AND CONVERSION. This lease, or any undivided interest in this lease, may, with the approval of the state, be assigned, subleased, or otherwise transferred as to the entire leased area, or any one or more legal subdivisions included in the leased area, or any separate and distinct zone or geological horizon underlying the leased area or one or more legal subdivisions of the leased area, to any person or persons qualified to hold a lease. No assignment, sublease, or other transfer of an interest in this lease, including assignments of working or royalty interests and operating agreements and subleases, will be binding upon the state unless approved by the state. The lessee shall remain liable for all obligations under this lease accruing prior to the approval by the state of any assignment, sublease, or other transfer of an interest in this lease. All provisions of this lease will extend to and be binding upon the heirs, administrators, successors, and assigns of the state and the lessee. Applications for approval of an assignment, sublease, or other transfer must comply with all applicable regulations and must be filed within 90 days after the date of final execution of the instrument of transfer. Transfer of this lease or an interest in this lease will be approved by the state unless (1) the lessee fails to comply with applicable statutes and regulations, (2) the state determines in writing that the transfer would adversely affect the interests of the State of Alaska, or (3) at the discretion of the state, if the transfer covers a portion of the leased area or a separate and distinct zone or geological horizon. Where an assignment, sublease, or other transfer is made of all or a part of the lessee's interest in a portion of the leased area, this lease may, at the option of the state or upon request of the transferee and with the approval of the state, be severed and a separate and distinct lease will be issued to the transferee having the same effective date and terms as this lease.

19. SURRENDER. The lessee at any time may file with the state a written surrender of all rights under this lease or any portion of the leased areas comprising one or more legal subdivisions or, with the consent of the state, any separate and distinct zone or geological horizon underlying the leased area or one or more legal subdivisions of the leased area. That surrender will be effective as of the date of filing, subject to the continued obligations of the lessee and its surety to make payment of all accrued royalties and to place all wells and surface facilities on the surrendered land or in the surrendered zones or horizons in condition satisfactory to the state for suspension or abandonment. After that, the lessee will be released from all obligations under this lease with respect to the surrendered lands, zones, or horizons.

20. DEFAULT AND TERMINATION; CANCELLATION. (a) The failure of the lessee to perform timely its obligations under this lease, or the failure of the lessee otherwise to abide by all express and implied provisions of this lease, is a default of the lessee's obligations under this lease. Whenever the lessee fails to comply with any of the provisions of this lease other than a provision which, by its terms, provides for automatic termination, and fails within 60 days after written notice of that default to begin and diligently prosecute operations to remedy that default, the state may terminate this lease as of the time of termination there is no well on the leased area capable of producing oil or gas in paying quantities. If there is a well on the leased area capable of producing oil or gas in paying quantities, this lease may be terminated by an appropriate judicial proceeding. In the event of any termination under this subparagraph, the lessee shall have the right to retain under this lease any and all drilling or producing wells for which no default exists, together with a parcel of land surrounding each well or wells and rights-of-way through the leased area that are reasonably necessary to enable the lessee to drill, operate, and transport oil or gas from the retained well or wells.

(b) The state may cancel this lease at any time if the state determines, after the lessee has been given notice and a reasonable opportunity to be heard, that (1) continued operations pursuant to this lease probably will cause serious harm or damage to biological resources, to property, to mineral resources, or to the environment (including the human environment), (2) the threat of harm or damage will not disappear or decrease to an acceptable extent within a reasonable period of time, and (3) the advantages of cancellation outweigh the advantages of continuing this lease in effect. Any cancellation under this subparagraph will not occur unless and until operations under this lease have been under suspension or temporary prohibition by the state, with due extension of the term of this lease, continuously for a period of five years or for a lesser period upon request of the lessee. Any cancellation under this subparagraph will entitle the lessee to receive compensation as the lessee demonstrates to the state is equal to the lesser of (1) the value of the cancelled rights as of the date of cancellation, with due consideration being given to both anticipated revenues from this lease and anticipated costs, including costs of compliance with all applicable regulations and allocations, liability for clean-up costs or damages, or both, in the case of an oil spill, and all other costs reasonably anticipated under this lease, or (2) the excess, if any, over the lessee's revenues from this lease (plus interest on the excess from the date of receipt to date of reimbursement) of all consideration paid for this lease and all direct expenditures made by the lessee after the effective date of this lease and in connection with exploration or development, or both, under this lease, plus interest on that consideration and those expenditures from the date of payment to the date of reimbursement.

21. RIGHTS UPON TERMINATION. Upon the expiration or earlier termination of this lease as to all or any portion of the leased area, the lessee will be directed in writing by the state and will have the right at any time within a period of one year after the termination, or any extension of that period as may be granted by the state, to remove from the leased area or portion of the leased area all machinery, equipment, tools, and materials. Upon the expiration of that period or extension of that period and at the option of the state, any machinery, equipment, tools, and materials that the lessee has not removed from the leased area or portion of the leased area become the property of the state or may be removed by the state at the lessee's expense. At the option of the state, all improvements such as roads, pads, and wells must either be abandoned and the sites rehabilitated by the lessee to the satisfaction of the state, or be left intact and the lessee absolved of all further responsibility as to their maintenance, repair, and eventual abandonment and rehabilitation. Subject to the above conditions, the lessee shall deliver up the leased area or those portions of the leased area in good condition.

22. DAMAGES AND INDEMNIFICATION. (a) No rights under the AS 38.05.175 reservation may be exercised by the lessee until the lessee has provided to pay the owner of the land, his lessees and permittees, upon which the AS 38.05.175 reserved rights are sought to be exercised, full payment for all damage sustained by the owner by reason of entering the land. If the owner for any reason does not settle the damages, the lessee may enter the land after posting a surety bond determined by the state, after notice and an opportunity to be heard, to be sufficient as to form, amount, and security to secure to the owner, his lessees and permittees, payment for damages, and may institute legal proceedings in a court of competent jurisdiction where the land is located to determine the damages which the owner of the land may suffer. The lessee agrees to pay for any damages that may become payable under AS 38.05.130 and to indemnify the state and hold it harmless from and against any claims, demands, liabilities, and expenses arising from or in connection with such damages. The furnishing of a bond in compliance with this paragraph will be regarded by the state as sufficient provision for the payment of all damages that may become payable under AS 38.05.130 by virtue of this lease.

(b) The lessee shall indemnify the state for, and hold it harmless from, any claim, including claims for loss or damage to property or injury to any person caused by or resulting from any act or omission committed under this lease by or on behalf of the lessee. The lessee is not responsible to the state under this subparagraph for any loss, damage, or injury caused by or resulting from the sole negligence of the state.

(c) The lessee expressly waives any defense to an action for breach of a provision of this lease or for damages resulting from an oil spill or other harm to the environment that is based on an act or omission committed by an independent contractor in the lessee's employ. The lessee expressly agrees to assume responsibility for all actions of its independent contractors.

23. BOND. (a) If required by the state, the lessee shall furnish a bond prior to the issuance of this lease in an amount equal to at least \$5 per acre or fraction of an acre contained in the leased area, but no less than \$10,000, and must maintain that bond as long as required by the state.

(b) The lessee may, in lieu of the bond required under (a) above, furnish and maintain a statewide bond in accordance with applicable regulations.

(c) The state may, after notice to the lessee and a reasonable opportunity to be heard, require a bond in a reasonable amount greater than the amount specified in (a) above where a greater amount is justified by the nature of the surface and its uses and the degree of risk involved in the types of operations being or to be carried out under this lease. A statewide bond will not satisfy any requirement of a bond imposed under this subparagraph, but will be considered by the state in determining the need for and the amount of any additional bond under this subparagraph.

(d) If the leased area is committed in whole or in part to a cooperative or unit agreement approved or prescribed by the state, and the unit operator furnishes a statewide bond, the lessee need not maintain any bond with respect to the portion of the leased area committed to the cooperative or unit agreement.

24. AUTHORIZED REPRESENTATIVES. The Director of the Division of Minerals and Energy Management, Department of Natural Resources, State of Alaska, and the person executing this lease on behalf of the lessee shall be authorized representatives for their respective principals for the purposes of administering this lease. The state or the lessee may change the designation of its authorized representative or the address to which notices to that representative are to be sent by a notice given in accordance with Paragraph 25 below. Where activities pursuant to a plan of operations are underway, the lessee shall also designate, pursuant to a notice under Paragraph 26 below, by name, job title, and address, an agent who will be present in the state during all lease activities.

25. NOTICES; PROTEST. (a) Any notices required or permitted under this lease must be by electronic media producing a permanent record or in writing and must be given personally or by registered or certified mail, return receipt requested, addressed as follows:

TO THE STATE:

DIRECTOR, DIVISION OF MINERALS AND ENERGY MANAGEMENT
DEPARTMENT OF NATURAL RESOURCES
POUCH 7-034
ANCHORAGE, ALASKA 99510

TO THE LESSEE:

J. Andrew Bachner et al
c/o Main Hurdman
1001 Noble Street
Fairbanks, Alaska 99701

(b) Any notice given under this paragraph will be effective when delivered to the above authorized representative.

(c) A lessee who wishes to protest the amount of money due the state under the lease or any action of the state regarding a provision of this lease must file a written protest with the Division of Minerals and Energy Management within 30 days after the mailing date of the state's notice or bill. A lessee who fails to file a protest within the required time waives any further right to protest. The state will establish the administrative appeal procedure to be followed and will inform the lessee of the procedure no later than 30 days after the filing of the written protest.

26. STATUTES AND REGULATIONS. This lease is subject to all applicable state and federal statutes and regulations in effect on the effective date of this lease, and insofar as is constitutionally permissible, to all statutes and regulations placed in effect after the effective date of this lease. A reference to a statute or regulation in this lease includes any change in that statute or regulation whether by amendment, repeal and replacement, or other means. This lease does not limit the power of the State of Alaska or the United States of America to enact and enforce legislation or to promulgate and enforce regulations affecting, directly or indirectly, the activities of the lessee or its agents in connection with this lease or the value of the interest held under this lease. In case of conflicting provisions, statutes and regulations take precedence over this lease.

27. INTERPRETATION. This lease is to be interpreted in accordance with the rules applicable to the interpretation of contracts made in the State of Alaska. The paragraph headings are not part of this lease and are inserted only for convenience. The state and the lessee expressly agree that the law of the State of Alaska will apply in any judicial proceeding affecting this lease.

28. INTEREST IN REAL PROPERTY. It is the intention of the parties that the rights granted to the lessee by this lease constitute an interest in real property in the leased area.

29. WAIVER OF CONDITIONS. The state reserves the right to waive any breach of a provision of this lease, but any such waiver extends only to the particular breach so waived and does not limit the rights of the state with respect to any future breach; nor will the waiver of a particular breach prevent cancellation of this lease for any other cause or for the same cause occurring at another time. Notwithstanding the foregoing, the state will not be deemed to have waived a provision of this lease unless it does so in writing.

30. SEVERABILITY. If it is finally determined in any judicial proceeding that any provision of this lease is invalid, the state and the lessee may jointly agree by a written amendment to this lease that, in consideration of the provisions in that written amendment, the invalid portion will be treated as severed from this lease and that the remainder of this lease, as amended, will remain in effect.

31. LOCAL HIRE. The lessee is encouraged to hire Alaska residents to the extent they are available and qualified, to perform work done in Alaska in connection with this lease. The lessee shall submit annually to the Director, Division of Minerals and Energy Management, for transmission to the Alaska Department of Labor, a report that details the specific measures the lessee and its contractors and subcontractors have taken or are planning to take to recruit qualified Alaska residents for available jobs, and describes on-the-job training opportunities. The report must also include statistical data concerning the number of resident personnel hired within the past year for Alaska operations.

32. CONDITIONAL LEASE. If all or a part of the leased area is land that has been selected by the state under laws of the United States granting lands to the state, but the land has not been patented to the state by the United States, then this lease is a conditional lease as provided by law until the patent becomes effective. If for any reason the selection is not finally approved, or the patent does not become effective, any rental, royalty, or other production or profit-based payments made to the state under this lease will not be refunded.

33. NONDISCRIMINATION. The lessee and the lessee's contractors and subcontractors may not discriminate against any employee or applicant because of race, religion, marital status, change in marital status, pregnancy, parenthood, physical handicap, color, sex, age, or national origin as set out in AS 18.60.220. The lessee and its contractors and subcontractors must, on beginning any operations under this lease, post in a conspicuous place notices setting out this nondiscrimination provision.

34. DEFINITIONS. All words and phrases used in this lease are to be interpreted where possible in the manner required in respect to the interpretation of statutes by AS 01.10.04D. However, the following words have the following meanings unless the context unavoidably requires otherwise:

(1) "oil" means crude petroleum oil and other hydrocarbons, regardless of gravity, that are produced in liquid form by ordinary production methods, including liquid hydrocarbons known as distillate or condensate recovered by separation from gas other than at a gas processing plant;

(2) "gas" means all natural gas (except helium gas) and all other hydrocarbons produced that are not defined in this lease as oil;

(3) "associated substances" means all substances except helium produced as an incident of production of oil or gas by ordinary production methods and not defined in this lease as oil or gas;

(4) "drilling" means the act of boring a hole to reach a proposed bottom hole location through which oil or gas may be produced if encountered in paying quantities, and includes redrilling, sidetracking, deepening, or other means necessary to reach the proposed bottom hole location, testing, logging, plugging, and other operations necessary and incidental to the actual boring of the hole;

(5) "reworking operations" means all operations designed to secure, restore, or improve production through some use of a hole previously drilled, including, but not limited to, mechanical or chemical treatment of any horizon, plugging back to test higher strata, etc.;

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

(7) "force majeure" means war, riots, acts of God, unusually severe weather, or any other cause beyond the lessee's reasonable ability to foresee or control and includes operational failure of existing transportation facilities and delays caused by judicial decisions or lack of them.

35. ROYALTY ON PRODUCTION. (a) Except for oil, gas, and associated substances used on the leased area for development and production or unavoidably lost, the lessee shall pay to the state as a royalty 12 1/2 percent in amount or value of the oil, gas, and associated substances saved, removed, or sold from the leased area and of the gas used on the leased area for extraction of natural gasoline or other products from the leased area.

36. VALUE. (a) For the purposes of computing royalties due under this lease, the value of royalty oil, gas, or associated substances must not be less than the highest of:

(1) the field price received by the lessee for the oil, gas, or associated substances; (2) the volume-weighted average of the three highest field prices received by other producers in the same field or area for oil of like grade and gravity, gas of like kind and quality, or associated substances of like kind and quality at the time the oil, gas, or associated substances are sold or removed from the leased or unit area or the gas is delivered to an extraction plant if that plant is located on the leased or unit area; if there are less than three prices reported by other producers, the volume-weighted average will be calculated using the lesser number of prices received by other producers in the field or area;

(3) the lessee's posted price in the field or area for the oil, gas, or associated substances; or (4) the volume-weighted average of the three highest posted prices in the same field or area of the other producers in the same field or area for oil of like grade and gravity, gas of like kind and quality, or associated substances of like kind and quality at the time the oil, gas, or associated substances are sold or removed from the leased or unit area or the gas is delivered to an extraction plant if that plant is located on the leased or unit area; if there are less than three prices posted by other producers, the volume-weighted average will be calculated using the lesser number of prices posted by other producers in the field or area.

(b) If oil, gas, or associated substances are sold away from the leased or unit area, the term "field price" in subparagraph (a) above will be the cash value of all consideration received by the lessee or other producer from the purchaser of the oil, gas, or associated substances, less the reasonable costs of transportation away from the leased or unit area to the point of sale. The "reasonable costs of transportation" are as defined in 11 AAC 83 228 - 11 AAC 83 229 as those regulations exist on the effective date of this lease.

(c) In the event the lessee does not sell in an arm's-length transaction the oil, gas, or associated substances after removal from the leased or unit area, the term "field price" in subparagraphs (a) and (b) above will mean the price, on the leased or unit area, the lessee would expect to receive for the oil, gas, or associated substances if the lessee did sell the oil, gas, or associated substances in an arm's-length transaction. The lessee shall determine this price in a consistent and logical manner using information available to the lessee and report that price to the state.

(d) The state may establish minimum values for the purposes of computing royalties on oil, gas, or associated substances obtained from this lease, with consideration being given to the price actually received by the lessee, to the price or prices paid in the same field or area for production of like quality, to posted prices, to prices received by the lessee and other producers from sales recurring away from the leased area, and to other relevant matters. In establishing minimum values, the state may use, but is not limited to, the methodology for determining "prevailing value" as defined in 11 AAC 83 227 in circumstances where terms of a contract set a single price for oil, gas, or associated substances for periods of longer than six years without adjustments tied to market conditions, or where the terms of a contract set prices which do not reasonably reflect market conditions for production from that field or area prevailing at the time the contract is executed or renegotiated, or where fraud or an intent to evade payment is demonstrated. Each minimum value determination will be made only after the lessee has been given notice and a reasonable opportunity to be heard. Under this provision, it is expressly agreed that the minimum value of royalty oil, gas, or associated substances under this lease may not necessarily equal the price of the oil, gas or associated substances.

37. ROYALTY IN VALUE. Unless the state elects to receive all or a portion of its royalty in kind as provided in Paragraph 38 below, the lessee shall pay to the state that value of all royalty oil, gas, and associated substances as determined under Paragraph 36 above. Royalty paid in value will be free and clear of all lease expenses (and any portion of those expenses that is incurred away from the leased area), including, but not limited to, expenses for separating, cleaning, dehydration, gathering, saltwater disposal, and preparing the oil, gas, or associated substances for transportation off the leased area. All royalty that may become payable in money to the State of Alaska must be paid on or before the last day of the calendar month following the month in which the oil, gas, or associated substances are produced. The amount of all royalty in value payments which are not paid when due under this lease or which are subsequently determined to be due as the result of a redetermination will bear interest from the date the obligation accrued, until it is paid in full, at a variable annual rate equal to 1.25 percent plus the prime rate as announced from time to time by the Bank of America, San Francisco, California. Royalty payments must be accompanied by copies of run tickets or other information relating to valuation of royalty as the state may require which may include, but is not limited to, evidence of sales, shipments, and amounts of gross oil, gas, and associated substances produced.

38. ROYALTY IN KIND. (a) At the state's option, which may be exercised from time to time upon not less than six months' notice to the lessee, the lessee shall deliver all or a portion of the state's royalty oil, gas, or associated substances produced from the leased area in kind. Delivery will be on the leased area or at a place mutually agreed to by the state and the lessee, and must be delivered to the State of Alaska or to any individual, firm, or corporation designated by the state.

(b) Royalty oil, gas, or associated substances delivered in kind must be delivered in good and merchantable condition and be of pipeline quality, and must be free and clear of all lease expenses (and any portion of those expenses incurred away from the leased area), including, but not limited to, expenses for separating, cleaning, dehydration, gathering, saltwater disposal, and preparing the oil, gas, or associated substances for transportation off the leased area.

(c) After having given notice of its intention to take, or after having taken its royalty oil, gas, or associated substances in kind, the state, at its option and upon six months' notice to the lessee, may elect to receive a different portion or none of its royalty in kind. If, under federal regulations, the taking of royalty oil, gas, or associated substances in value by the state creates a supplier-purchaser relationship, the lessee hereby waives its right to continue to receive royalty oil, gas, or associated substances under that relationship, and further agrees that it will require any purchasers of the royalty oil, gas, or associated substances likewise to waive any supplier-purchaser rights.

(d) The lessee shall furnish storage for royalty oil and natural gas liquids produced from the leased or unit area to the same extent that the lessee provides storage for the lessee's share of oil and natural gas liquids. The lessee shall not be liable for the loss or destruction of stored royalty oil and natural gas liquids from causes beyond the lessee's reasonable control.

(e) If a state royalty purchaser refuses or for any reason fails to take delivery of oil, gas, or associated substances, or in an emergency, and with as much notice to the lessee as is practical or reasonable under the circumstances, the state may elect without penalty to underfill for up to six months all or a portion of the state's royalty on oil, gas, or associated substances produced from the leased or unit area and taken in kind. The state's right to underfill is limited to the portion of royalty oil, gas, or associated substances that the royalty purchaser refused or failed to take delivery of, or the portion necessary to meet the emergency condition. Underfilled oil, gas, or associated substances may be recovered by the state at a daily rate not to exceed 10 percent of the royalty interest share of daily production at the time of the underfill recovery.

39. REDUCTION OF ROYALTY. After initial production for two years from the field in which the leased or unit area is located has occurred, the state, in its discretion, may reduce the lessee's obligations to pay royalty on all of the leased area or on any tract or portion of the leased area segregated for royalty purposes upon (1) request by the lessee, (2) a clear showing by the lessee that the revenue from all oil, gas, and associated substances produced from the field is insufficient to produce a reasonable rate of return with respect to the lessee's total investment in the field, and (3) a clear showing by the lessee that a reduction in royalty will increase total production from the field.

40. SHARE OF NET PROFIT. The lessee shall pay to the State of Alaska 40% of the net profit derived from this lease. For the purposes of this paragraph, calculation of the net profit will be determined in accordance with 11 AAC 83.201 through 11 AAC 83.206 as those regulations exist on the effective date of this lease, which by reference are made a part of this lease. The amount of interest to be earned on the net profit share development account pursuant to 11 AAC 83.212 will be the average of the prime rates of the Citibank, NA New York, Chase Manhattan Bank, NA New York, and the Bank of America, NY and SA San Francisco, prevailing during the month.

41. EFFECTIVE DATE. This lease takes effect on August 1, 1983.

BY SIGNING THIS LEASE, the state as lessor and the lessee agree to be bound by its provisions.

LESSEE
By: J. Andrew Bachner
Title: J. Andrew Bachner
By: James P. Dieringer, Jr.
Title: James P. Dieringer, Jr.
By: W.G. Stroecker
Title: W.G. Stroecker
By: Richard E. Wagner
Title: Richard E. Wagner

STATE OF ALASKA
By: Kay Brown
Title: Kay Brown, Director, DMEM

Third Judicial District)
1st

This is to certify that on July 19, 1983, before me appeared KAY BROWN of the Division of Minerals and Energy Management, of the State of Alaska, Department of Natural Resources, and who executed this lease and acknowledged voluntarily signing it on behalf of the State of Alaska as lessor.

Carol D. Wilkinson
Notary public in and for Alaska
My commission expires: STATE OF ALASKA
NOTARY PUBLIC
CAROL D. WILKINSON
My Commission Expires: Oct. 19, 1984

INSERT NOTARY ACKNOWLEDGEMENT OF LESSEE'S SIGNATURE HERE.

This is to certify that on June 23, 1983, before me appeared J. Andrew Bachner, James P. Dieringer, Jr., W.G. Stroecker, and Richard E. Wagner of J. Andrew Bachner et al. and who executed this lease and acknowledged voluntarily signing it.

Ellen G. Ring
Notary public in and for Alaska
My commission expires: 9-11-84



EXHIBIT "A"

BOOK 40 PAGE 852
Barrow Recording District

TRACT 39-01

T. 13 N., R. 13 E., Uniat Meridian, Alaska

Section 17,	Protracted, All, 640.00 acres;
Section 18,	Protracted, All, 631.00 acres;
Section 19,	Protracted, All, 633.00 acres;
Section 20,	Protracted, All, 640.00 acres;
Section 25,	Protracted, All, 640.00 acres;
Section 26,	Protracted, All, 640.00 acres;
Section 27,	Protracted, All, 640.00 acres;
Section 28,	Protracted, All, 640.00 acres;
Section 29,	Protracted, All, 640.00 acres.

This tract contains 5744.00 acres more or less.

8 40 579
32.00

RECORDED - ~~5123~~
BARROW RECORDING
DISTRICT

MAY 16 12 00 PM '84

REQUESTED BY AS/DNR

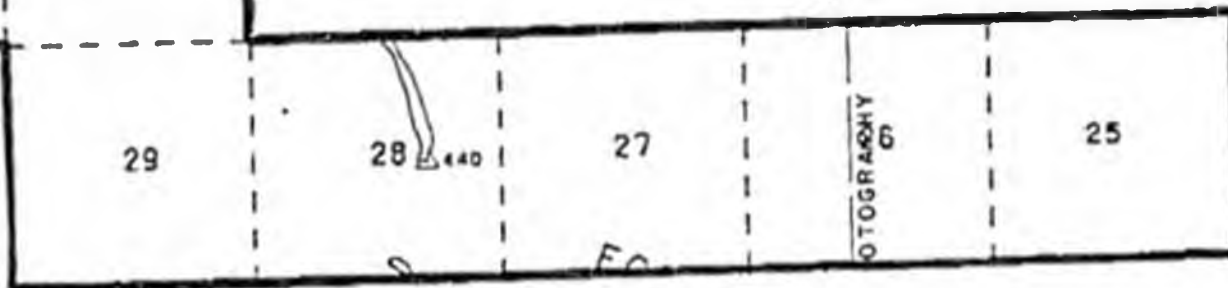
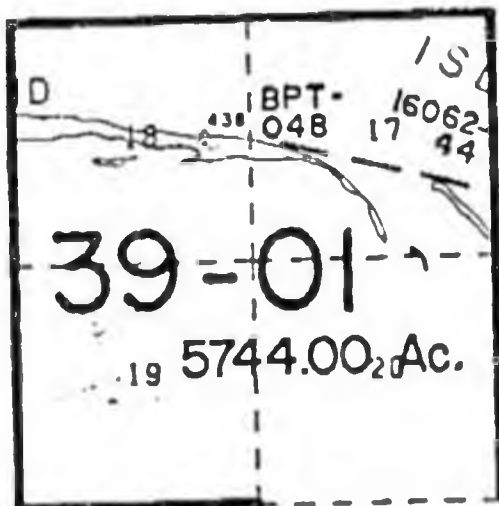
ADDRESS DIV. OF OIL + GAS

POUCH 7-034

ANCHORAGE, AK. 9951C

ATTN: ROSINA

304731



MITIGATING MEASURES

AS 38.05.035(a) (14) and the departmental delegation of authority give the Director, Division of Minerals and Energy Management (DMEM), the authority to impose conditions or limitations, in addition to those imposed by statute, to ensure that a resource disposal is in the state's best interest. Lease stipulations will be enforced throughout the term of the lease. Measures listed under "Plans of Operations and Other Terms of Sale" will be imposed through Plans of Operations and other permits to mitigate the social and environmental effects of lease activities. These measures have been developed considering the Social, Economic, and Environmental Analysis for Lease Sale 39, public comment, and measures imposed in prior north slope lease sales.

Lease Stipulations

1. Spill Prevention Control and Countermeasure (SPCC) Plans:

A Spill Prevention, Control and Countermeasure Plan must be submitted to the Department of Environmental Conservation for approval prior to onshore drilling operations and construction of onshore oil and gas storage facilities (with a capacity of greater than 660 gallons), transfer, and transportation facilities. In addition to addressing the prevention, detection and cleanup of oil, the SPCC plan for drilling operations should include, but not be limited to, methods for controlling blowouts, location of spill clean-up equipment, identification and location of a suitable alternative drilling rig, and the time required to obtain equipment, mobilize, rig-up, and commence drilling of a relief well, if needed.

2. Discovery of historic or archeologic objects:

In the event any site, structure, or object of historic or archeologic significance is discovered during operations on the leased area, the lessee must report immediately such findings to the Director, DMEM, and make every reasonable effort to preserve and protect such site, structure, or object from damage until the Director, after consultation with the State Historic Preservation Officer, has given directions as to its preservation.

3. Seasonal drilling restriction:

This stipulation will be reevaluated periodically on the basis of experience and new information.

A principle purpose of this stipulation is to ensure that the migration route of the bowhead whale will be oil free in the fall.

This stipulation assumes compliance with otherwise applicable laws and regulations, including a Plan of Operations approved by the Department of Natural Resources (DNR) and an Oil Discharge Contingency Plan approved by the Department of Environmental Conservation (DEC).

The restrictions set out below apply only to exploratory drilling offshore. As a matter of policy, the state does not intend to impose seasonal drilling restrictions during development or production stages; however, seasonal restrictions will be imposed as necessary in the development and production stages to satisfy requirements of the federal Endangered Species Act and other applicable state and federal laws and regulations.

The seasonal drilling restriction does not apply to exploratory operations on Pingok Island, which has been identified by the Commissioner of Natural Resources, in consultation with the Commissioners of Environmental Conservation and Fish and Game, as analogous to upland areas because of its size and configuration.

Logistical, construction, and other activities related to exploratory drilling may be restricted outside the barrier islands during the fall whale migration.

The threshold depth as used in this stipulation is a point above which major accumulations of hydrocarbons are not likely. This depth will be determined on a case-by-case basis by the Division of Minerals and Energy Management after consultation with the Alaska Oil and Gas Conservation Commission and, when appropriate, the Minerals Management Service.

Tier 1 is effective immediately. Tier 2 will be available on a case-by-case basis for each proposed well.

TIER 1

- A. On and inside the barrier islands--(Figure 1 indicates the tracts and portions of tracts that are located "on and inside" and "outside" the barrier islands.)
1. Exploratory drilling and other downhole activities above a predetermined threshold depth will be allowed year-round.
 2. Testing will be allowed year-round provided that casing has been set through the zones to be tested and DNR and DEC find compliance with applicable laws and regulations.
 3. Exploratory drilling and other downhole activities below the predetermined threshold depth will be allowed from November 1 to May 15, except on tracts at the mouths of major rivers that are inundated by river overflow in the spring. On those tracts, which are shown in Figure 8, exploratory drilling and other downhole activities below the predetermined threshold depth must cease by April 30 unless the Commissioner of Natural Resources, in consultation with the Commissioners of Fish and Game and Environmental Conservation, determines that ice conditions justify an extension to May 15. Exploratory drilling and other downhole activities below the predetermined threshold depth will be allowed during the "open water" period except during the fall bowhead whale migration.

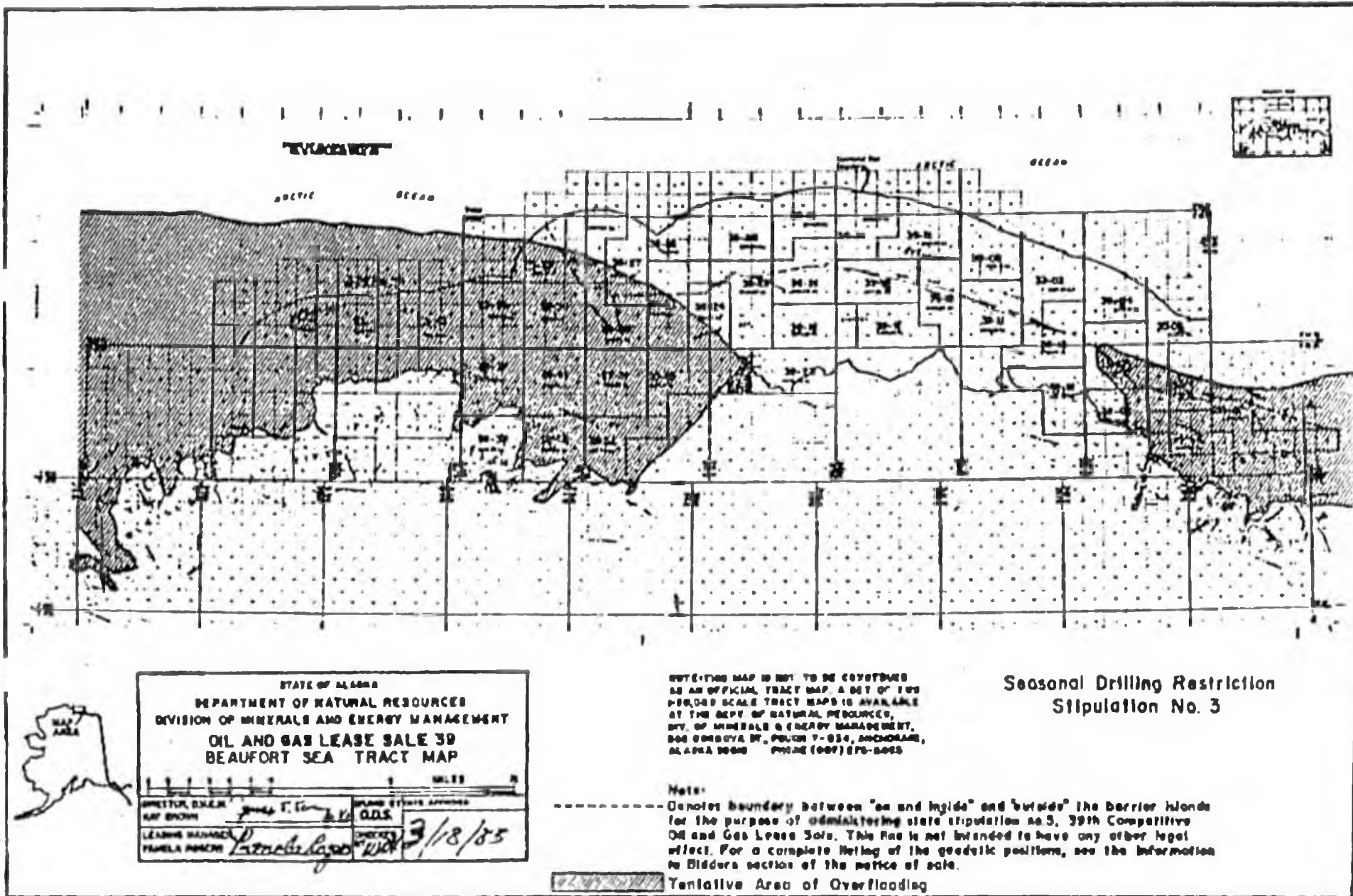


FIGURE 1

For the purpose of administering this stipulation, "open water" shall begin when the ice concentration between the drill site and a major onshore staging and support area (such as the West Dock) does not restrict the transport of heavy equipment and supplies (including drilling muds, cleanup equipment, casing and drill rigs) and when the ice concentration within a mile radius of the drill pad is 25 percent or less. Once a determination is made that open water conditions exist, drilling and other downhole activity below the threshold depth will not be suspended until the commencement of the bowhead whale migration or freezeup, whichever is first, even if ice incursions result in ice concentrations greater than 25 percent.

The Director, Division of Minerals and Energy Management (DMEM), in consultation with the Department of Environmental Conservation (DEC), shall determine when the criteria stated above have been met based on: 1) information obtained from on-site inspections by Department of Natural Resources (DNR) or DEC representatives, at the request of the lessee, or 2) corroborating information and photographs obtained from a qualified independent consultant hired by the lessee who certifies that these conditions exist.

4. A monitoring program will be required if lessees propose to drill above the threshold depth or test through casing during the fall bowhead whale migration. The program will be initiated and funded by the lessee(s) proposing to conduct the activity. The proposed monitoring program should be submitted with the lessee's Plan of Operations for the well for review by DNR, the National Marine Fisheries Service and other members of the Beaufort Sea Biological Task Force. If the proposed monitoring program is approved by DNR, the lessee may conduct the stipulated operations during the migration period (provided other necessary state and federal permits have been obtained).

8. Outside the barrier islands

1. Exploratory drilling and other downhole activities above the predetermined threshold depth will be allowed year-round except during the fall bowhead whale migration.

2. Testing will be allowed year-round, except during the fall bowhead whale migration, provided that casing has been set through the zones to be tested and DNR and DEC find compliance with applicable laws and regulations.

3. Exploratory drilling and other downhole activities below the predetermined threshold depth will be allowed from November 1 to May 15, except on tracts at the mouths of major rivers that are likely subject to river overflow in the spring. Exploratory drilling and other downhole activities below the predetermined threshold depth on these tracts must cease by April 30 unless the Commissioner of Natural Resources, in consultation with the Commissioners of Fish and Game and Environmental Conservation, determines that ice conditions justify an extension to May 15.

TIER 2

All exploratory drilling and other downhole activities will be allowed areawide year-round except outside the barrier islands during the fall bowhead whale migration. Whale monitoring will be required to determine when the whales are actually migrating through or near the area.

This modification of the drilling restriction will be approved on a case-by-case basis for the benefit of lessees who demonstrate compliance with applicable laws and regulations, including the theoretical and physical capability to detect, contain, clean up and dispose of spilled oil in broken ice conditions.

Plans of Operations and Other Terms of Sale

Lessees must submit a detailed plan of operations to the Division of Minerals and Energy Management for approval prior to conducting any exploratory or development operations. The lessee shall concurrently submit an informational copy of its plan of operations to the North Slope Borough. The following restrictions will be imposed as a condition of the approval of plans of operations:

1. Road and pipeline crossings must be aligned perpendicular or near perpendicular to watercourses. Permanent facilities will be prohibited within 500 feet (152 m) of the Colville and Ugnuvarik rivers. Facilities will be prohibited within 100 feet (30 m) of all other streams and fish-bearing lakes unless the Director, Division of Minerals and Energy Management, after consultation with the Department of Fish and Game, determines that such facilities placement will not disturb critical wildlife habitats or that such a requirement is not feasible or prudent. The Department of Fish and Game will identify potential fish-bearing lakes within 30 days of the date a request for approval of a plan of operations is received. The Department of Fish and Game will confirm the presence or absence of fish at the earliest opportunity when ice conditions permit. If fish are not present in lakes, the 100 foot setback provision may be waived.
2. Measures will be required to minimize the impact of industrial development on key wetlands, waterfowl and shorebirds. Key wetlands include deep pendent grass ponds and lakes (Class IV) and basin - complex wetlands (Class VI), and coastal wetlands (Class VIII). Measures will include restricting certain facility siting to the least environmentally sensitive portions of these wetlands. Specific measures include the requirements that:
 - a. Lessees identify on a map or aerial photograph the largest surface area within which it is anticipated that a facility is to be sited, or an activity is to occur. The map or photograph must accompany the plan of operations submitted to DMEM. DMEM and the Department of Fish and Game will identify the least environmentally sensitive area(s) within the industry-identified area of interest. The industry-identified surface area must be large enough to contain the proposed facility and to accommodate planned expansion.

- b. Drill pads, roads, pipelines and other facilities must be sited outside of productive Class IV, VI and VIII wetlands, unless the Director, DMEH, after consultation with the Department of Fish and Game, determines that there are no feasible alternatives.
 - c. Where facilities must be sited within Class IV, VI and VIII wetlands, such facilities will be sited, designed and constructed in a manner that will maintain natural hydrological patterns and prevent oil contamination.
 - d. Draining or dewatering Class IV, VI and VIII wetlands is prohibited.
3. Impermeable lining and diking will be required for sewage ponds and onshore oil storage facilities (with a storage capacity greater than 660 gallons). Buffer zones of not less than 100 feet and up to 1,500 feet will be required to separate oil storage facilities (with a capacity greater than 660 gallons) and sewage ponds from freshwater supplies, streams, lakes, and Class IV and VI wetlands unless the Director, DMEH, after consultation with the Department of Environmental Conservation, determines that such a requirement is not feasible or prudent. Sumps and reserve pits must be impermeable and otherwise fully contained through diking or other means.
4. All lease activities and structures must be designed to maintain normal water flow or drainage patterns and to allow free movement and safe passage of fish and mammals, unless the Director, DMEH, after consultation with the Department of Fish and Game, determines that such a design is not feasible or prudent.
5. Exploration activities must be supported only by ice and winter roads and trails, existing road systems, and air service. On-tundra travel may be permitted if the Director, Division of Land and Water Management and the Director, DMEH, determine that travel can be accomplished without disturbing the vegetative mat or an emergency condition exists.
6. Facilities and surface transportation routes must be consolidated to the extent feasible and prudent.
7. No restriction of public access to, or use of, the leased area will be permitted as a consequence of oil and gas activities except in the immediate vicinity of drill sites, buildings and other related structures. Such areas where access is to be restricted must be identified in the plan of operations. No lease facilities or operations may be located where they would block public access to or along navigable and public waters as defined in AS 38.05.365(22) and (23). If lease facilities are proposed to be located in the vicinity of these public waters, an easement will be reserved under AS 38.05.127 and 11 AAC 53.330 to ensure the right of public access.
8. The lessee must include in any exploration and/or development plans a proposed environmental training program for all personnel involved in exploration or development activities (including personnel of the lessee's contractors and subcontractors) for review and approval by

the Director, DMEM. The program must be designed to inform each person working on the project of specific types of environmental, social, and cultural concerns which relate to the individual's job. The program must be formulated and implemented by qualified instructors experienced in each pertinent field of study and must employ effective methods to ensure that personnel understand and use techniques necessary to preserve archeological, geological, and biological resources. The program must also be designed to increase the sensitivity and understanding of personnel to community values, customs, and life styles in areas in which such personnel will be operating.

The lessee must also submit for review and approval a continuing technical environmental briefing program for supervisory and managerial personnel of the lessee and its agents, contractors, and subcontractors.

9. The lessee is encouraged to hire Alaska residents to the extent that they are available and qualified, to perform work done in Alaska in connection with this lease. As indicated in paragraph 3) of the lease form, the lessee must submit annually to the Director, Division of Minerals and Energy Management, for transmission to the Department of Labor, a report that details the specific measures the lessee and its contractors and subcontractors have taken or are planning to take to recruit qualified Alaska residents for available jobs, and describes on-the-job training opportunities. The report must also include statistical data concerning the number of resident personnel hired within the past year for Alaska operations.
10. Solid waste disposal on natural or artificial islands and into marine waters, rivers, streams, natural lakes and Class IV and VI wetlands is prohibited. Before the lessees dispose of solid waste in other areas, the disposal must be approved through permits by the Commissioner, Department of Environmental Conservation.
11. Discharge of produced water, drilling muds, and cuttings:
 - a. Disposal of produced water to freshwater bodies, including Class IV and VI wetlands, is prohibited. Disposal of produced waters in upland areas, including Class IV and VI wetlands, will be by subsurface disposal techniques, except that the Commissioner of the Department of Environmental Conservation may permit alternate disposal methods if he determines that subsurface disposal techniques are not feasible or prudent.
 - b. Discharge of drilling muds and cuttings to lakes, streams, rivers, and Class IV and VI wetlands is prohibited. Upland disposal of contaminated muds and cuttings may be made into approved sumps and reserve pits which are impermeable and otherwise fully contained through diking or other means.

- c. Discharge of produced waters into open or ice-covered marine waters of less than 10 meters in depth is prohibited. All submerged Sale 39 tracts, except seaward portions of Tracts 3, 4, 8, 9, 13, 14, 19, 20, 25, 27, 28, and 33 are within the 10-meter isobath. The Commissioner of the Department of Environmental Conservation may approve discharges into waters greater than 10 meters in depth based on a case-by-case review of environmental factors and consistency with the conditions of a development production phase general NPDES permit for the sale area.
 - d. Disposal of oil-based or oil-contaminated drilling muds and cuttings to offshore waters and on sea ice is prohibited.
 - e. During winter exploratory drilling, drilling muds and cuttings free of hydrocarbon contamination may be disposed of on the sea ice surface in areas free of cracking or major stress fractures. During periods of reduced ice thickness or instability, uncontaminated drilling muds and cuttings may be discharged under sea ice if ice surface disposal methods, such as direct disposal by pumping, artificial thickening of sea ice or use of light or routine drilling effluent handling equipment, are impractical. Each part of drilling fluid discharged under sea ice must be prediluted with nine parts seawater.
 - f. During summer exploratory drilling, drilling muds and cuttings free of hydrocarbon contamination may be discharged to open water. The discharge shall be diluted at a ratio of at least nine parts seawater to one part drilling fluid. Drilling muds and cuttings generated from winter drilling may not be stockpiled at the drill site for open water disposal except when above ice disposal is determined impractical due to broken ice conditions. The disposal of drilling muds within the two-meter isobath and the entirety of Simpson Lagoon is prohibited unless the lessee can demonstrate to the satisfaction of the Commissioner of the Department of Environmental Conservation that effluents can be adequately dispersed.
 - g. Disposal of drilling muds and cuttings during development and production will be subject to the conditions of NPDES permits issued by the Environmental Protection Agency and those State of Alaska Coastal Management Program consistency requirements incorporated in or accompanying the NPDES permit.
12. Exploration facilities, with the exception of drill pads, will be temporary and must not be constructed of gravel. However, use of existing abandoned gravel structures may be permitted on an individual basis by the Director, DNEM, after consultation with the Director of the Division of Land and Water Management and the Department of Fish and Game. Approval for use of abandoned structures will depend on the extent and method of restoration needed to return these structures to a usable condition.

13. In meeting gravel needs for exploration, development, and production, gravel from nearby abandoned drill pads and existing material sites must be used first unless the Director, Division of Land and Water Management, after consultation with the Director, DMEM, and the Department of Fish and Game, determines that the reuse of such sources is not feasible and prudent.
14. Gravel mining sites required for exploration activities must not be located within an active floodplain of watercourses, unless the Director, Division of Land and Water Management, after consultation with the Department of Fish and Game, determines that a floodplain source will cause the least adverse environmental impact. Mining site development and rehabilitation within floodplains must follow the procedures outlined in Gravel Removal Guidelines For Arctic and Subarctic Floodplains, 1980, U.S. Fish and Wildlife Service-Woodward Clyde Consultants. Under AS 16, Department of Fish and Game approval is required if the mining site is located within an anadromous stream or could block fish passage.
15. Borrow extraction from barrier islands is prohibited. Borrow extraction from lagoons and nearshore areas is prohibited unless the Director, Division of Land and Water Management finds, in consultation with the Department of Fish and Game and the Department of Environmental Conservation, that, on the basis of scientific evidence, borrow extraction in these areas will not adversely affect the environment or that no alternative feasible and prudent source exist.
16. Gravel mining sites required for development activities will be restricted to the minimum number of upland or approved offshore sites needed to develop the field efficiently and with minimal environmental damage. Where feasible, upland gravel sites will be designed and constructed to function as reservoirs for winter water supplies. Gravel mining will not be allowed from active floodplains during development and production activities, unless the Director, Division of Land and Water Management, after consultation with the Department of Fish and Game, determines that there is no other feasible and prudent alternative.
17. Pipelines will be located so as to facilitate the containment and clean up of spilled hydrocarbons. Where feasible, pipelines will be located on the upslope side of roadways and construction pads unless the Director, Division of Land and Water Management, determines that an alternative site is an acceptable environmental alternative.
18. All garbage and refuse will be incinerated. Residue and nonburnables will be disposed of at an approved upland site. No new solid fill disposal sites, except possibly for the disposal of drilling muds and cuttings, will be approved during the exploratory phase.
19. Except for those on approved exploratory drill sites, stationary fuel storage facilities shall not be placed, nor vehicle refueling occur, within the active floodplains. Exceptions may be allowed during the permitting process under AS 16.06.870 for the refueling of slow-moving construction equipment, such as graders, tractor pulled scrapers and front end loaders, within floodplains.

20. Prior to the construction or placement of any onshore structure, road, or facility resulting from exploration, development, or production activities, the lessee must conduct an inventory of archeological and historical sites within the area affected by a proposed activity. Such inventory must consider literature provided by the North Slope Borough and local residents, documentation of oral history regarding historic and prehistoric uses of such sites, evidence of consultation with the Alaska Heritage Resources Survey and the National Register of Historic Places, and site surveys. The inventory must also include a detailed analysis of the potential effects estimated to result from the proposed activity. The inventory must be submitted to the Director, DHEM, for distribution to the Director of the Division of Parks and the Mayor of North Slope Borough for purposes of review and comment. In the event that an archeological or historical site or area may be adversely affected by an activity, the Director, DHEM, after consultation with the Director of the Division of Parks and the North Slope Borough, will direct the lessee as to what course of action will be necessary to mitigate the adverse effect.
21. Upon abandonment of drilling sites, roads, buildings, airstrips or other facilities, such facilities will be removed and the site rehabilitated, unless the Director, DHEM, after consultation with the departments of Fish and Game and Environmental Conservation, determines that such removal and rehabilitation is not in the state's interest.
22. The following measures will be imposed by the Department of Fish and Game under Title 16 of the Alaska Statutes to protect anadromous streams:
- a. Alteration of river banks is prohibited unless approved by the Department of Fish and Game.
 - b. Except for approved stream crossings, equipment must not be operated within willow stands (Salix spp.).
 - c. The operation of equipment, excluding boats, in open water areas of rivers and streams will be prohibited unless approved by the Department of Fish and Game.
 - d. Bridges must be used as watercourse crossings whenever feasible. Culverts may be used only when bridges are shown not to be feasible or prudent. The siting, design, and construction of both bridges and culverts must be approved by the Department of Fish and Game prior to the placement of either of these structures.
 - e. Removal of freshwater or snow cover from fish bearing rivers, streams, and natural lakes will be prohibited from freeze up until spring breakup. Compaction of snow cover overlying fish-bearing waterbodies will be prohibited except for perpendicular crossings approved by the Department of Fish and Game. If ice thickness is not sufficient to facilitate a crossing, ice and/or snow bridges will be required.

- f. Water intake pipes utilized for summer water removal from the river must be surrounded by a screened enclosure to prevent fish entrainment and impingement. Pipes and screening must be designed and constructed so that the maximum water velocity at the surface of the screen enclosure is no greater than 0.1 foot per second. Screen mesh size shall not exceed 0.04 inch unless another size has been approved by the Department of Fish and Game.
- g. To protect fish and other aquatic fauna, explosives must not be detonated within, beneath, or in close proximity to fish-bearing waters unless prior drilling indicates that the waterbody, including its substrate, is solidly frozen. The minimum acceptable offset from fish-bearing waters for various size charges is:

1-2 pound charge	--	80 feet
5 pound charge	--	120 feet
10 pound charge	--	170 feet
25 pound charge	--	270 feet
100 pound charge	--	530 feet

Lessees are advised that documented anadromous rivers in and adjacent to the lease sale area include: the Colville, Ungnuvarik, and Kuparuk rivers.

23. The lessee will be responsible for ensuring that an adequate supply of water is available for winter use through development of such means as storage reservoirs and snow melting. Water appropriations shall be authorized pursuant to AS 46.15.
24. The following measures will be required to minimize impacts on the Central Arctic Caribou Herd.
- a. The movement of equipment and personnel to and from Sale 39 tracts through the Kuparuk calving ground of the Central Arctic Herd depicted in Figure 3 may be restricted between May 15 and June 25. All authorized movement of equipment and personnel must be on established roads and must be consolidated and scheduled to reduce disturbance to caribou. The necessity and conditions for limiting equipment and personnel movement will be identified on a case-by-case basis during review of plans of operations by the Director, Division of Minerals and Energy Management, in consultation with Alaska Department of Fish and Game.
- b. Pipelines should be consolidated to the extent feasible and must be constructed to allow safe passage of caribou. Adequate elevation, ramping, or burial of pipelines will be required in areas identified by the Department of Fish and Game as important caribou movement zones.

25. Routes of travel must avoid preferred polar bear denning habitat unless human safety dictates otherwise. Polar bears den on Pingok and Cottle islands and within 25 miles of the coastline in deeply drifted areas (6 ft. or greater) adjacent to the cutbanks of drainages. The use of explosives will be prohibited within 1/4 mile of cutbanks identified by the Department of Fish and Game. The Department of Fish and Game will make maps identifying documented high density polar bear denning habitat available to the Director and lessees within 45 days of the date a request for approval of a plan of operations is received.
26. The following provisions will govern aircraft operations in and near the sale area.
 - a. From May 15 through September 30, aircraft must fly at altitudes of greater than 1,500 feet (457 m) or at a lateral distance of one mile around barrier islands, lagoons, river deltas, and wetlands within one mile of the Beaufort Sea coast (excluding take-offs and landings).
 - b. From May 15 through June 20, aircraft overflights within 30 miles (24 km) of the coast between the Colville and Kuparuk rivers must avoid caribou by an altitude of at least 1,500 feet (457 m) or a lateral distance of one mile (1.6 km) (excluding take-offs and landings).
 - c. Human safety will take precedence over aircraft restrictions.
27. Surface use will be restricted, as necessary, to prevent unreasonable conflicts with local subsistence harvests.
28. Bidders are advised that the North Slope Borough (NSB) Assembly has adopted a Comprehensive Plan and Land Management Regulations under Title 29 of the Alaska Statutes. The regulations require NSB approval for certain activities necessary for exploration and development of the lease. The state may not in all instances accept this assertion of jurisdiction.
29. During the conduct of all activities related to this lease, the lessee will be subject to the provisions of all valid coastal zone plans and ordinances. DHEM will require, as a condition for consistency approval of lease operations, such modification or stipulations as may be necessary to ensure consistency with the Coastal Management Act, and with sound planning and management of coastal zone resources.
30. Plans of operations for lease activities and specific permit applications which are subject to approval by the U.S. Corps of Engineers or which require a Certificate of Reasonable Assurance from the Department of Environmental Conservation must be submitted simultaneously for state agency review and approval, at least 60 days prior to the proposed conduct of such activities.

31. If only the subsurface estate is owned by the state, or if the surface is owned by the state but subject to third party interests, including any native allotments, the lessee must not enter upon such land until the lessee makes a good faith effort to agree with the surface interest holder on settlement of damages that may be caused by lease activities. If an agreement cannot be reached, Director, DHEM, has the authority to approve the activity, provided adequate provisions have been made with the state to pay for any damages the surface interest holder may suffer.
32. The proposed activities under a plan of operations must not unreasonably diminish the use and enjoyment of lands encompassed within a native allotment. Before entering a pending or approved native allotment, lessees must contact the Bureau of Indian Affairs and the Bureau of Land Management and obtain approval to enter, if required. Lessees must also comply with applicable federal law on native allotments.
33. In conducting offshore geophysical surveys, neither lessees nor their agents will use explosives in open water areas. Offshore geophysical surveys will be restricted as necessary during the spring to comply with the provisions of the Marine Mammal Protection Act. Offshore geophysical surveys will be restricted as necessary during the fall to comply with the provisions of the Endangered Species Act as they relate to the bowhead whale. In determining these restrictions, the Director, DHEM, will at a minimum consult the North Slope Borough, the Alaska Eskimo Whaling Commission, the Beaufort Sea Biological Task Force, and affected permittees.
34. Continuous fill causeways are prohibited. Noncontinuous fill causeways may be permitted when the Director, DHEM, after consultation with the Department of Fish and Game and the Department of Environmental Conservation, determines that a causeway is necessary for field development and that no other feasible and prudent alternative exists.
35. An Oil Discharge Contingency Plan will be required for offshore operations under AS 46.04.030 and 18 AAC 75.
36. Oil and gas transportation pipelines will be encouraged if the Director, DHEM, determines that the laying of such pipelines is technically feasible and environmentally preferable to transport via oil tanker. Pipelines, including flow and gathering lines, must be designed and constructed to provide adequate protection from water currents, storm and ice scouring, subfreezing conditions, and other hazards as determined on a case-by-case basis. Following the installation of a pipeline of sufficient capacity, no crude oil will be transported by surface vessel from offshore production sites, except in an emergency. The Director, DHEM, will evaluate the emergency and determine an appropriate response to the condition. If the use of a pipeline is not feasible and preferable and surface transportation must be employed, all vessels used for carrying hydrocarbons to shore will conform with all standards established for such vessels, pursuant to the Ports and Waterways Safety Act of 1972 (46 U.S.C. 391(a)) and the Port and Tanker Safety Act of 1978 (46 U.S.C. 1221).

37. Many of the environmental concerns associated with the offshore tracts within the area of the Joint Federal-State Beaufort Sea Sale (Sale 30) apply to the offshore tracts in the Sale 39 area. Consequently, in the enforcement of Stipulation No. 3 and Terms of Sale Nos. 8, 15, 33, and 36 of Sale 39, the Director, DHEM, will continue to receive recommendations from a biological task force composed of designated representatives of the following state agencies: Department of Fish and Game, Department of Environmental Conservation, and Department of Natural Resources. In addition, the office of the Governor and representatives of interested federal agencies, including the Bureau of Land Management, U.S. Fish and Wildlife Service, Minerals Management Service, the National Marine Fisheries Service, and the Environmental Protection Agency will be afforded the opportunity to continue their participation in these consultations.
38. The movement of equipment and personnel to and from Sale 39 tracts through the whistling zwan staging area in T13N, R8E, Umiat Meridian 3 will be restricted as necessary between July 15 and September 1. The necessity and conditions for limiting equipment and personnel movement will be identified on a case-by-case basis during review of plans of operations by the Director, DHEM, in consultation with the Department of Fish and Game.
39. For the purpose of administering the seasonal drilling restriction, Stipulation 3, the boundary between the areas classified as "on or inside" and "outside" the barrier islands will be a line connecting the following salient points:

<u>Salient Pt. No.</u>	<u>Latitude</u>	<u>Longitude</u>
16045-5	70°14'19.00" N=7792349.21	146°38'17.00" E=513710.76
16062-44	70°28'35.30" N=7819850.41	148°49'06.40" E=432180.64
BPT-001	70°33'13.40" N=7830108.992	149°56'53.50" E=390487.531
BPT-002	70°33'14.20" N=7830127.595	149°56'41.20" E=390615.559
BPT-003	70°33'31.60" N=7830628.325	149°55'25.40" E=391423.076
BPT-007	70°33'50.00" N=7831057.169	149°50'38.20" E=394410.503
BPT-008	70°34'13.50" N=7831597.007	149°44'02.10" E=398525.888

<u>Salient Pt. No.</u>	<u>Latitude</u>	<u>Longitude</u>
BPT-014	70°34'02.30" N=7831066.516	149°37'17.70" E=402678.052
BPT-015	70°33'54.10" N=7830766.831	149°35'34.10" E=403734.968
BPT-024	70°33'00.90" N=7828848.509	149°24'55.90" E=410248.229
BPT-025	70°32'41.80" N=7828200.199	149°22'35.90" E=411669.399
BPT-031	70°31'43.80" N=7826214.688	149°14'32.40" E=416592.684
BPT-032	70°31'30.50" N=7825744.507	149°11'57.80" E=418174.547
40-X	70°29'24" N=7821637.360	149°03'12" E=423474.097
41-X	70°29'27" N=7821728.505	149°03'07" E=423528.980
BPT-048	70°28'49.60" N=7820332.598	148°51'12.20" E=430891.228
HDE-027	70°33'21.90" N=7830116.402	150°11'50.00" E=604102.175
HBE-031	70°33'08.10" N=7829784.852	150°08'31.20" E=606172.061
Western Termination	70°35'50.80" N=7834584.60	144°16'50.23" E=600800.00

DECISION AND FINDINGS OF THE COMMISSIONER
ALASKA DEPARTMENT OF NATURAL RESOURCES

THETIS ISLAND UNIT AGREEMENT

FEBRUARY 12, 1993

AGO 10169401

TABLE OF CONTENTS

- I. INTRODUCTION AND BACKGROUND 1
- II. DISCUSSION OF DECISION CRITERIA 2
 - A. The Conservation of All Natural Resources 2
 - B. The Prevention of Economic and Physical Waste 2
 - C. The Protection of all Parties of Interest 3
- III. DISCUSSION OF CONSIDERATIONS 3
 - A. The Environmental Costs and Benefits of
Unitized Exploration or Development 3
 - B. The Geological and Engineering
Characteristics of the Reservoir 4
 - C. Prior Exploration Activities in the Unit Area 4
 - D. The Applicant's Plans for Exploration or
Development of the Unit Area 4
 - E. The Economic Costs and Benefits to the State
and Other Relevant Factors 5
- IV. AMENDMENTS TO THE MODEL UNIT
AGREEMENT FORM 5
- V. FINDINGS AND DECISION 6

I. INTRODUCTION AND BACKGROUND

On November 13, 1992, Exxon Corporation, Amerada Hess Corporation, and Chevron USA, Inc., (collectively Exxon) applied for approval of the proposed Thetis Island Unit Agreement (Agreement). The Agreement proposes to combine for unitized exploration and development six individual state of Alaska oil and gas leases (collectively leases) comprising an area of approximately 25,085 acres. The proposed Thetis Island Unit area is located in state-owned waters of the Beaufort Sea immediately northwest of the Kuparuk River Unit.

The Leases involved in the proposed unit were issued as a result of the state of Alaska Lease Sale No. 39, Beaufort Sea Offshore/Uplands, held on May 17, 1983. These Leases, ADL 355025, ADL 355026, ADL 355027, ADL 355028, ADL 355033, and ADL 379301 were issued on state of Alaska lease form DMEM-4-83 (Net Profit Share) which provides for a 12.5% royalty share and a 30% net profits interest for the State. The Leases became effective August 1, 1983 for a primary term of ten (10) years.

Exxon Corporation, the proposed unit operator, was not an original working interest owner in the Leases. Exxon Corporation acquired working interest in the Leases by virtue of farmout/participation agreements with the original working interest owners, Amerada Hess and Chevron.

The proposed Agreement is the state of Alaska Model Unit Agreement form (Revised April 1990) with modifications proposed by both Exxon and the State. The proposed modifications include (1) changing the royalty share from a 12.5% share plus a net profit share to a flat royalty of 16.6667% under AS 38.05.180(p), (2) a waiver of the working interest owners' right to earn an exploration incentive credit under AS 38.05.180(i), and (3) a waiver of any right to a reduction of royalty under AS 38.05.180(j) or (p) until ten years after the start of sustained unit production from the unit area.

The Agreement provides for plans of exploration, development and operations within the unit area without regard to internal lease boundaries. The plan of exploration sets forth a five year schedule during which Exxon agrees to a number of conditions required by the state. Exxon agrees to drill three wells and acquire seismic data within the unit area during the term of the plan of exploration, with provisions for unit termination if diligent exploration and development of the unit area does not continue on schedule.

The Agreement provides that the Commissioner of the Department of Natural Resources (Commissioner) must separately approve the unit plan of operations before any operations may be undertaken within the unit area. The plan must contain: (1) statements and maps or drawings giving the sequence and schedule of operations; (2) the projected use requirements of the proposed operations, including the location and design of well sites, material sites, water supplies, waste sites, buildings, roads and utilities; (3) plans for rehabilitating the affected area; and (4) a description of procedures designed to minimize adverse effects on other natural resources and other uses of the area, including fish and wildlife habitat, historic and archeological sites, and public use. These plans must be circulated to other state and local agencies for their review and comment before approval by the Commissioner. The proposed plans must also be consistent with the Alaska Coastal Management Program before operations may commence.

Pursuant to 11 AAC 83.306, the Division of Oil and Gas (Division) determined that the application was complete on November 23, 1992. Pursuant to 11 AAC 83.311, public notice of the application was published in the Tundra Times on November 25, 1992 and in the Anchorage Daily News on November 27, 1992. Copies of the application and the public notice were also provided to interested parties in conformance with 11 AAC 83.311, as well as to the Alaska Departments of

Environmental Conservation and Fish and Game, the North Slope Borough, and the Alaska Oil and Gas Conservation Commission (AOGCC). The public notice invited comments on the application from interested parties and members of the public.

The public notices allowed thirty days to submit any comments. The comment period ended December 28, 1992. One comment was received by the Division from the North Slope Borough, Office of the Mayor. That comment expressed no objection to the proposed Thetis Island Unit.

II. DISCUSSION OF DECISION CRITERIA

In accordance with AS 38.05.180(p) and 11 AAC 83.303, the Commissioner will approve a proposed unit agreement if the Commissioner finds that the agreement is necessary or advisable to protect the public interest. To find that a proposed unit agreement is necessary or advisable to protect the public interest, the Commissioner must find that the proposed unit will: (1) promote the conservation of all natural resources; (2) promote the prevention of economic and physical waste; and (3) provide for the protection of all parties of interest, including the State.

In evaluating these criteria, the Commissioner will consider: (1) the environmental costs and benefits of unitized exploration and development; (2) the geological and engineering characteristics of the potential hydrocarbon accumulation or reservoir proposed for unitization; (3) prior exploration activities in the proposed unit area; (4) the applicant's plans for exploration or development of the proposed unit area; (5) the economic costs and benefits to the State; and (6) any other relevant factors (including mitigation measures) the commissioner determines necessary or advisable to protect the public interest. The following discusses these criteria and considerations with respect to the proposed Thetis Island Unit.

- (A) The Conservation of All Natural Resources. Unitization of oil and gas reservoirs is generally recognized as a prudent means of conservation. Without unitization, the unregulated development of reservoirs tends to be a race for possession by competitive operators. The results can be: (1) overly dense drilling, especially along property lines; (2) rapid dissipation of reservoir pressure; and (3) irregular advance of displacing fluids, all of which contribute to the loss of ultimate recovery or economic waste. The concentration of surface activity; duplication of production, gathering, and processing facilities; and haste to get oil to the surface also increase the likelihood of environmental damage (such as spills and other surface impacts). Although conservation orders and field rules issued by the AOGCC would mitigate some of these impacts without an agreement to unitize operations, unitization provides the most practical method for maximizing oil and gas recovery, while minimizing negative impacts on other resources.

The Agreement will promote the conservation of both surface and subsurface resources through the unitized (rather than the lease-by-lease) development. Although the extent of any oil and gas contained in the prospective reservoirs has not been determined, the Agreement will accelerate exploration and maximize recovery from the Leases if a commercial hydrocarbon reserve is discovered.

- (B) The Prevention of Economic and Physical Waste. Traditionally, under unitized operations, the assignment of undivided equity interests in the oil and gas reservoirs to each lease largely resolves the resource conservation problem. Economic and physical waste, however, could still occur without an equitable cost sharing formula, and a well designed and coordinated development plan. Consequently, a unit agreement must equitably divide costs as well as hydrocarbons (benefits), and plan to maximize physical and economic recovery from any reservoir.

AGO 10169404

An equitable allocation of hydrocarbon shares discourages hasty or unnecessary surface development. An equitable cost-sharing agreement promotes efficient development of common surface facilities and operating strategies. An equitable cost-sharing agreement, and a mutually acceptable unit operator, allow the working interest owners in the unit to decide rational well spacing requirements, reinjection strategies, and the proper common, joint-use surface facilities. Unitization prevents economic and physical waste by eliminating redundant expenditures for a given level of production, and avoiding loss of ultimate recovery by adopting a unified reservoir management strategy.

Unitized operations greatly improve development of reservoirs with variable productivity across adjoining Leases. Marginal economic reserves, which otherwise would not be produced on a lease by lease basis, often can be produced through unitized operations. Facility consolidation saves capital, and promotes better reservoir management for all working interest owners through pressure maintenance and secondary recovery procedures. In combination, these factors allow less profitable areas of a reservoir to be developed and produced in the interest of all parties, including the State.

- (C) The Protection of All Parties in Interest, Including the State. Unitization seeks to protect the economic interests of all working interest owners of a common reservoir. By combining their interests and jointly operating under a unit agreement and unit operating agreement, each individual working interest owner is assured an equitable allocation of costs and revenues commensurate with the value of its lease(s).

The State's economic interest is furthered under the Agreement because exploration will likely occur earlier than without unitization. Diligent exploration under a single approved unit plan without the complications of competing operators is certainly in the State's best interest because it promotes efficient evaluation of the State's resources, yet minimizes impacts to the region's cultural, biological, and environmental resources. If a commercial discovery is made, the State's economy will be stimulated from the production-based revenue, oil and gas-related jobs, and service industry activity.

The Agreement provides for accurate reporting and record-keeping, State concurrence with operating procedures, royalty settlement, in kind taking, and emergency storage of oil, all of which will further the State's interest.

III. DISCUSSION OF CONSIDERATIONS

The following matters were considered in evaluating the criteria discussed in Part II, above.

- (A) The Environmental Costs and Benefits of Unitized Exploration or Development. The proposed unit area is habitat for a variety of fish, waterfowl and marine mammals. As a result, the area is occasionally used by residents for subsistence hunting and fishing. It is anticipated that oil and gas activity in the proposed unit area will impact some habitat, and may impact some subsistence activity. The extent of this impact will depend on a number of variables, including the effectiveness of actions taken to mitigate the impact, the availability of alternative habitat and subsistence areas, and the ability of the fish and marine mammals to adapt to some displacement and changes in their habitat.

AGO 10169405

If ongoing measures such as seasonal restrictions on specific activities in certain areas, especially designated primary waterfowl areas, required consolidation of facilities, and regulation of waste disposal, continue to minimize surface impacts, the anticipated exploration and development related activity is not likely to significantly impact bird, fish, and mammal populations. In any case, the anticipated activity under the Agreement will impact habitat and subsistence activity less than if the Leases were developed and produced individually. Unitized exploration, development and production minimizes surface impact.

The Leases contain stipulations designed to protect the environment. These stipulations address the protection of primary waterfowl areas, site restoration, construction of pipelines, seasonal restrictions on operations, and avoidance of seismic hazards. Virtually all activities which may occur following unitization are subject to a coastal zone consistency determination, and must comply with both the State and North Slope Borough coastal zone management plans.

State unitization regulations require that the Commissioner approve a proposed plan of operation before any operations may be undertaken. A proposed plan of operation must describe the operating procedures designed to prevent or minimize adverse effects on natural resources and other uses of the unit area and adjacent areas. Further, before undertaking operations, the unit operator must guarantee full payment of all damage sustained to the surface estate, by reason of entering the land. Finally, a proposed plan of operations must include plans for rehabilitation of the affected unit area after completion of operations.

- (B) The Geological and Engineering Characteristics of the Reservoir. Pursuant to 11 AAC 83.356(a), a unit must encompass the minimum area required to include all or part of one or more oil or gas reservoirs, or all or part of one or more potential hydrocarbon accumulations. Geological, geophysical, and engineering data from Unocal's East Harrison Bay #1 Well, and wells in the nearby Kuukpik Unit and Kuparuk River Unit, as well as geophysical (seismic) records from the proposed unit area, were evaluated by the State to determine the appropriate boundaries for the proposed unit area. These data included both confidential and non-confidential well logs, geological cross sections, seismic sections, and test results from the earlier wells drilled in the area. In addition, Exxon's geologic structure and isopach maps derived from its proprietary interpretation of these data were examined.

The State's evaluation of the subsurface geology supports the configuration of the Thetis Island Unit area as proposed. Exxon has demonstrated that a legitimate geological prospect, which may contain one or more producible oil and gas accumulations, underlies the proposed unit area. The Division's review of the geological information support the inclusion of the six leases within the proposed unit area.

- (C) Prior Exploration Activities in the Unit Area. As mentioned above, exploration wells have been drilled around the proposed unit area, but not within it. In addition, many miles of geophysical (seismic) data have been acquired to define the potential structures and traps which may contain hydrocarbon accumulations within and around the proposed unit area.
- (D) The Applicant's Plans for Exploration or Development of the Proposed Unit Area. In the five year term of its initial unit plan of exploration, Exxon commits to drill three exploration wells and conduct additional geophysical (seismic) data activity to delineate any hydrocarbon resources determined to exist within the unit area. The plan

includes: (1) drilling the initial unit test well before April 30, 1993; (2) drilling the second unit exploratory well during the 1994-1995 winter drilling season; (3) drilling the third unit exploratory well or acquiring additional seismic data during the 1995-1996 winter season, and (4) drilling the third exploratory well before the expiration of the initial five year term.

The plan sets forth a timely sequence of reservoir delineation activities to facilitate the reservoir's ultimate development and production if oil or gas is discovered in commercial quantities. Completion of these exploration activities as scheduled will satisfy the performance standards and diligence requirements to which the State and Exxon have agreed as a condition for approval of the Agreement. If any of the activities in the initial unit plan are not performed as scheduled, the plan will be in default, and the Agreement will automatically terminate on the date of any such non-performance. These provisions insure that the lease extensions resulting from unitization pursuant to 11 AAC 83.336(a)(2) continue only so long as Exxon proceeds diligently with exploration and development.

- (E) The Economic Costs and Benefits to the State and Other Relevant Factors. Approval of the Agreement economically benefits the State in the near term through employment associated with the assessing of the hydrocarbon potential of the subject Leases. In addition, should a commercial discovery result, the State's long-term royalty and tax revenues will be enhanced, and private development capital will remain available for alternative oil and gas activity in the State.

The Working Interest Owners of the proposed Thetis Island Unit have provided technical data sufficient to define the prospect under consideration, have committed their diverse lease interests to the proposed unit, have agreed to a plan of exploration which assures a timely sequence of drilling and development activities in order to evaluate and develop all the acreage within the proposed unit area and have committed their combined financial resources to pursuing that plan.

IV. AMENDMENTS TO THE MODEL UNIT AGREEMENT FORM

As noted, the six leases proposed for inclusion in the unit provide for a 12.5% royalty share and a 30% net profits interest for the State. In its application, Exxon requested that the State's net profits interest be removed in exchange for an increase in the fixed royalty share from 12.5% to 16.6667%. Exxon submitted privileged and confidential geotechnical and economic data to the Division in support of this request. In this information, Exxon's economic assessment (which included an assessment of the geologic risk) of the Thetis Island prospect indicated that the current lease net profits provision precluded exploration and development of the proposed unit area. Increasing the nominal royalty rate in lieu of retaining the net profits share would create more favorable economic conditions for exploratory drilling to occur sooner rather than later, if at all.

AS 38.05.180(p) provides in pertinent part:

The commissioner may, with the consent of the holders of the Leases involved, establish, change, or revoke drilling, producing, and royalty requirements of the leases and adopt regulations with reference to the Leases, with like consent on the part of the lessees, in connection with the institution and operation of a cooperative or unit plan as the commissioner determines necessary or proper to secure the proper protection of the public interest. [Emphasis added.]

AGO 10169407

Based on the Division's independent analysis of Exxon's confidential economic and geologic information, it was concluded that Exxon's request would be in the State's best interest and would meet the criteria of the statute if Exxon also agreed to waive: (1) any right to earn the exploration incentive credit under AS 38.05.180(i) originally available under the lease term; and (2) any right to request a reduction of royalty under AS 38.05.180(j) or (p) until ten years after the start of sustained unit production. After negotiations with the Division, Exxon has agreed to these conditions.

Pursuant to AS 38.05.180(p), approval of the Agreement is conditioned upon submittal by Exxon and approval by the State of amendments and additions to the state of Alaska Model Unit Agreement form which incorporate all of the agreed upon amendments to the Leases which were proposed for inclusion in the unit area.

The State proposed amendment language which was forwarded to Exxon for its review on November 23, 1992. (See attachment). As a further condition of the State's approving the Agreement, the required amendments must be ratified by the lessees, submitted by Exxon, and approved by the State no later than forty-five (45) days following the effective date of this Decision.

V. FINDINGS AND DECISION

Based on the foregoing, I find:

1. The public notice requirements of 11 AAC 83.311 were met.
2. The Agreement, conditioned upon the performance of its plan of exploration, is advisable to protect the public interest, and is in the State's best interest.
3. The Agreement will conserve all natural resources, including hydrocarbons, gravel, sand, water, wetlands, and other valuable habitat.
4. The Agreement will prevent the waste of oil and gas, and increase the probability of recovering more oil and gas from the unit area if oil or gas is discovered in commercial quantities.
5. The Agreement, with the amendments outlined in Article IV of this Decision and Findings, will equitably and adequately protect all parties in interest, including the state of Alaska.
6. The Agreement will not further diminish access to public and navigable waters beyond those limitations (if any) imposed by law or already contained in the oil and gas Leases covered by the Agreement.
7. The unitized development and operation of the subject leases with any others which may be incorporated in the future, if oil or gas is discovered, will reduce the amount of land and fish and wildlife habitat that would otherwise be disrupted by individual lease development. This reduction in environmental impacts and interference with subsistence activity is in the public interest.

Some environmental impact, however, is still likely. Unit development must proceed according to an approved plan of development. Before undertaking any specific operations, a unit plan of operations must be submitted to the Division and other appropriate state and local agencies for review and approval. All other required

permits also must be granted before drilling operations may commence. Additional mitigating measures, beyond those provided within the individual Leases, will be imposed, if necessary or advisable, through conditioning the approval of a plan of operations and other permits. Adverse environmental impacts will be minimized by requiring strict adherence to these mitigating measures.

8. The Agreement, with the amendments outlined in Article IV of this Decision and Findings, will assure a fair and equitable return to the State from any production of hydrocarbons from the unit area.
9. The economic benefits to the State as a result of the expedited unitized exploration and potential development of the Thetis Island Unit area outweigh the economic costs to the State of extending the primary term of certain of the Leases committed to the unit.
10. Based upon the geological and engineering data submitted to the Division in support of the unit application, the area included within the Thetis Island Unit encompasses all or part of one or more potential hydrocarbon accumulations.
11. The Agreement provides for further expansions and contractions of the unit area in the future, as warranted by additional information and data. Therefore, the public interest and the correlative rights of all parties are protected.
12. Exxon's initial plan of exploration provides for the rational exploration of potential hydrocarbon zones in the unit area, as well as for diligent development activities before the ultimate production of any hydrocarbons that may be produced. Additional exploration and/or development plans are required to be submitted once the initial plan of exploration expires.
13. The plan of exploration meets the requirements of 11 AAC 83.303 and 11 AAC 83.341 if the following condition is incorporated into the plan:

The proposed exploration activities conducted in accordance with the time lines specified constitute the performance standards and diligence requirements to which the State and the Thetis Island Unit Working Interest Owners have agreed. The approval of the Thetis Island Unit is conditioned upon Exxon Corporation's compliance, as Unit Operator, with these specific performance standards. If any of the exploration activities outlined in the unit plan of exploration are not performed as scheduled, the exploration plan will be in default and the unit agreement will terminate.
14. Pursuant to 11 AAC 83.341, an annual update to the plan of exploration which describes the status of projects undertaken and the work completed, as well as any proposed or expected changes to the unit plan of exploration, must be submitted for approval to the State. Any changes to the unit plan of exploration, if approved by the State, will be in accordance with Article 8 of the Agreement.
15. Pursuant to AS 38.05.180(p), Paragraph 40 of the Leases entitled "Share of Net Profit," shall be eliminated from each of the Leases. Further, the royalty rate specified in Paragraph 35 of the Leases shall be increased from 12.5% to 16.6667%. Finally,

AGO 10169409

all lessees agree to (1) waive any right to earn the exploration incentive credit under AS 38.05.180(i) and the terms and conditions of state of Alaska Lease Sale No. 39; and (2) waive any right to request a reduction of royalty under AS 38.05.180(j) of (p) until ten years after the start of Sustained Unit Production.

16. As a further condition of the approval of the Agreement, it must be amended and ratified by the lessees to accommodate the terms and conditions of Article V.(15) to this Decision and Findings. The amendments must be submitted by Exxon and approved by the State no later than forty-five (45) days following the effective date of this Decision and Findings.

17. The Agreement, modified by the terms and conditions imposed upon it by this Decision and Findings, meets the requirements of AS 38.05.180(p) and 11 AAC 83.303.

For the reasons enumerated earlier in this Finding and subject to the conditions noted in this Decision and Finding, I hereby approve the Thetis Island Unit Agreement effective this date.



James E. Eason, Director
Division of Oil and Gas

Feb. 12, 1993
Date

for: Glenn A. Olds, Commissioner
Alaska Department of Natural Resources

Attachments: Delegation of Authority from Commissioner to Director, Division of Oil and Gas
Division of Oil and Gas letter to Exxon, dated November 23, 1992

Thetis Island approval was

AGO 10169410




Alaska State Legislature

Official Business

State Capitol
Juneau AK 99801

MEMO

TO: Betty Wallace
Barrow LIO
via fax: 852-7114

FROM: Annette Kreitzer, Aide to 
Senate Resources Committee

DATE: April 2, 1996

RE: SB 318: Northstar Lease Agreement

Attached is information you requested for SB 318.

Schedule of meetings: 3 pages
Legal Opinions: 11 pages
Lease Agreement 15 pages
TOTAL: 30 pages including this one

Am sending you almost everything, with the exception of the leases referred to in the agreement. If you desire to add on to the teleconferences; please call Juneau to do so. It will be listen only until the committee gets through the fact finding, then (probably beginning Saturday, April 13) the committee will begin taking public testimony.



Alaska State Legislature

Senate Resources Committee

State Capitol
Juneau AK 99801

Official Business

MEMO

TO: All Legislators

FROM: Senator Loren Leman, Chairman
Senate Resources Committee *Loren Leman*

DATE: April 2, 1996

RE: SB 318: Northstar Lease Agreement Hearings

Attached are the topics for the next scheduled hearings on SB 318. Please feel free to attend the hearings.

Scheduled Hearings:

Wednesday, April 3: 7:00 - 9:00 p.m. in the Butrovich Room

Thursday, April 11: 6:00 - 8:00 p.m. in the Butrovich Room

Saturday, April 13: 10:00 a.m. to 1:00 p.m. in the Anchorage LIO

Chapter 085
Chapter: CH085
Source: SCS CSHB 207 (FIN) am S
Action Date: June 19, 1995
Effective Date: June 20, 1995
95

AN ACT

Relating to adjustments to royalty reserved to the state to encourage otherwise uneconomic production of oil and gas; and providing for an effective date.

* Section 1. AS 36.30.850(b) is amended by adding a new paragraph to read:

(33) contracts between the Department of Natural Resources and contractors qualified to evaluate hydrocarbon development, production, transportation, and economics, to assist the commissioner of natural resources in evaluating applications for oil and gas royalty increases or decreases or other oil and gas royalty adjustments, and evaluating the related financial and technical data, entered into under AS 38.05.180(j).

* Sec. 2. AS 38.05.180(j) is amended to read:

(j) The [TO PROLONG THE ECONOMIC LIFE OF AN OIL AND GAS FIELD OR TO REESTABLISH COMMERCIAL PRODUCTION OF SHUT-IN OIL OR GAS THAT WOULD NOT OTHERWISE BE ECONOMICALLY FEASIBLE, THE] commissioner

(1) may provide for an increase or decrease or otherwise modify [SHALL ADOPT REGULATIONS TO ALLOW REDUCTION OF] royalty, to allow for production that would not otherwise be economically feasible, on individual leases, leases unitized as described in (p) of this section, leases subject to an agreement described in (s) or (t) of this section, or interests unitized under AS 31.05; the commissioner may act under this subsection to modify the royalty

(A) after the effective date of this Act and not later than July 1, 2015, so long as the authority to modify royalty under this subparagraph has been authorized or reauthorized by law within the 10 years preceding the commissioner's action to modify the royalty, to allow for production from an oil or gas field or pool if

(i) the oil or gas field or pool has been delineated sufficiently to allow the commissioner to conduct the analyses and make the findings required by this subsection; and

(ii) the field or pool has not previously produced oil or gas for sale;

(B) to prolong the economic life of an oil or gas field or pool as costs per barrel or barrel equivalent increase; or

(C) to reestablish production of shut-in oil or gas;

(2) [THE COMMISSIONER] may not grant a [REDUCTION OF] royalty modification unless the lessee or lessees requesting the modification make [REDUCTION MAKES] a clear and convincing showing that a modification of royalty meets the requirements of this subsection and is in the best interests of the state;

(3) shall

(A) [THE REVENUE FROM THE LESSEE'S SHARE OF ALL HYDROCARBONS PRODUCED FROM THE FIELD IS AND IS LIKELY TO CONTINUE TO BE INSUFFICIENT TO PRODUCE A REASONABLE RATE OF RETURN WITH RESPECT TO THE LESSEE'S TOTAL INVESTMENT IN THE FIELD. THE COMMISSIONER MAY] condition any [A] royalty modification [REDUCTION] granted under this subsection in any way necessary to protect the state's best interests;

(B) describe, in the findings and determinations required by this subsection, the relevant factors, including price, projected production rate or volume, predicted ultimate recovery, and development, operating, and transportation costs, upon which the modification is based;

(C) for a modification under (1)(A) of this subsection, set out the terms and conditions, which

(i) must include a mechanism for adjusting royalty percentage based on price; using forecasts of the range of future prices and their probabilities, the mechanism must provide that the value of the potential revenue increases resulting from royalty percentage increases must exceed the value of the potential revenue losses resulting from royalty percentage decreases; and

(ii) may include, in addition to the royalty percentage adjustment based on price, which must meet the conditions specified in (i) of this subparagraph, a further adjustment based on production rate or volume from the field or pool; and

(D) for a modification under (1)(B) or (1)(C) of this subsection, set out the terms and conditions, which may include substitution of a sliding scale royalty or other mechanism to modify the royalty if there is a change in the relevant factors, such as price, projected production rate or volume, predicted ultimate recovery, and development, operating, and transportation costs, upon which the modification is based;

(4) may not grant a royalty modification for a field or pool

(A) under (1)(A) of this subsection if the royalty modification for the field or pool would establish a royalty rate of less than five percent in amount or value of the production removed or sold from a lease or leases covering the field or pool;

(B) under (1)(B) or (1)(C) of this subsection if the royalty modification for the field or pool would establish a royalty rate of less than three percent in amount or value of the production removed or sold from a lease or leases covering the field or pool;

(5) may not grant a royalty modification under this subsection without including an explicit condition that the royalty modification is not assignable without the prior written approval of the commissioner; the commissioner shall, in the preliminary and final findings and determinations, set out the conditions under which the royalty modification may be assigned;

(6) shall require the lessee or lessees to submit, with the application for the royalty modification, financial and technical data that demonstrate that the requirements of this subsection are met; the commissioner shall

(A) require disclosure of the financial and technical data related to development, production, and transportation of oil and gas from the field or pool that are necessary to make a determination as to whether or not to grant the request for royalty modification; and

(B) keep the data described in (A) of this paragraph confidential under AS 38.05.035(a)(9) at the request of the lessee or lessees making application for the royalty modification; the confidential data may be disclosed by the commissioner to legislators and to the legislative auditor and as directed by the chair or vice-chair of the Legislative Budget and Audit Committee to the director of the division of legislative finance, the permanent employees of their respective divisions who are responsible for evaluating a royalty modification, and to agents or contractors of the legislative auditor or the legislative finance director who are engaged under contract to evaluate the royalty modification, provided they sign an appropriate confidentiality agreement;

(7) may require the lessee or lessees making application for the royalty modification to pay for the services of an independent contractor, qualified to evaluate hydrocarbon development, production, transportation, and economics, who is selected by the commissioner

assist the commissioner in evaluating the application and financial and technical data; selection of an independent contractor under this paragraph is not subject to AS 36.30;

(8) shall

(A) make and publish a preliminary findings and determination on the royalty modification application; if the preliminary findings and determination concerns a royalty modification under (1)(A) of this subsection, the preliminary findings and determination shall also be presented to the governor for the governor's approval or disapproval; the governor may not delegate a determination to approve or disapprove a preliminary findings and determination under this subparagraph;

(B) for a royalty modification under (1)(A) of this subsection, if the governor approves the preliminary findings and determination under (A) of this paragraph,

(i) give reasonable public notice of the preliminary findings and determination;

(ii) concurrently with the issuance of the public notice, unless directed by the Legislative Budget and Audit Committee to do otherwise, make available copies of the commissioner's preliminary findings and determination on the royalty modification application and the supporting financial and technical data, including the work papers, analyses, and recommendations of any contractors retained under (7) of this subsection, to persons authorized under (6)(B) of this subsection to review the data; and

(iii) invite public comment on the preliminary findings and determination during a 30-day period for receipt of public comment;

(C) for a royalty modification under (1)(B) or (C) of this subsection, if the preliminary findings and determination approves a royalty modification,

(i) give reasonable public notice of the preliminary findings and determination; and

(ii) invite public comment on the preliminary findings and determination during a 30-day period for receipt of public comment;

(9) shall address in any findings and determinations required under this subsection the reasonably foreseeable effects of the proposed royalty modification on the state's revenue;

(10) shall offer to appear before the Legislative Budget and Audit Committee to provide the committee a review of the commissioner's preliminary findings and determination on the royalty modification application and the supporting financial and technical data; if the Legislative Budget and Audit Committee accepts the commissioner's offer, the committee shall give notice of the committee's meeting to all members of the legislature; if, under (6)(B) of this subsection, the financial and technical data must be kept confidential at the request of a lessee or lessees making application for the royalty modification, the commissioner may appear before the committee in executive session;

(11) shall make copies of the preliminary findings and determination available to

(A) the presiding officer of each house [INTEREST, INCLUDING RESTORATION OF THE STATE'S ROYALTY SHARE IN THE EVENT OF AN INCREASE IN THE PRICE OF OIL OR GAS. BEFORE APPROVING A ROYALTY REDUCTION, THE COMMISSIONER SHALL MAKE A WRITTEN FINDING THAT THE STATE HAS OBTAINED THE MAXIMUM POSSIBLE ECONOMIC RETURN THAT IS COMPATIBLE WITH ALLOWING A REASONABLE RATE OF ECONOMIC RETURN FOR THE LESSEE, AND SEND COPIES OF THE FINDING TO ALL MEMBERS] of the legislature;

(B) the chairs of the legislature's standing committees on resources; and

(C) the chairs of the legislature's special committees on oil and gas, if any;
(12) shall, within 30 days after the close of the public comment period under (8) of this subsection,

(A) prepare a summary of the public response to the commissioner's preliminary findings and determination;

(B) make a final findings and determination and present it to the governor for the governor's approval or disapproval; the governor may not delegate a decision to approve or disapprove a final findings and determination presented under this subparagraph; the commissioner's final findings and determination regarding a royalty modification, if approved by the governor, is final and not appealable to the court;

(C) transmit a copy of the final findings and determination prepared under (B) of this paragraph to the lessee or lessees making application for the royalty modification;

(D) with the consent of the lessee or lessees applying for the royalty modification, amend the lease or unitization agreement of the lessee or lessees applying for the royalty modification consistent with the commissioner's approved final findings and determination; and

(E) make copies of the final findings and determination available to each person who submitted comment under (8) of this subsection and who has filed a request for the copies;

(13) is not limited by the provisions of AS 38.05.134(3) or (f) of this section in the commissioner's determination under this subsection.

• Sec. 3. AS 38.05.180(p) is amended to read:

(p) To conserve the natural resources of all or a part of an oil or gas pool, field, or like area, the lessees and their representatives may unite with each other, or jointly or separately with others, in collectively adopting or operating under a cooperative or a unit plan of development or operation of the pool, field, or like area, or a part of it, when determined and certified by the commissioner to be necessary or advisable in the public interest. The commissioner may, with the consent of the holders of leases involved, establish, change, or revoke drilling, producing, and royalty requirements of the leases and adopt regulations with reference to the leases, with like consent on the part of the lessees, in connection with the institution and operation of a cooperative or unit plan as the commissioner determines necessary or proper to secure the proper protection of the public interest. The commissioner may not decrease royalty on leases in connection with a cooperative or unit plan except as provided in (j) of this section. The commissioner may require oil and gas leases issued under this section to contain a provision requiring the lessee to operate under a reasonable cooperative or unit plan, and may prescribe a plan under which the lessee must operate. The plan must adequately protect all parties in interest, including the state.

• Sec. 4. AS 38.05.140(s) is amended to read:

(s) When separate tracts cannot be individually developed and operated in conformity with an established well-spacing or development program, a lease, or a portion of a lease, may be pooled with other land, whether or not owned by the state, under a communization or drilling agreement providing for an apportionment of production or royalties among the separate tracts of land comprising the drilling or spacing unit when determined by the commissioner to be in the public interest. Operations or production under the agreement are considered as operations or production as to each lease committed to the agreement. The commissioner may not decrease royalty on leases in connection with a communization or drilling agreement except as provided in

(j) of this section.

• Sec. 5. AS 38.05.180(t) is amended to read:

(t) The commissioner may prescribe conditions and approve, on conditions, drilling, or development contracts made by one or more lessees of oil or gas leases, with one or more persons, when, in the discretion of the commissioner, the conservation of natural resources or the public convenience or necessity requires it or the interests of the state are best served. All leases operated under approved drilling or development contracts and interests under them, are excepted in determining holding or control under AS 38.05.140. The commissioner may not

decrease royalty on a lease or leases that are subject to a drilling or development contract except as provided in (j) of this section.

* Sec. 6. This Act takes effect immediately under AS 01.10.070(c).

SB

318

(File 3)

State of Alaska
Department of Natural Resources
Division of Oil and Gas
3601 C Street, Suite 1380, Anchorage, Alaska 99503

Fax Confirmation Phone (907)465-2400 Fax (907)465-3886

FACSIMILE TRANSMITTAL

DATE & TIME: April 3, 1996 4:20 PM

PLEASE DELIVER TO: Annette Kreitzer
Alaska Senate Resources Committee

FAX NUMBER: 465-3810

NUMBER OF PAGES (including cover): 11

FROM: Ken Boyd

COMMENTS:

Senator Halford asked for a legal analysis regarding the conclusion that the development account on a lease is transferable by the original lessee to the lessee's assignee.

Attached is a copy of a decision by Judge Fabe, now Justice Fabe, reversing the DNR's decision that the development account could not be transferred. Justice Fabe's rationale was that the state's oil and gas leasing statute, AS 38.05.180, contemplates a lease-specific system, not a lessee-specific system and the development account is lease, not lessee, specific. Accordingly, she concluded that an assignment of the lease constitutes an assignment of the development account.

cc: Jeff Landry, DOL

Attachment

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

BP EXPLORATION (ALASKA),
INC.,)

Appellant,)

vs.)

STATE OF ALASKA, DEPARTMENT
OF NATURAL RESOURCES,)

Appellee.)

Case No. JAN-90-225 Civil
Case No. JAN-90-277 Civil
(Consolidated)

MARATHON OIL COMPANY, an
Ohio Corporation,)

Appellant,)

vs.)

STATE OF ALASKA, DEPARTMENT
OF NATURAL RESOURCES,)

Appellee.)

DECISION

This court, having considered the parties' briefs on appeal, the record on appeal, and oral argument on January 24, 1991, hereby REVERSES the decision of the Department of Natural Resources for the following reasons:

I. FACTUAL BACKGROUND

In December, 1979, the State of Alaska conducted an oil and gas lease sale, issuing a net profit share lease

(hereafter "NPSL") to Marathon Oil Company (hereafter "Marathon") and Amerada Hess Corporation (hereafter "Amerada"), as co-lessees. The NPSL method is generally described in AB 38.05.180 as:

a fixed cash bonus with a fixed royalty share reserved to the state of not less than 12 1/2 percent in amount or value of the production removed or sold from the lease with the share of the net profit derived from the lease reserved to the state as the bid variable. AB 38.05.180(f)(5).

The relevant regulations, 11 AAC 83.201-295, detail the system, under which the lessee maintains a production revenue account, a development account, and a net profit payment account. When the lease begins to produce, the lessee applies revenue gained against the development costs expended. Only after recovering the development costs does the lessee begin to pay the state a percentage of its net profits.

In 1980, Marathon and Amerada entered into a contract with BP Exploration, Inc. (hereafter "BP") to drill a well. Surface entry was to be on land leased to BP, and the bottom hole was to be on land leased by Marathon and Amerada. Disagreements arose as to various details of the drilling, and a lawsuit resulted. In an effort to settle the case, Marathon and BP entered into a preliminary agreement by which Marathon would assign its interest in the lease to BP, retaining a future production override in return for BP's payment of an undisclosed amount. As an essential part of the agreement, Marathon and BP intend that Marathon's development account, worth \$23 million, transfer entirely to BP.

The parties wrote to the Department of Natural Resources (hereafter "DNR"), requesting DNR's interpretation of the relevant regulations as to whether the development account could transfer to BP. DNR, on April 14, 1989, responded that the development account was lessee, not lease, specific and that the account would not transfer in its entirety. Under DNR's interpretation, BP would have a development account balance that reflected its own direct costs, as well as that portion of the BP/Marathon contract that could be attributed to "acquisition of development expenses".

Marathon and BP asked DNR to reconsider its position and, on August 3, 1989, DNR confirmed its earlier interpretation, stating that the decision "comports with both the purposes of NPSL leasing and the insistency of industry that NPSL account balances be lessee-specific to account for the unique situation of each lessee". Again, on October 4, 1989, after reconsidering its earlier decisions and meeting with the parties, DNR's director affirmed DNR's position, noting that "[w]hile policy or fairness considerations arguably favor the treatment requested by Marathon and BP, 11 AAC 83.219(b)(7) precludes this treatment". The commissioner, on appeal, affirmed the director's decision on December 7, 1989.

11 AAC 83.219, entitled "Development Costs", provides as follows:

(b) The lessee's development costs for a NPSL equal direct charges, as defined in 11 AAC 83.243, that are not excluded under 11 AAC 83.217 and that are directly attributable to a NPSL for...

* * *

(7) that portion of the full consideration given by the lessee in acquiring a production interest in the NPSL that is properly attributable to the wells, facilities and equipment on or in support of the NPSL which directly result in or are necessary for continued or enhanced production from the NPSL, as opposed to the consideration given for the lease itself; the lessee transferring the production interest must credit his development account for a like amount.... 11 AAC 83.219(b)(7).

BP and Marathon presently appeal DNR's decision.

BP argues that DNR erroneously interpreted 11 AAC 83.219, asserting that the development account is lease, not lessee, specific and that an assignment of the lease constitutes an assignment of the development account. In support of this position, BP refers to the statute's language, federal interpretation of similar federal statutes, and legislative intent. BP also alleges that this interpretation violates the lease's express terms.

Marathon joins in with these arguments and adds that DNR's decision represents an unconstitutional taking, violates equal protection, unjustly enriches the state, and constitutes a restraint of alienation.

II. STANDARD OF REVIEW

The primary issue on appeal is whether DNR correctly interpreted the leasing statute and regulation, AS 38.05.180

and 11 AAC 83.219, respectively, in refusing to recognize the validity of the transfer from Marathon to BP of the development account.

The Alaska Supreme Court in Trustees for Alaska v. State DNR, 795 P.2d 805 (Alaska 1990), held:

To be valid a regulation must be consistent with the authorizing statute and reasonably necessary to carry out the statute's purpose....An administrative agency's interpretation of its own regulation is normally given effect unless plainly erroneous or inconsistent with the regulations. Id. at 812.

III. INTERPRETATION OF 11 AAC 88.219

DNR interprets the statute and, particularly, the regulation to provide that only a small portion of the expenses which Marathon incurred on developing the lease will transfer to BP, reflecting only what BP paid Marathon for "wells, facilities, and equipment". This interpretation is both unjust and unlawful and must be set aside as plainly erroneous.

In reviewing the regulation, the court's first step is to address whether 11 AAC 88.219 is both consistent with AS 38.05.180 and reasonably necessary to carry out the statute's purpose. See Trustees for Alaska v. State DNR, SUPRA.

Because the plain language of AS 38.05.180 contemplates a lease-specific system, and 11 AAC 83.219, as interpreted by DNR, contemplates a lessee-specific system, 11 AAC 83.219 is inconsistent with the statute. Specifically, AS 38.05.180(f)(5)

discusses "production removed or sold from the lease" and the "share of the net profit derived from the lease" when describing the NPBL bidding method. (Emphasis added.) A plain reading of this language indicates that calculations are based on the money expended upon and earned from the lease. The statute does not suggest an intent to link these accounts to a particular lessee.

BP's analysis of the legislative history, the analogous federal statute, and other regulations support this reading, which is also apparent from the statute's face. For example, BP points to various reports contemplated by the Legislature when discussing the Alaska Land Act's 1978 amendments. Of particular interest is a 1977 report by Mason Gaffney, "Oil & Gas Leasing Policy: Alternatives for Alaska in 1977 (A Report to the State of Alaska, Jay S. Hammond, Governor, Department of Natural Resources, Guy Martin, Commissioner, and to the Alaska State Legislature, Interim Committee on Oil and Gas Taxation and Leasing Policy, Chancy Croft, Chairman)" (Feb. 1, 1977) (Microfiche No. 511-517, Anchorage Law Library). In this report, Gaffney discusses the net profit share in terms of a "net proceeds tax", and notes that this tax "is in rem: it is levied on the income and expenses attributable to a particular 'thing', in this case the leasehold". Id. at 52-53. He clearly distinguishes it from the example of an income tax, which is levied "in personam". Id.

The analogous federal statute and regulations, found in 43 U.S.C. § 1337(a)(1)(D), (E), (F) (West 1986) and 30 C.F.R. 220, also aid interpretation. In answer to a question about the assignability of the development account (called a "capital recovery account", in the federal scheme), the federal Minerals Management Service stated:

Because the NPSL capital account is maintained by lease and includes all costs incurred during the term of the NPSL, any costs incurred by the lessee would be carried forward to the assignee in the case of a farmout. That is, the assignee would begin NPSL operation with the same balance in the NPSL capital account as that remaining at the time of the farmout. December 3, 1985 letter from William S. Geldmiller, Chief, Royalty Valuation & Standards Division, United States Department of the Interior, Minerals Management Service, to Daniel Mills, Landman, Texaco U.S.A. (Doc. Supp. at 93.)

The federal statute, like the state statute, has language describing the NPSL system in terms of profits derived "from the lease". Thus, the federal government's interpretation of the NPSL as lease-specific, provides support for reading Alaska's NPSL system in the same manner.

The three-fold purpose of AS 38.05.180 has been discussed in Kelly v. Zamarello, 486 P.2d 906 (Alaska 1971), and includes an intent "to insure that leases on valuable oil and gas producing state lands will be made available to the public on a fair and equitable basis, that the state will be adequately compensated for its natural resources, and that the state's resources are developed in an orderly fashion".

Id. at 912. The purposes of the NPBL system specifically include avoiding premature lease abandonment, allowing less well financed operators to compete, and enabling payments to correspond with benefits. University of California, Walter J. Mead, Professor of Economics, "Comments From an Economic Perspective on House Bill No. 854 in the Legislature in the State of Alaska, Tenth Legislature -- Second Session", May 15, 1978. (Doc. Supp. at 415-416.)

11 AAC 83.219, as interpreted by DNR, furthers none of these aims and specifically detracts from some. For example, the fact that some of Marathon's expenses would be lost runs counter to the general purpose of fair and equitable availability of leases. Also, although the statute intends to insure adequate compensation of the state, DNR's interpretation would give the state, in this instance, more compensation than it would have had if Marathon had not transferred its interest. Thus, the regulation is not reasonably necessary to further the statute's purpose.

The correct interpretation of 11 AAC 83.219(b)(7) is that it pertains only to partial assignments of leasehold interests and would not apply to the complete assignment contemplated by BP and Marathon. This interpretation is consistent with the statute and furthers the statutory purposes by preventing double deductions of development costs.

Specifically, it prevents a development cost that is included in the assignor's development account from also being included in the assignee's development account. This interpretation gives effect to the regulation's requirement that "the lessee transferring the production interest must credit his development account for a like amount". 11 AAC 83.219(b)(7). This sentence would have no meaning under DNR's interpretation that the regulation applies to total assignments, as the assignor would have no development account to credit.

The effect of applying this regulation to a partial assignment is that there is no net change in the total amount of development costs that will be used to calculate net profits from the lease. It merely results in a reallocation of the total development costs.

The state alternatively argues that BP and Marathon are effectuating a partial assignment, because Marathon plans to retain an overriding royalty interest. The court finds that the agreement assigns all of Marathon's interests as lessee to BP, particularly given the fact that the regulation defines a lessee as someone who holds a "working interest" which, by definition, differs from a "royalty interest". See 11 AAC 83.295(27) and 11 AAC 83.295(30). Consequently, because this is a total assignment and the regulation, properly interpreted, applies to partial assignments, DNR's decision must be REVERSED.

DATED at Anchorage, Alaska this 25 day of July,
1991.

Dana Page
DANA PAGE
SUPERIOR COURT JUDGE

I certify that on 7/25/91,
a copy of the above was mailed to each
of the following at their address of
record: Mason / Maassen / Johansson
J. Parson
Secretary / Deputy Clerk

State of Alaska
Department of Natural Resources
Division of Oil and Gas
3601 C Street, Suite 1380, Anchorage, Alaska 99503

Fax Confirmation Phone (907)465-2400 Fax (907)465-3886

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DATE & TIME: April 3, 1996 2:35 PM

PLEASE DELIVER TO: Annette Kreitzer
Alaska Senate Resources Committee

FAX NUMBER: 465-3810

NUMBER OF PAGES (including cover): 9

FROM: Ken Boyd

COMMENTS:

Attached is Kevin Banks' analyses of 1) the effect of a delay on the Northstar development and 2) an increase in the reserve estimates. Please call if you have any questions.

Attachment

MEMORANDUM
DEPARTMENT OF NATURAL RESOURCES

State of Alaska
DIVISION OF OIL AND GAS

TO: Ken Boyd
Director

DATE: April 3, 1996

THRU:

FILE NO:

TELEPHONE: 269-8799

FROM: Kevin Banks 
Petroleum Economist

SUBJECT: Northstar Unit - Senate
Resource Committee
Requests

In response to Senator Halford's request about the effect on the economic benefits if a lawsuit delays development of the Northstar Unit, I analyzed the effect on economic benefits caused by a delay for any reason. In short, any delay increases the economic benefits to the state while decreasing the economic benefits to BPXA. The attached graph and table illustrate this point.

The graph shows that, as full production start-up is delayed beyond 1999, the net profit share falls and the supplemental royalty rises. The net profit share declines because the development account accrues interest at the prime rate. The supplemental royalty increases as the start-up date is delayed because of the effect of inflation, i.e., the supplemental royalty is triggered by a price that rises at just one-half the rate of inflation.

The first table shows in greater detail the effects of delaying full production start-up until 2002. This table is similar to one that was supplied in the DNR Northstar Briefing Paper, but includes a column to show the revenues from the supplemental royalty if the project is delayed.

I also considered Senator Halford's request to run the model at double BPXA's "most likely" reserve estimate of 130 million barrels. Following the hearing, I spoke to Senator Halford and he said I should be "realistic." Based on conversations with BPXA and DNR's resource evaluation staff, I do not believe that recovery of double the 130 million barrel estimate is realistic. Instead, I have run the model based on an assumption of 180 million barrels, which is the highest number put forward by either BPXA or DNR staff.

The four tables labeled "Reserves of 180+ Million Barrels" and "Reserves of 105+ Million Barrels" illustrate what happens to revenues if the reserves are much higher (though not doubled as Senator Halford suggested) and much lower than BPXA's "most likely" case. In the first two tables, I assume that reserves are 180 million barrels. This reserve estimate represents a 70 percent recovery rate--an unusually high number.¹ I also assumed that this recovery estimate is

¹Doubling the reserves as requested by Senator Halford would require a 100 percent recovery of BPXA's most likely original-oil-in-place estimate. The initial recovery rate for the Prudhoe Bay field was estimated at 40 percent. After substantial investment, the current recovery estimate has changed to 55 percent. A 70 percent recovery might be possible but only after extraordinary expense. Furthermore, the field would have to produce for many years before attaining this level.