THE STATE of ALASKA
GOVERNOR MIKE DUNLEAVY

Department of Natural Resources

OFFICE OF THE COMMISSIONER

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The Honorable Peter Micciche
Chairman, Senate Resources Committee
State Capitol Room 504
Juneau, AK 99801

The Honorable John Lincoln
Co-Chair, House Resources Committee
State Capitol Room 102
Juneau, AK 99801

The Honorable Geran Tarr
Co-Chair, House Resources Committee
State Capitol Room 128
Juneau, AK 99801

Dear Senator Micciche and Representatives Lincoln and Tarr:

Thank you for the opportunity to present information on the proposed BP-Hilcorp Transaction in a joint meeting of the standing Resources Committees. Per the request of the committee members, this document provides a primer on how the Department of Natural Resources ("DNR") handles financial assurances associated with dismantlement, removal, and restoration ("DR&R") of State oil and gas leases.

All parties holding an interest in a State oil and gas lease must return the leased land to the State in a condition acceptable to the Commissioner of the Department of Natural Resources upon lease termination or surrender. The obligation to return the land in acceptable condition at the end of field life originates from the lease and is found in all State oil and gas leases. The operations required to restore the land to a condition acceptable to the Commissioner are commonly referred to as dismantlement, removal, and restoration ("DR&R").

The DR&R obligations are incurred by the lessee when improvements are placed on State lands, but the extinguishment of these obligations may not occur for many years. The lag between creation and extinguishment creates a material risk that the lessee may not have the financial wherewithal at the end of field life to fulfill its DR&R obligations to the State. To help ensure that the DR&R obligations are met, the DNR regularly enters into financial assurances agreements ("FAAs") with its lessees.

The FAAs between the DNR and its lessees are negotiated agreements tailored to satisfy the policy and risk management goals of DNR while also meeting the needs of the specific lessee. Commonly entered into when a lease is assigned, FAAs seek to balance at least two competing policy objectives. The first of these is ensuring that State lands are returned in good condition. The second is ensuring the captured maximum benefit of Alaska's natural resources by preventing the inefficient deployment of capital, thereby reducing the probability of maximum recovery of the oil and gas resource. Through the flexible FAA process developed by DNR through many years and several administrations, the State can manage its lands in a robust yet flexible manner.

DNR typically evaluates two key dimensions that inform its risk: magnitude of the DR&R obligation and the financial strength of the lessee. Typically, the FAA will require the lessee to supply DNR with a third-party, independent estimate of the current expected cost to retire all of the infrastructure on State lands, even though it is possible that critical infrastructure like roads and gravel pads may not be required to be removed under the ultimately approved DR&R plan implemented at the end of field life. The cost estimate report from a qualified engineering firm allows DNR to understand the magnitude of the "all-in" DR&R obligation. In order to understand financial strength, the DNR analyzes financial information supplied by the lessee, operational history and extent, third-party estimates of reserves, and third-party indications of credit quality (e.g., rating agency assessments).

Having developed an understanding of the risk to the State, the FAA then prescribes an assurances structure. The types of instruments used to provide security to the State vary across agreements as necessitated by the risk to the State. In some cases, the State has required the creation of a dedicated sinking fund to secure against its risk. In such cases, an account is created to hold funds exclusively for the purpose of extinguishing DR&R obligations. In a sinking fund-type structure, it is common that the lessee make regular cash contributions to the account according to a schedule defined in the FAAs. In other cases, for example when the lessee is a wholly owned subsidiary of a financially capable corporate parent, the State has accepted a guarantee from the well-capitalized parent that the DR&R obligations of the subsidiary will be executed. In many cases, the State will require that the lessee obtain third-party surety bonding from a large, well-capitalized financial institution acceptable to DNR.

The DNR also recognizes that the risk of failure to complete DR&R is not static. The risk to the State evolves as the financial health of the lessee, markets, technology, and policy change through time. Many of the FAAs require the lessee to regularly submit updated information so the DNR can understand its risk in an ongoing fashion. Not only does the financial information submitted to the DNR provide an up-to-date understanding of risk, but also acts as a trigger to update the financial assurances provided to the DNR. The assurance structure prescribed in many FAAs contain financial metrics and standards that both the DNR and the lessee agree will be used to periodically measure the financial strength of the lessee. Should a material change in the financial health of the lessee be observed at a future measurement period, a corresponding change in the level of security provided to the State is required.

Regardless of the amount of the DR&R estimate or the FAA, the lessee is still obligated for the full cost of DR&R. A lessee's DR&R obligation is not limited by a FAA. The flexible FAA process enables efficient deployment of capital for the operators, so as not to drive projects into an uneconomic state, and yet still provides assurances to DNR for future DR&R.

Please let me know if you need any additional information.

Sincerely,

Corri A. Feige, Commissioner,
Department of Natural Resources