

Final
Finding and Determination
For a Solicitation for Offers to Purchase
Alaska North Slope Royalty Gas



Alaska Department of
**NATURAL
RESOURCES**
DIVISION OF OIL & GAS
**550 West 7th Avenue, Suite 800
Anchorage, Alaska 99501-3510**

December 26, 2001

I. INTRODUCTION AND BACKGROUND

The Commissioner of the State of Alaska Department of Natural Resources has determined that it is in the best interests of the State to solicit offers to purchase, in competitive sale, a portion of the State's royalty share of natural gas (Royalty Gas) that may be produced from Alaska's North Slope (ANS) upon completion of a natural gas pipeline. Because of the possibility of an "open season" in 2002 for nominating shipping space on a future gas pipeline, an offer to sell now responds to a commercial opportunity to improve the State's future royalty revenues from ANS natural gas and promote new private investment in the State.

On December 26, 2001 the department will issue a Solicitation for Offers to Purchase ANS Royalty Gas. Proposals offering to purchase Royalty Gas must be received by the Division of Oil and Gas no later than January 31, 2002. The department will open the offers at a public meeting on February 1, 2002, but the department will not determine which proposals will result in contract awards until it has evaluated all the proposals. The department intends begin negotiating royalty in-kind (RIK) gas sale contracts with successful proposers in February 2002. The solicitation and sale schedule is detailed in section D below.

On October 29, 2001, the department issued a "Preliminary Finding and Determination for a Competitive Sale of Alaska North Slope Royalty Gas" (Preliminary Finding) and solicited comments from the public.¹ During the comment period, the Alaska Oil and Gas Royalty Development Advisory Board (Royalty Board) convened a public meeting to discuss the merits of a sale and take public testimony. After review of the Royalty Board's and public's comments on the Preliminary Finding the commissioner has determined that a competitive sale of the State's royalty share of ANS gas at this time is in the State's best interest. The "Final Finding and Determination for a Solicitation for Offers to Purchase Alaska North Slope Royalty Gas" (Final Finding) documents the commissioner's determination.

The commissioner reserves the right to cancel or postpone the solicitation for offers and the competitive RIK sale at any time. After the RIK sale is conducted, the State will negotiate the final contract terms with successful buyers. No RIK gas sale contracts that result from the RIK sale will be effective until they are approved by the Legislature.

A. Background

Under the terms of most of its leases with North Slope oil and gas producers, the State has a right to one-eighth of the oil and gas production as its royalty share. Some leases provide for higher royalty rates. The leases, along with various unit agreements and royalty settlement agreements, grant the State the right to take its royalty share of oil and gas production in-kind (RIK) or in-value (RIV). When the State takes its royalty share as RIV, the lessees market the royalty share and pay the State the cash value received. When the State takes its royalty share as RIK, it takes possession of the oil and gas and sells it in the market.

Currently half of the royalty oil production at the Prudhoe Bay Unit (PBU) has been taken as RIK and sold to Williams Alaska Petroleum, Inc. for use in Williams' North Pole refinery. The

¹ Written public comments and the State's responses appear in Appendix A and B.

State has also sold other volumes of oil as RIK to various purchasers in the past. Current North Slope royalty gas production is less than 4,000 Mcf per day.² The State has elected to take its royalty share of gas in-value and the lessees have sold to ANS utilities and the Trans-Alaska Pipeline System (TAPS) as fuel.

B. Why have a competitive RIK gas sale now?

Successful development of the vast ANS natural gas resource has challenged the State and the oil producers since the Prudhoe Bay oil field was first discovered. In the last year the major ANS oil and gas producers have renewed attempts to evaluate the challenges of transporting ANS gas to market. Construction of an ANS gas pipeline is by no means certain. But if a new gas pipeline were built to deliver natural gas from the North Slope to markets in the U. S. Lower 48 or elsewhere, the State's royalty share could rise to 500,000 Mcf per day or more by the end of the decade.

There are several important reasons for the State to conduct an immediate ANS RIK gas sale. First, potential buyers are motivated to purchase RIK gas at this time in order to be able to nominate capacity on the gas pipeline during an "open season," which is currently expected to occur in 2002. An "open season" is an opportunity during the early stages of a proposed pipeline's design for potential owners to invite potential shippers to secure transportation capacity on the future pipeline. An open season nomination is a firm commitment by the shipper to fill the capacity it nominated when the pipeline is operational or to pay demand charges for the unused space. It is an important (and often required) step in the process of applying to the U.S. Federal Energy Regulatory Commission (FERC) and the Canadian National Energy Board (NEB) for the certificate of public convenience and necessity for a pipeline.

In recent months companies have expressed interest in securing a gas supply from the State as a precondition to their participation in an "open season" for a future Alaska gas pipeline. Companies have suggested using RIK gas for marketing in the Lower 48, for potential in-state petrochemical plants, and as a "back-stop" to gas production for North Slope lease holders. The State also received a proposal in December 2000 to buy gas to fuel a power plant for a large Internet data center on the North Slope.³ With a gas sale contract from the State in hand, these companies could reduce some of the risk involved in committing to pipeline space in the open season.

Second, the sale of RIK may contribute to earlier commercialization of ANS gas and the successful completion of a pipeline by bringing additional participants to the open season. Evidence of additional participants interested in purchasing and transporting Royalty Gas on an Alaska gas pipeline could influence the timing and design of the pipeline.

Third, as discussed further in the explanation of Royalty Gas sale contracts, the State will receive more royalty revenues by taking the gas in-kind and disposing of it through an RIK sale than it would receive if the royalty gas were left in-value and marketed for the State by the lessees.

² Mcf = one thousand cubic feet; Bcf = one billion cubic feet.

³ The Alaska Legislature passed a resolution directing the department to consider sale of RIK gas for this purpose. (22nd Legislature; SCS CSHCR 17)

Finally, the RIK gas sale may attract proposals from other in-state buyers who would use the gas on the North Slope or buyers who may wish to supply in-state utilities or industrial users along the pipeline route.⁴

The State cannot guarantee when or if the ANS RIK gas it is proposing to offer for sale now will ever be delivered. But the prospects for an ANS natural gas pipeline project and an upcoming “open season” for nominating transportation capacity on a future gas pipeline has presented the State with an opportunity now to offer a portion of its future Royalty Gas as RIK in a competitive sale for delivery when an Alaska gas pipeline is developed.

C. What happens next?

Since publication of the Preliminary Finding, the Division of Oil and Gas has met with the Alaska Natural Gas Pipeline Project Team (ANGPPT), a consortium of the three largest ANS oil and gas producers. The ANGPPT indicated that an open season would not occur in the first quarter 2002 as had been assumed at the time of the Preliminary Finding. For this reason the department has extended the time schedule for some steps listed in the Preliminary Finding. Because the 2002 Legislative session will end in May, however, any RIK gas sale contracts submitted to the Legislature have to be negotiated by the end of the first quarter 2002.

The next step in the process is publication of a Solicitation for Offers to Purchase RIK Gas. The Solicitation will specify certain conditions of the offering, including the quantity of gas offered for sale, the term of the sale contract, the point of delivery, the date that proposals are due, and qualifications to participate in the sale. It will request that potential purchasers to submit proposals that specify terms the purchaser would like to include in a final RIK gas sale contract with the State. The Solicitation for Offers will provide at least 30 days notice to potential purchasers and indicate where the various application documents may be obtained.

Because of the current uncertainty surrounding completion of a gas pipeline project and a potential completion date still many years off, detailed contract requirements that are normally found in an RIK gas sale contract have yet to be developed. The Solicitation will include a sample RIK gas supply sale contract that illustrates the type of contract the State expects to negotiate for the sale of its Royalty Gas (“*Sample Contract*”). The *Sample Contract* is intended to be illustrative only; it will not contain all the terms that will appear in the final contracts.⁵ The *Sample Contract* will specify certain standard contract terms that are generally included in the State’s final contracts, such as payment, default, security, and warranty clauses. Other contract terms, such as the base price to be paid for the gas, quantity purchased, volume measurement, and the timing of gas deliveries, will be negotiated after proposals are opened.

Offers must be received by the Division of Oil and Gas by no later than January 31, 2002. The department will open and announce the offers at a public meeting on February 1, 2002. But the successful offers will not be announced until after the department has evaluated all the proposals

⁴ Other North Slope uses could conceivably include a gas-to-liquids plant, a small plant to make methanol for oil field operations, or enhanced oil recovery (EOR) projects in fields outside of the Prudhoe Bay Unit.

⁵ A copy of the *Sample Contract* is attached to this Final Finding in Appendix D.

offered. The department expects the offers to present a number of variable terms and conditions that the department will need to evaluate and recommend to the commissioner before they are awarded. The department intends to complete the evaluations and notify the potential buyers whether their offers have been accepted no later than February 2002. After the offers are accepted the department will begin negotiating RIK gas supply contracts with the buyers.

Upon written request of the potential purchaser, the commissioner will hold as confidential to the extent provided by AS 38.05.035(a)(9)(D), any cost, financial or other proprietary information contained in an offer. All offers will be made public when the department submits the RIK gas sale contract to the Royalty Board, except as otherwise provided by law.

If the commissioner rejects any offers received under the solicitation, the commissioner will notify the Royalty Board and document the reasons for the rejection. As provided in 11 AAC 03.210 and 11 AAC 03.230, potential purchasers whose offers were rejected may request a conference with the commissioner before any contracts are executed.

Finally, the negotiated RIK gas sale contracts will be submitted to the Royalty Board for review and approval at a public meeting. The contracts will then be forwarded to the Legislature for approval with the Royalty Board's recommendations.

D. Schedule for Offers and RIK Gas Sale

The table below summarizes the schedule for the State's RIK gas sale purchase solicitation. Under this schedule successful RIK gas purchasers should know by March 2002 whether the commissioner and the Royalty Board have approved their contracts.

Schedule for the 2002 Solicitation for Offers to Purchase ANS RIK Natural Gas Sale	
Publish Final Finding and Solicitation	December 26, 2001
Proposals due at Division of Oil and Gas	January 31, 2002
Public opening of RIK Proposals	February 1, 2002
<i>The following dates are tentative and may be delayed or cancelled</i>	
Award Successful RIK Proposals	February 15, 2002
Publish Notice of Royalty Board Hearing	February 15, 2002
Convene Royalty Board Hearing	March 1, 2002
Executed RIK gas sale contracts to Legislative for approval	March 15, 2002

II. DEVELOPING RIK GAS PURCHASE PROPOSALS

A. To be considered, proposals must meet the following Minimum Cash Bonus and Base Price conditions.

Minimum Cash Bonus: In order to participate in the competitive sale, potential buyer's offer must include a minimum cash bonus. The minimum cash bonus must equal \$1.00 per Mcf per day of Maximum Quantities the buyer proposes to purchase (see the *Sample Contract* at Article

3.1.1.). For example, if a potential buyer proposes to purchase 200,000 Mcf per day of the State's royalty gas, it must include a minimum \$200,000 cash bonus with its proposal. If the quantities of RIK gas the potential buyer proposes to purchase will vary from season to season during the life of the contract, the offer should include a cash bonus based on the period of greatest quantity.

The State will initially retain the minimum cash bonus submitted with the successful offers and refund the cash bonuses of the offers that are rejected. The minimum cash bonuses of the successful offers will be refunded, without interest, if the Royalty Board or Legislature has not approved the final contracts by August 31, 2002, or if an open season has not occurred by December 31, 2004, or if an ANS gas pipeline is not in service or royalty gas has not been delivered to the pipeline by July 31, 2012. (See discussion of Term below.)

Base Price: The potential purchaser must offer a base price. For the purposes of this competitive RIK sale "Base Price" is as defined in paragraph 3.3.1 in the *Sample Contract*. It will be the higher of a fixed dollar per-volume unit price or the volume-weighted average of the amounts paid by the lessees on royalty gas left in-value (RIV). (See 11 AAC 03.210 (c).)

The State will consider offers that include a different mechanism to calculate the Base Price so long as it satisfies the definition of Base Price as the volume-weighted average of the amounts paid by the lessees on royalty gas left in-value (RIV). If the State is not satisfied with a proposed Base Price mechanism, the State will detail an acceptable mechanism.

The mechanism for calculating the value of RIV is set out in the State's current leases, unit agreements and royalty settlement agreements. A majority of the gas-producing leases in the Prudhoe Bay Unit (PBU) and the Point Thomson (PTU) Unit are the State's Form DL-1 leases that contain the following RIV value terms.

ROYALTY IN VALUE. At the option of Lessor, which may be exercised from time to time upon not less than six months' notice to Lessee, and in lieu of royalty in kind, Lessee shall pay to Lessor the field market price or value at the well of all royalty oil and/or gas. All royalty that may become payable in money to Lessor shall be paid on or before the last day of the calendar month following the month in which the oil or gas is produced. The payments shall be accompanied by copies of run tickets or other satisfactory evidence of sales, shipments, and amounts of gross production. (Form DL-1 lease at paragraph 15)

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

In the event of a major gas sale, the lease language above, together with the provisions of unit agreements, royalty settlement agreements, or new settlement language, will define value for much of the RIV gas. Although the lease terms were disputed in the ANS Royalty Litigation, many issues were resolved as the litigation progressed. For example, the State agreed to pay field costs on PBU RIK gas. The State and the lessees in several royalty settlement agreements have also resolved the question of value with respect to RIV oil and natural gas liquids (NGLs). The royalty settlement agreements also define value for the current production of RIV gas.

The final determination of RIV value may take several years after the gas is delivered. For example, implementation of the lease terms to determine the value of RIV gas typically requires the State to audit the lessees for gas sale receipts and transportation cost deductions. The State then assesses the effect of terms, like those quoted above from the Form DL-1 leases that contain “higher-of” provisions to determine the final value for RIV gas. Additionally, retroactive changes in transportation or processing charges could result in changes to the RIK gas Base Price. Accordingly, the RIK gas buyer will have a contingent liability for upward adjustments in the RIK gas Base Price that may take several years to finally determine.

The RIK buyer is also subject to the possibility that the State and one or more lessees may settle an RIV obligation by invoking a different methodology than that specified in the leases. If the State and a lessee agree to define the method of valuing RIV differently than the leases currently specify, the Base Price of the RIK gas sale contract could be affected. It would still be calculated using the weighted-average of the amounts paid by the lessees on royalty gas in-value, but would use the newly agreed-upon values. This could result in application of different Base Price calculations and different timeframes for adjustments under the affected leases.

Price Premium: Potential Buyers may offer a Price Premium over the Base Price. A Base Price premium might be structured as a flat, per-unit addition to the Base Price, or a percentage of the Base Price added to the Base Price.

Option Price: An option price or fee could be offered for the ability to increase or decrease the quantity the buyer would purchase during the life of the RIK gas sale contract. The *Sample Contract* provides a mechanism for the buyer to reserve a quantity option. (See e.g. *Sample Contract* at Article 3.1.2- reduction, 3.4-reservation fee, and 9.4 termination fee.)

B. In addition to the required Minimum Cash Bonus and Base Price, an offer may propose Special Commitments.

Potential buyers may offer Special Commitments in addition to the minimum cash bonus and Base Price. A potential buyer is not required to propose a Special Commitment; however, Special Commitments may be given weight in the State’s evaluation process. In order to be given weight in the evaluation process, the benefits to the State of special commitments must be quantifiable.

A Special Commitment could be a commitment to in-state processing, in-state use, in-state investment, in-state exploration, local hire, or anything else that a potential buyer offers to enhance its proposal. But, such commitments must be measurable and enforceable. Forecasts or

other reasonable statistical measures that indicate the in-state economic and social benefits they afford should be provided.

Among the in-state benefits the State will consider are the economic and social benefits of increased employment, increased household incomes, in-state construction, purchases of local and state goods and services, consumer benefits in the form of lower cost energy, local and state property taxes, corporate income taxes, and economic growth in related industrial sectors. (A listing of these considerations is found in AS 38.06.070.)

If a proposal includes in-state investments and asks the State to consider the benefits offered by Special Commitments, it should describe the Special Commitments to incorporate into the RIK gas sale contract as performance obligations. For example, if an offer proposes benefits from in-state investments it should include quantifiable performance standards. If an offer proposes benefits from in-state use of the RIK gas, it should provide a mechanism to assure that the gas purchased under the contract will be used in-state. It should also offer some restriction on the resale of the RIK gas beyond adjustments required for the efficient operation of the buyer's facilities.

Special Commitments and performance obligations will be subject to all contract remedies available to the State if a buyer fails to meet its performance terms. These may include cancellation of the sales contract, substitution of performance obligations, reduction in sales volumes, damages and other remedies available at law.

C. Proposals should address the following terms and conditions as specifically as possible.

Quantity: RIK proposals must specify the quantity of gas desired. The State's royalty share from the ANS leases is not a specified daily quantity, but rather a specified percentage of production. The State recognizes, however, that potential RIK purchasers who expect to participate in an open season will want to contract for a specified daily quantity of gas. For this reason, the State's draft *Sample Contract* assumes that royalty gas will be measured volumetrically in Mcfs, but for a final RIK gas sale contract it may need to be converted to percentage of production.

No Guarantee of Quantity: The State cannot guarantee a certain quantity of gas under an RIK gas sale contract supply. The State can deliver royalty gas only to the extent it receives royalty gas from the lessees. The quantity of royalty gas available to the State may vary and may be interrupted from time to time depending on a variety of factors, including the rate of production from the leases and units. Furthermore, the State may be required to nominate royalty gas as a percentage of its total royalty gas, and not by quantity. Accordingly, prospective buyers must be willing to accept the risk of receiving more or less than the desired quantity at any given time.

The State will consider offers that request seasonal variations in quantity, but the proposal should include a schedule that predicts by month, year or season the quantity that will be required throughout the term of the contract. Potential purchasers should be aware that in order to vary the quantity of royalty the it takes in-kind under any lease, the State must provide several months' notice to the lessee depending on the terms of the lease, unit agreement, or settlement

agreement. For instance, the State must nominate RIK gas in the PBU at least six months before the production month in which the nomination will be effective.

The State and the successful purchaser will ultimately negotiate a Maximum Quantities term for the final RIK gas sale contract. (See e.g. *Sample Contract* at Article 3.1.1) A purchaser may also negotiate a provision to reduce the Maximum Quantities up to 50% with at least two years notice. (See e.g. *Sample Contract* at Article 3.) If a potential purchaser wishes to negotiate for terms that would permit terminating the contract or reducing the Maximum Quantities by more than 50 percent, it should include a proposal for the option. (See e.g. *Sample Contract* at Article 9.4 and the discussion of Option Price above.)

Six months before the production month in which the RIK gas will be delivered, the State will notify the PBU and PTU operators of the percent of royalty gas it nominates for the production month to tender to the buyer. The *Sample Contract*, Article 3, provides an illustration for the buyer to notify the State of its quantity nomination for RIK gas seven months before the production month. The buyer's nomination may not exceed the Maximum Quantities and a reservation fee will be required for the difference in quantity between the Maximum Quantities and the quantity of royalty gas actually purchased.

The *Sample Contract* specifies that the State will reserve 30 percent of its ANS royalty gas in-value. The State has an interest in keeping some of its royalty in-value for two reasons. First, it provides the base price measure used in determining RIK gas prices. Second, the State's interests are best served by retaining the option to sell some of its RIK gas in the future. For these reasons, the State will not sell 100 percent of its royalty gas, and offers should be for a lesser volume.

No Guarantee of Quantity: The State cannot guarantee a certain quantity of gas under an RIK gas sale contract supply. The State can deliver royalty gas only to the extent it receives royalty gas from the lessees. The quantity of royalty gas available to the State may vary and may be interrupted from time to time depending on a variety of factors, including the rate of production from the leases and units. Furthermore, the State may be required to nominate royalty gas as a percentage of its total royalty gas, and not by quantity. Accordingly, prospective buyers must be willing to accept the risk of receiving more or less than the desired quantity at any given time.

Term: RIK proposals must specify the time period of the sales contract. The delivery of RIK gas will not begin until gas is produced for the gas pipeline. Although the State would prefer a contract term that is relatively short, the State understands that the potential buyers may need RIK gas sale contract terms that matches the term of their pipeline transportation commitments. The state will negotiate a term based on the buyer's proposal.

The RIK gas sale contract will be terminated if the Royalty Board or Legislature has not approved the final contract by August 31, 2002, or if an open season does not occur By December 31, 2004, or if an ANS gas pipeline is not in service or royalty gas has not been delivered to the pipeline by July 31, 2012. The State selected these dates to balance the requirements of potential purchasers with the State's requirements to take advantage of alternative opportunities as soon as possible should the pipeline project be delayed.

It is important to note that, while the period of deliveries will be negotiated in the final contract, obligations to pay for price and volume adjustments may extend for months or years after the deliveries.

Source: In drafting the *Sample Contract*, the State assumed that RIK gas would likely come from the PBU and the presently undeveloped PTU and be delivered into an ANS gas pipeline. Estimated total production of gas is 2.5 Bcf per day from the PBU and 1.5 Bcf per day from the PTU, but could be substantially different. The state's royalty share of this production will be approximately 400 mmcf per day. The State cannot guarantee that RIK gas will be available from a specific unit or source.

Under the terms of the *Sample Contract* the State will deliver RIK gas first from the PBU and, if adequate volumes of royalty gas are not available from the PBU, then from the PTU. This allocation will be subject to the 30 percent reservation described above and a mechanism that prorates the volumes of RIK from each unit based on the buyer's monthly nomination. Under this proration each buyer of royalty gas will pay the same Base Price per Mcf calculated from the weighted-average royalty values for royalty in-value. However, the State reserves the right to supply the contract quantity of RIK gas from either or both PBU or PTU or other units, unless otherwise negotiated in the final RIK gas sale contract.

III. DISCUSSION OF *SAMPLE CONTRACT* TERMS

The final RIK sale contracts negotiated by the State will include contract terms similar to those found in a standard gas sale contract with certain terms to reflect the unique nature of the RIK sale. Because of the uncertainty of the future of a gas pipeline and the need to act quickly, the State reserves the right to negotiate all contract terms with the successful buyers. Below is a discussion of the type of terms the State expects to include in the final RIK gas sale contracts.

The final RIK gas sale contracts and the all commitments of the State and the buyers are contingent on the successful completion of an ANS gas pipeline by 2012.

A. Point of Delivery

The RIK gas sale contract will define the point(s) of delivery as the transfer point where the State receives its royalty gas in-kind from the lessees. Specific points of delivery are not yet known.

B. Field and Conditioning Costs

The RIK gas sale contract will require that the purchaser pay any and all field and conditioning costs chargeable against the State's royalty share of gas subject to the contract.

Field and conditioning costs may vary from lease-to-lease and unit-to-unit. Various lease, unit, and royalty settlement agreements address whether field and conditioning costs, or one or the other, may be charged against the State's royalty share of gas. The State's obligation to pay these costs may depend on whether the State takes its royalty share in kind or in value. In

addition, the RIK purchaser will be effectively bound by any future agreement between the State and lessees as to field and conditioning costs chargeable against the royalty gas sold.

This term is non-negotiable.

C. Payments

The State will bill the buyer each month using its best estimate of price and volume. The State will make adjustments in later months as information about price and volume becomes available.

This term is non-negotiable.

D. Security

The security provision is to protect the State's interests if the buyer defaults on payments, becomes unable to take all of the sale gas it specified under the RIK gas sale contract, or otherwise fails to meet its performance obligations. The State's risk exposure takes at least three forms. First, under the contract the State will bill the buyer for RIK gas the State supplied in the previous month. If the buyer defaults the State may not receive payment for the gas it already supplied. Second, there is the "de-nomination" risk. The State must provide at least six months notice to the lessees to de-nominate RIK and return it to RIV. During this six-month period the State may have to find other buyers for RIK gas the buyer cannot accept or pay for, or the State may have to pay the lessees to take the RIK gas back in-value. Third, if the contract includes Special Commitments, there is the risk that the buyer will fail to meet the commitments. Insofar as the State may have awarded a gas sale contract in part because of the benefits to the state provided by the Special Commitments, the State will regard the buyer's failure to perform those commitments as real damages to the State and may pursue damages in addition to the amount of the security.

The *Sample Contract* illustrates potentially acceptable forms of security: 1) an irrevocable stand-by letter of credit giving the State the right to draw on the letter of credit or present drafts to the issuer at any time through at least six months after the State's final delivery of gas; 2) a security contract between the buyer and a promisor for the direct benefit of the State; and 3) a provision for any special security arrangements offered by the buyer in its RIK proposal and negotiated with the State. Other forms of security may be determined by the commissioner to be adequate to secure the State. The commissioner may require additional security to protect the State's interests.

The requirement to provide security is non-negotiable; however, the security terms may be negotiated to some degree.

E. Default and Termination

The commissioner may suspend or terminate the State's obligations to sell RIK gas or reduce volumes if the buyer fails to do one or more of the following:

- The buyer fails to perform any of its obligations under the contract and fails to cure the non-performance or the non-performance continues for more than 30 days after the buyer has been notified by the State of the non-performance;
- The buyer fails to pay in full any sum of money owed under the contract within two business days after the State gives the buyer notice that payment is due and has not been paid;
- The buyer fails to provide written assurances satisfactory to the State of its intention to perform its obligations under this agreement and provide evidence or assurances of transportation arrangements;
- The buyer fails to comply with all terms of the RIK sale contract to secure payment;
- There is a substantial change in the buyer's financial condition, business operations, property, or ownership that may affect the buyer's ability to perform its obligations under the contract; or
- If any representation or warranty made by the buyer in accordance with the contract is found to have been materially false or incorrect when made.

The buyer is required to notify the State immediately if the buyer is insolvent or unable to pay any of its debt. This automatically terminates the State's obligations to deliver gas. If the buyer defaults, all monetary obligations are immediately due.

If the buyer defaults or the contract is terminated, the State may immediately give notice to the lessees "de-nominating" its RIK. However, the State must provide the lessees with six-months' notice of nomination. Consequently, the buyer may be obligated to continue to take the gas during the notice period if the State chooses not to assume physical possession of the gas, or is unable or unwilling to sell the gas in a distress situation.

If the buyer initiates termination of the contract, the State requires a minimum of six months and ten days written notice of early termination of the contract.

This term is non-negotiable.

F. Successors and Assigns

Neither party to the contract may assign or encumber the agreement without first obtaining the written consent of the other party.

This term is non-negotiable.

G. Interpretation of Terms and Conditions

The State will include a dispute resolution procedure in the RIK gas sale contract. It will permit either the State or the buyer to start the process by providing written notice of a disagreement or dispute to the other party. The State and the buyer are permitted to submit to the commissioner written arguments and evidence supporting their views of the dispute and a proposed resolution. The buyer must agree to be bound by the commissioner's resolution of the dispute if the resolution is reasonable and not arbitrary.

This term is non-negotiable.

G. Other Provisions

The sales contract will contain other standard provisions such as force majeure, buyer and seller warranties, metering, and balancing. To the extent permitted by law and as appropriate to the proposal, a provision for local hire may also be included. Finally, because any contract will be entered into many years before first gas deliveries, a provision will be included to allow a change in terms if necessary to better implement the original intent of the parties.

IV. ANALYSIS OF STATE BENEFITS

To determine whether a sale of the State's Royalty Gas at this time is in the State's best interest, the commissioner considered (1) the economic impacts of the proposed sale to the State; (2) the projected social impacts of the transaction; and (3) the projected positive and negative environmental effects related to the transaction.⁶

The State will always sell its royalty gas as it does royalty oil. When the State keeps its royalty in-value, it "sells" it to the lessees who, in turn, deliver into the market and pay the State the value. When the State sells its royalty in-kind, it becomes a participant in the market where the lessees sell their production. In both instances the State receives the value for its royalty.

Regardless of whether a buyer purchases ANS gas from the State or a producer, its availability may be an incentive to make in-state investments. For example, access to an assured supply of gas from the State might facilitate financing for the buyer or allow the buyer to commit to capacity on an ANS gas pipeline in an open season. By making its ANS royalty gas available at this time the State hopes to encourage such investments and, in so doing, contribute to diversity in the State economy.

At this stage it is not possible to know whom, if anyone, will be successful buyers, or what or where any facilities might be built as a result of a competitive RIK sale. In order to consider the impacts of the proposed sale, DNR contemplated four reasonable scenarios possible for RIK sales:

1. To a buyer who will deliver the gas to markets in the Lower 48;
2. To a facility on the North Slope;
3. To an industrial facility in Fairbanks or another Alaskan community along the pipeline route; and
4. To gas or electric utilities in Alaska.

Three of the scenarios contemplate in-state sales that would likely involve local construction and operation of facilities. These scenarios would have economic, social and environmental effects of their own. But incremental economic, social, and environmental effects, beyond royalty revenues and administrative effects, attributed solely to sale of RIK gas are, with few exceptions, unlikely. However, the RIK sale could accelerate the timing of potential economic benefits.

⁶ See AS 38.05.183(e) and AS 38.06.070(a).

A. Projected Economic Impacts

The RIK gas sale should generate greater royalty revenues and, possibly, stimulate an earlier commercialization of ANS gas. Consider the following scenarios:

Scenario 1: Sales of RIK gas to buyers who will deliver the gas to markets in the Lower 48. A Scenario 1 sale will generate economic benefits to the State in the increase in royalty revenue that results from RIK sales. About 70 percent of the additional royalty revenue will go to the State general fund. The extent of the economic effects will depend on the size of the RIK price premiums offered or cash bonuses received and the nature of their expenditure by the state

Suppose, for example, that current holders of undeveloped oil and gas leases on the North Slope are awarded RIK gas sale contracts and commit to capacity on the pipeline during an open season. These RIK purchasers have an additional incentive to step-up exploration and development of their own gas resources. They would hold reserved pipeline capacity to transport their own new gas production to market as they reduce their gas purchases under the RIK gas sale contract. The principle economic effect would be to accelerate the timing of new jobs in the exploration phase, increased personal incomes from wages, local purchases and contracting, and potentially new gas development. It could also contribute to more vigorous competition and higher bonus bids for oil and gas leases that the State will offer in ANS lease sales in the future.

The RIK sale may affect production of equity gas from the PBU and PTU. If new explorers buy RIK gas and lever the purchases into firm capacity nominations in the open season, the existing resource owners (as pipeline sponsors) could design a larger pipeline to meet throughput requirements. The existing resource owners might be encouraged to produce equity gas earlier and at higher rates because they can produce equity gas to meet their firm transportation commitment instead of shipping RIV gas.

Alternatively, if pipeline capacity is not increased, the existing resource owners may have to reduce their equity production if the new exploration is successful. If the new explorers who have bought RIK gas are successful in gas exploration and begin to produce gas from their newly developed leases, they would reduce their purchases of RIK gas. The RIV gas volumes from the PBU and PTU will increase and displace some equity gas of the existing resource owners. This situation could result in a decrease in the revenues for the existing resource owners and underutilization of the PBU and PTU conditioning plants and other lease investments.

However, existing resource owners have not provided estimates of the potential benefits of early higher rates of equity production and costs of potential future reductions of equity production or pipeline expansion.

Scenario 2: Sales of RIK gas to industrial users on the North Slope. The State's RIK gas will not be offered at a subsidized price and, if the market factors are favorable without a subsidy, other sources of ANS gas can be and have been induced to supply North Slope industrial users. Under

Scenario 2, the economic effects would result from increased royalty revenues of selling the State's royalty in-value.

Scenario 3: Sales to an industrial facility in Fairbanks or other Alaskan community along the pipeline route. The volume of RIK gas expected to be produced for the ANS gas pipeline will probably be insufficient to supply the NGLs needed for a petrochemical plant. Such a development would have to supplement any RIK gas purchase with gas supplied from other ANS producers.

A company's decision to move forward on such a project, like any investor's decision to move forward on a major industrial use of ANS gas, will result from an evaluation of the market fundamentals including gas supply prices, transportation logistics, and the demand for industrial products. As in Scenario 2, a Scenario-3 RIK gas sale to an industrial facility would produce increased royalty revenues to the State. The economic benefits of a petrochemical plant would go beyond royalty revenue receipts. They would include employment opportunities during construction and operation, personal incomes, property tax revenues, corporate income taxes, and the impact through value added through the manufacture of intermediate products such as polyethylene and propane. But these benefits value-added benefits would accrue to the project whether the gas supplying the plant comes from the State's RIK or from a gas producer.

Scenario 4: RIK gas sales for local utility gas and electric power generation. A study conducted by Econ One Research for the department has evaluated the economic feasibility of sales of ANS gas to electric or gas utilities in Alaska.⁷ (See Appendix C.) The pipeline designs promoted by various sponsors in recent months consist of high-pressure, dense-phase (i.e., containing NGLs) pipelines. Gas suitable for space heat or electric generation cannot be removed from the pipeline without lowering pipeline pressure and extracting the NGLs. These costs, combined with the acquisition, transportation, and distribution costs of delivering ANS gas to Alaska customers, suggest that in order to achieve sufficient economies of scale, utility gas supplies will be limited to only the largest concentrations of gas dispositions in Alaska.

If ANS gas can be supplied economically to local gas and power utilities, consumers may benefit from lower energy prices as compared to the price of alternatives energy supplies in the State. If utilities are able to acquire ANS gas for less than the cost of ANS gas in the Lower 48 then this could invite commercial and industrial gas-related investment in Alaska. Current in-state demand for gas in all uses is approximately 227 Bcf per year. Utility gas usage for residential and electric power generation account for about 29 percent of total in-state gas usage. The remainder includes commercial and industrial usage, including LNG exports, ammonia-urea manufacturing, and gas for TAPS pump stations and North Slope field operations. According to Econ One, potential in-state usage of gas could increase by 140 Bcf per year in 2020 due to baseline growth, expanded gas service, new industrial uses, and fuel switching for power generation. This estimate, however, is based on several assumptions:

⁷ Dismukes, David E. et al. 2001. Alaska Natural Gas In-State Demand Study. Prepared on behalf of the Alaska Department of Natural Resources by Econ One Research, Inc., Los Angeles, California and Acadian Consulting Group, Baton Rouge, Louisiana.

- Relative energy prices in the future are consistent with levels observed today;
- The state's regional economy exhibits continued gradual economic expansion at rates comparable with the past five years (about a half percent per year in real dollars);
- In-state access to ANS gas from a high-pressure, dense-phase gas pipeline from the North Slope to Canadian and Lower-48 destinations is not cost prohibitive.

The study concludes that the economics of supplying ANS gas for various in-state uses, including new industrial uses and expansions of current industrial uses, are favorable only if the throughput in a spur pipeline to Southcentral Alaska is high enough to generate needed economies of scale. In order to reach competitive levels of throughput, the spur pipeline would have to serve some of the existing customer base now served by gas reserves in the Cook Inlet Basin as well as potential growth from expanded gas service and new industry applications. Rising gas prices in the Southcentral region may encourage new exploration and development of gas resources in the Cook Inlet but may also jeopardize industrial consumption and LNG exports. Even with rising Southcentral gas prices, ANS gas may not be competitive when the tariff on a spur pipeline linking Fairbanks with Southcentral is added to the cost of ANS gas deliveries to a meter-station tap near Fairbanks.

Natural gas distribution in the City of Fairbanks began in 1998 with LNG imports from gas produced in the Cook Inlet Basin and shipped north by the truckload at delivered, burner-tip prices of about \$7.50 per Mcf in 2001. Total gas usage for residential space heating Fairbanks has increased to about 155 million cubic feet per year in 2001 (0.155 Bcf per year). Various estimates, including the Econ One study indicates that baseline growth plus expanded residential gas service to areas not yet connected in the interior region including Fairbanks could increase gas usage to 2-to-6 Bcf per year by 2020. Conversion of electrical generation for the military bases and the University of Alaska Fairbanks complex could double estimated gas usage by 2020. These estimates are included in the statewide forecast above and build on the same assumption that the cost of gas delivered to interior region applications, including furnace and generator system conversion to natural gas, would be competitive with other energy alternatives.

B. Projected Social Impacts

The analysis of social impacts is similar to the analysis of economic benefits. The proposed RIK sale itself will have no significant or reasonably foreseeable effects on land use, local schools, roads, or other state infrastructure. Social impacts that might occur as a result of RIK gas sales to in-state facilities include:

- Additional employment opportunities while the facilities or pipelines are being built.
- Long-term employment opportunities once the facilities or pipelines are operational.
- Utility gas or electric supplies to towns and villages in interior Alaska.
- An additional tax base to local governments from facilities built in an organized borough or town, such as the North Slope or Fairbanks North Star Boroughs.

C. Projected Environmental Impacts

The sale by itself will have no incremental environmental impact. However, it is conceivable that some environmental impacts could indirectly result from activities or projects developed by the successful buyers. But before a project may commence permits must be obtained and findings must be made. The permit and findings process imposes conditions on allowable impact of projects.

Permits: Depending on the project proposed and the exact location, a combination of permits could be required prior to construction.

DNR, Div. of Mining, Land, and Water Land Use Permit – This permit could be required if a proposed facility is located on state land or crosses state land.

DEC Air Quality control Permit to Operate – The federal Prevention of Significant Deterioration (PSD) program, which is administered by DEC, establishes threshold amounts for the release of byproducts into the atmosphere. Oil and gas exploration and production operations with emissions below predetermined threshold amounts must still comply with state regulations designed to control emissions at these lower levels (18 AAC 50). Activities that exceed predetermined PSD threshold amounts are subject to a more rigorous application and review process. Such activities include the operation of turbines and gas flares.

DEC Wastewater Disposal Permit – Domestic gray water must be disposed of properly at the surface and a permit is required under 18 AAC 72.

Corps of Engineers Wetlands Permit – If a facility is proposed for location in wetlands a permit will be required from the Corps of Engineers. Before a permit may be issued, the Corps will need to complete an environmental assessment and possibly an environmental impact statement under the National Environmental Policy Act.

Alaska Coastal Management Program (ACMP): Alaska has a coastal management program in accordance with the Federal Coastal Zone Management Act of 1972. Alaska's program sets out statewide standards that govern how various uses, activities, resources, and habitats are managed under the ACMP.⁸ It applies generally to lands along Alaska's coast and along some rivers. Parts of the North Slope Borough are within the coastal zone, while Fairbanks is not within coastal zone boundaries.

In addition, communities and boroughs may adopt local management plans. The North Slope Borough has adopted a local coastal management plan (NSBCMP) under the ACMP. Any proposed facilities, including pipelines, must be consistent with both the ACMP and the NSBCMP.

⁸ 6 AAC 80.040 – 150.

Zoning: Both the North Slope Borough and the Fairbanks North Star Borough have developed zoning ordinances.⁹ Any industrial development would be subject to local zoning.

To the extent that RIK gas is sold to in-state utilities and users might displace other fuels such as coal or fuel oil, there may be beneficial impacts on air and other resources.

V. ANALYSIS OF THE PROPOSED RIK GAS SALE

As demonstrated by the proposal and contract terms discussed above, taking a portion of the State's royalty gas in-kind and selling it by competitive sale is in the best interests of the State.

The competitive sale could enhance the State's economic interests through increased revenues without any measurable negative social or environmental impacts. The State will not award an RIK gas sale contract if the sale price is not at least equal to the amount the State would receive if it took its royalty in-value. The competitive process gives the State the opportunity to accept proposals that offer the greatest benefit to the State. And the State can impose contract conditions that protect the State's interest while affording the flexibility necessary to attract serious proposals.

The sale and contract terms do not preclude a purchaser from exporting the royalty gas from the State. At 4 bcf per day, total production of ANS gas exceeds by four-fold future potential in-state domestic and industrial usage. However, using the most optimistic gas demand forecast from the Econ One study and the most pessimistic Cook Inlet gas supply outlook, the State's royalty share by itself will not be sufficient to meet in-state requirements in 2020.¹⁰ Nevertheless, 30 percent of the ANS gas state royalty share reserved in this sale could satisfy baseline utility gas demand growth predicted in the Econ One study for residential and power generation usage. This level of demand will materialize only if ANS gas can be acquired, delivered, and distributed to customers throughout the Southcentral and Interior region at competitive prices.

In determining that the proposed sale is in the best interests of the State, the commissioner also considered the criteria of AS 38.06.070.

1. Revenue needs and fiscal condition of the State: The economic condition of the State is largely dependent on its royalty revenues from oil and gas sales. Supplementing the current royalty revenue sources grows more important each year as production declines in the larger fields on the North Slope. The State can be paid for its royalty gas either in-value by the lessees or in-kind through competitive sales such as the one proposed. Because contract award will depend, in part, on the price premium offered for the RIK gas supply and cash bonus offered for an option to buy RIK gas, revenues from the sale of RIK gas will exceed the in-value alternative.

⁹ The North Slope Borough's zoning ordinances are located under North Slope Borough Ordinances Title 19 and the Fairbanks zoning ordinances are located under Fairbanks Ordinances Title 18.

¹⁰ This shortfall assumes that demand will grow as a result of baseline economic growth, gas utility expansion in the Southcentral and Interior regions, an expansion of the ammonia-urea plant, a new petrochemical plant is built, and oil- and coal-fired power generation in the Interior is replaced by gas. It also assumes that relative prices for gas in remain unchanged and ANS gas is competitive to alternative energy sources.

If the Price Premium offered in this sale is \$0.05 per mcf and the volume sold under the contract is 200 mmcf per day, the State will receive an extra \$3.7 million per year for the RIK gas.

The sale may also enhance competition for oil and gas leases on State lands. As more companies with access to the pipeline compete for leases, bonus bids for these leases can be expected to be higher. The greater diversity of companies undertaking exploration and development on the North Slope and along the pipeline route may contribute to new royalty revenues for the State.

2. Local and regional requirements for petroleum products: In selling its RIK gas the State becomes another seller in the same market where the State's RIV gas is sold. Offering the State's gas at market prices should not adversely affect the market for ANS gas in the State.

3. Desirability of localized capital investment, increased payroll, and secondary development effects: Depending on the commitments that buyers are willing to make, the sale may yield new investments and other economic benefits in addition to the direct revenues to the State.

4. The social impacts of the sale: No incremental social impacts are projected as a result of the RIK gas sale.

5. Additional costs to state and local governments caused by the development related to the proposed sale: No impact is projected on state and local governments. Any gas sold through the proposed RIK sale would otherwise also have been produced and sold at a lower value as RIV gas. No additional construction projects are assured as a result of this sale.

6. Local and regional labor market: The proposed RIK sale, itself, will have no direct effect in state labor markets, but it might affect the timing of development. If projects that have been proposed for use of the State's RIK gas are developed, there will be a beneficial effect on labor markets through construction projects and operational needs.

7. Environmental effects: The RIK sale by itself will have no negative incremental environmental effect.

8. Impacts on existing private commercial enterprises and investment patterns: Local uses of ANS gas could compete with other higher-priced energy supplies. However, the wholesale and retail markets for local gas will have more affect than the proposed sale will on the price and availability of ANS gas for local consumers, commercial and industrial users, and power generators. If the State's RIK gas is sold at lower prices than alternative fuels, existing private enterprises may realize lower costs and output growth. Incremental economic benefits are not assured by an RIK gas sale.

VI. CONCLUSION

Based on the considerations discussed above, the Commissioner has determined that it is in the best interests of the State to solicit purchase offers at this time for a competitive sale of a portion

of the State's royalty share of natural gas that may be produced from Alaska's North Slope upon completion of a natural gas pipeline.

A person affected by this decision may request reconsideration in accordance with 11 AAC 02. Any reconsideration request must be received by **January 15, 2002** and may be mailed or delivered to Pat Pourchot, Commissioner, Department of Natural Resources, 550 W. 7th Ave, Suite 1400, Anchorage, Alaska 99501; faxed to 1-907-269-8918; or sent by electronic mail to dnr_appeals@dnr.state.ak.us. If reconsideration is not requested by the deadline, this decision goes into effect as a final order and decision on January 25, 2002.

Failure of the commissioner to act on a request for reconsideration within 30 days after issuance of this decision is a denial of reconsideration and is a final administrative order and decision for purposes of an appeal to Superior Court. The decision may be appealed to Superior Court within a further 30 days in accordance with the rules of the court, and to the extent permitted by applicable law. An eligible person must first request reconsideration of this decision in accordance with 11 AAC 02 before appealing this decision to Superior Court. A copy of 11 AAC 02 may be obtained from any regional information office of the Department of Natural Resources.

<Signed>
Pat Pourchot, Commissioner

December 26, 2001
Date