Appendix B: Summary and Response to Comments

Ken Thompson

Ken Thompson, President of Pacific Rim Leadership Development, LLC and past-president of ARCO Alaska, Inc., responded to the Preliminary Finding in an e-mail dated November 19, 2001 and offered several suggestions as the State moves ahead through the sale process. The following is a summary of his comments and the department's response:

1) Mr. Thompson noted that the State has scheduled the sale process assuming that an "open season" will occur early in 2002. He recommended that State contact the three major North Slope producers to determine whether or not they were indeed planning an "open season" for the first quarter, 2002.

> The producer project team has indicated to the department that no decision to hold an open season has been made as of yet. The team also said that an open season would not occur in the first quarter, 2002. The department is also aware that the Foothills Pipeline consortium has made progress to advance a pipeline project of its own and to develop a proposal for the North Slope producers. It is unlikely that an open season for a Foothills Pipeline project will occur in the first quarter, 2002.
>
> The Royalty Board and Legislature must approve any contract(s) that the commissioner negotiates. If there is chance that a pipeline open season will occur anytime during 2002, the State still must proceed with the sale now so that the Legislature may review the contract in its upcoming 2002 session.

2) Mr. Thompson expressed his concern that RIK gas be available to supply in-state needs and advised the department to review its own study of in-state demand completed by Econ One. He recommended that there should be sufficient volumes of RIK gas to replace any potential shortfall of gas supplies in the Cook Inlet region. In a second comment on potential sale volume, he recommended that no more that 100,000 – 250,000 Mcf per day be sold in this sale (assuming total royalty gas production at 500,000 Mcf per day).

> Seventy percent of the combined total royalty gas production from the Prudhoe Bay and Pt. Thomson units will be offered in this sale. The remaining 30 percent (possibly 150,00 Mcf per day) will be reserved for possible future competitive sales. In our review of proposals received as a result of the RIK sale offer, future in-state gas demand will be considered.

3) In a similar vein as number 2 above, Mr. Thompson recommends that the State limit the term of the RIK gas sale contract(s) that result from this sale to not more than 5 years.

> Given the uncertainty surrounding the gas pipeline project at this stage, the State should preserve as much flexibility in a future RIK program as it can. Some potential buyers will require a RIK gas sale contract term equivalent to the term of

the firm transportation commitment they will have to make in the open season. The State's evaluation of proposals will have to balance the advantages of shorter term contracts to the State against the commercial requirements of the buyers to meet pipeline commitments.

4) If the notice of RIK sale yields more than one acceptable proposal, Mr. Thompson recommends that the State consider awarding more than one RIK gas sale contract and thereby create incentives among the buyers to pursue marketing opportunities for the State's RIK gas.

Together with his comments on volumes and contract term above, Mr. Thompson is recommending that the State cultivate customers who will be invited to bid in subsequent RIK sales as part of an ongoing RIK program. Such a program could very well evolve over time, in which the State sells much royalty gas in regular sales to a variety of in-state users and Lower 48 marketers. The department will continually evaluate the merits of such a program.

5) Mr. Thompson suggests that the sale price offered by the winning proposal could serve as an indicator of value under the lease terms. This price information could give the State some leverage as the producers make advance the pipeline projects.

It will depend on how the RIK price is ultimately calculated. The State may choose to use the RIK price in its determination of market value under the lease. Insofar as the Base Price is based on the volume-weighted average of the RIV value paid by the lessees, using the Base Price to measure RIV value would be circular.

6) Mr. Thompson proposes that the State offer and sell NGLs separately based on liquids prices versus a Btu-adjusted price.

The department is aware that the NGLs in the gas stream could add value to the State's royalty gas, both in terms of energy content per Mcf and also in the value per unit of energy. The requirement that the proposals provide a price that is at least equivalent to the RIV value should protect the State. The lease provisions provide that the State be fully compensated for the value of the liquids.

Anadarko Petroleum Corporation

Anadarko wrote in support of an RIK gas sale to the Royalty Board on November 12, 2001 and commented on the Preliminary Finding in a letter to the department dated November 27, 2001.

In its comments to the Royalty Board, Anadarko stressed its interest to purchase RIK gas "in conjunction with bidding for firm transportation" on the ANS gas pipeline. If Anadarko cannot participate in an open season and secure capacity on the pipeline now, its prospective gas discoveries on the North Slope may be stranded. Without RIK gas to fill a firm transportation commitment, Anadarko predicted it could face ship-or-pay demand charges on the pipeline of $180 million per year.

Anadarko also predicted that the State could capitalize on the current interest in the State's royalty gas from a number of industry players. The requirement of a minimum cash bonus, potential option payments, and possible in-state investment commitments means that the State may realize some form of compensation for its royalty gas several years in advance of royalty production. The requirement that the price of RIK gas not be less than the value of RIV protects the State from potential downside impacts.

In its comments on the Preliminary Finding, Anadarko reiterated its desire to use RIK gas to cover its firm transportation commitments in the ANS gas pipeline. Anadarko also raised several questions about the contract terms described in the Preliminary Finding.

1) Anadarko encouraged the State not to limit the quantity of royalty gas offered in the sale.

> The State will offer up to 70 percent of the combined total volume of royalty gas produced in the Prudhoe Bay and Pt. Thomson units.

2) Anadarko asked that the State not specify a contract term and instead allow potential buyers to include the length of the contract term commensurate with the term of the firm transportation commitment on the pipeline in their proposals.

> The RIK offer will ask potential buyers to describe the contract term that they will require. The State recognizes that some potential buyers will require that the term of the RIK gas sale contract be equivalent to the term of their firm transportation commitments.

3) Anadarko asked that the State not define a Point of Delivery until the RIK gas sale contract is finally negotiated. Anadarko anticipates that the royalty gas that will be offered in this sale will require conditioning to extract CO_2 and other diluents. The State should secure these conditioning services for royalty gas prior to delivery to the RIK purchaser.

> The contract defines the Point of Delivery as the location or locations where the State receives its royalty gas from the lessees. As for securing conditioning services before tendering its RIK to the buyer, the State may wish to preserve this option but will not take on the obligation to do so now.

4) Anadarko asked that the Final Finding include an RIK gas sale contract that will serve as the basis for contract negotiations. Anadarko also wanted the State to provide this contract to potential buyers to solicit comments.

> Attached to this Finding is a copy of the *Sample Contract*.

5) Anadarko indicated that it would require a substantial volume of RIK to backstop the development of minimum economic gas discovery on the North Slope. For this reason it recommended that the State not award contracts to multiple bidders. The RIK sale offer should

include a provision that will allow a successful proposal to be withdraw it is awarded volumes that are less than the quantity proposed.

> The State will make the determination to award one or more contracts on the merit of the proposals. If the award is for volumes insufficient to the winning proposal's requirements, the buyer may withdraw its proposal.

6) Anadarko is concerned that bidders not be allowed to initiate contact with the Division of Oil and Gas or the Royalty Board after proposals are revealed at the Opening.

> A limitation on buyer-initiated contacts with the division must be specific to the RIK sale. The division will need to deal with some of the same buyers on many other issues. Contact with Royalty Board members by prospective RIK buyers is prohibited by 11 AAC 26.110.

7) According to Anadarko the Preliminary Finding left unclear whether the minimum cash bonus was only assessed against the winning proposal or a non-refundable payment due from all proposals.

> Only the winning proposal(s) will be required to pay the minimum cash bonus. The minimum cash bonus will be refunded to buyers whose proposals are rejected. The State will also refund the minimum cash bonus if any of the conditions in Article VIII occur.

8) Anadarko suggested that the RIK gas price not be used in the determination of the RIV price because the RIK price will include a premium price added to the RIV base price.

> It will depend on how the RIK price is ultimately calculated. The State may choose to use the RIK price in its determination of market value under the lease. Insofar as the Base Price is based on the volume-weighted average of the RIV value paid by the lessees, using the Base Price to measure RIV value would be circular.

9) Anadarko wants further explanation of the RIV value that appears in the discussion of the Base Price in order to reduce some of the uncertainty in its determination.

> The Preliminary Finding included this discussion to provide potential buyers with an appreciation of the potential uncertainty related to the calculation of the Base Price.

10) Anadarko requested that the department consider adopting a reasonable statute of limitations for adjustment of RIV price to be used as the Base Price for RIK.

> The department does not accept this recommendation.

11) Anadarko favored the requirement in the Preliminary Finding to impose some punitive recourse should the buyer fail to carry out the proposed in-state investments that appear in its proposal. This provision takes away the incentive for bidders to embellish and/or renege on the in-state investment commitments contained in their proposals.

The department has included those provisions.

12) Anadarko expressed the concern that the volume of gas sold under the contract must not exceed the buyer's firm transportation capacity.

The *Sample Contract* includes a provision that will allow the buyer to reduce its Maximum Quantities up to 50 percent upon two years advance notice. If the buyer wishes to reduce the Maximum Quantities by more than 50 percent, the buyer must pay a fee. The buyer may also adjust its monthly nomination.

13) Anadarko suggested that the State's discretion to nominate RIK gas from the Prudhoe Bay and Pt. Thomson units to supply the contract could disadvantage the buyer because of the way field costs are determined in each unit. Anadarko would prefer to take RIK gas from royalty gas sourced from leases other than the DL-1 leases within the Point Thompson Unit. If state RIK volumes sold to all buyers requires taking RIK from the Pt. Thomson Unit DL-1 leases, then the RIK from the Pt. Thomson DL-1 leases should be prorated to all buyers.

Article 3.1.5. in the *Sample Contract* addresses this issue.

14) Anadarko wants a condition precedent that will allow the buyer or seller to terminate the RIK gas sale contract if no open season has occurred prior to April 30, 2005. Anadarko also provided contract language that would allow the State or the buyer to terminate the RIK gas sale contract if the pipeline is not in-service by December 31, 2011. The State should defer its right to terminate the RIK until December 31, 2013 if the buyer is unable to terminate its firm transportation obligations.

According to Article VII of the *Sample Contract*, either party may terminate the RIK gas sale contract, if the open season for the gas pipeline is not completed by December 31, 2004. The agreement terminates if the pipeline is not in service by July 31, 2012 or no royalty gas has been delivered by that date. The State will refund the minimum cash bonus, without interest, if these conditions precedent occur. 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.

15) Anadarko raised several issues with respect to field costs and conditioning costs that may be allowed as royalty deductions in the calculation of value for RIV and RIK. It should be clear that any RIK gas that bears the field cost that the State would not have otherwise incurred must be borne by the buyer. What remains unclear to Anadarko is whether or not the State will bear a proportionate share of the gas conditioning costs. Anadarko would like to see in the RIK sale offer and the RIK gas sale contract how the Base Price based as it is on the RIV value would

include all deductions for transportation, treating and conditioning costs, field costs that might apply to RIK but not RIV.

> The principle that governs the calculation of the Base Price is that the State will not be worse off for selling its royalty gas. The department cannot predict how the conditioning costs will be accounted for in the calculation of RIV value. 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.

16) Anadarko objected to the timing for the State to suspend performance or terminate the contract if the buyer fails to make full payment within one day's notice that payment is past due.

> Article 9.1.1(i) allows two business days.

17) Anadarko recommended that the text in Section III.G. in the Preliminary Finding be redrafted in the Final Finding, RIK sale offer, and RIK gas sale contract to clarify that the Commissioner's finding under the procedures of Article XII "Interpretation of Terms and Conditions" may be appealed in court.

> The buyer may appeal the commissioner's decisions. The State is unwilling to add any provision that limits its discretion and deference to its decisions.

18) Anadarko supports the inclusion of a contract provision that will facilitate changes to the RIK gas sale contract in order to preserve the intent of the parties should changes in the market occur during the course of the contract.

> The department will consider a Reopener provision in Article XXVI in the *Sample Contract*.

19) Anadarko asked that the Final Finding clarify that an RIK sale that results in incremental in-State benefits is not contrary to state regulations as long as the RIK sale terms do not create a situation where the State is subsidizing the buyer.

> The State has an interest in facilitating in-state investments and the State may use its RIK to achieve this goal.

AEC Marketing (USA) Inc.

AEC Marketing (USA) Inc. ("Alberta Energy") supports the RIK gas sale. In a letter dated November 9, 2001 to the Royalty Board, Alberta Energy provided a transcript of its testimony for the Royalty Board hearing. This testimony provides detailed discussion of the situation faced by new explorers in the Brook Range foothills. Alberta Energy fears that the lack of pipeline capacity could postpone production of gas from its prospective exploration targets for more than 20 years. Explorers like Alberta Energy will have to obtain firm transportation capacity in the first open season or face the possibility that an expansion of the pipeline sometime in the future will not occur when Alberta Energy's will want to develop its prospects. The substantial risk of assuming a firm transportation commitment is a burden on Alberta Energy's exploration program. Alberta Energy is interested in RIK gas as a backstop to its own supply to fill the firm transportation commitment.

In its testimony and referenced in its comments on the Preliminary Finding dated November 27, 2001, Alberta Energy requested that the State leave as many terms and conditions open as possible for the proposals. Given the uncertainty in the details of an RIK gas sale contract, Alberta Energy feels that bidders can bring creativity and innovation to maximize value for the State.

> The issue of future access to the pipeline by currently non-producers on the North Slope and potential in-state users of ANS gas prompted the State to conduct the RIK sale. While many terms in the RIK gas sale contract will be open for proposals, other terms dealing with the department's rights in normally found in recent RIK gas sale contracts are not subject to negotiation.

Williams Energy Marketing & Trading

Williams' comment letter arrived on December 6, 2001 after the November 30, 2001 deadline. Williams indicated an interest in marketing the State's ANS royalty gas and provided four comments on the sale:

1) Williams felt that the schedule for the sale was extremely restrictive and may be difficult to administer by the State.

> Our schedule is driven by the need to provide RIK gas supply to potential buyers so that the buyers can participate in an open season. Although the open season, if it will occur, will not be scheduled in the first quarter, 2002. The timing of the Legislative session compels the State to hold the RIK gas sale now. Some of the milestones in the schedule published in the Preliminary Finding have been postponed to prepare the Final Finding and other sale documents and to give the State more time to negotiate with the winning proposals.

2) Williams argued that a minimum cash bonus is not a normal industry standard and rather felt that the State should pre-qualify bidders.

> The minimum cash bonus is intended to cover the cost of the sale. Only the winning proposal(s) will pay the minimum cash bonus and the cash bonus will be refunded should the any of the conditions precedent in Article VIII occurs.

3) Williams recommended that the volume sold in the RIK gas sale contract equal the transportation capacity.

> The buyers of the State's RIK gas will have to arrange their own transportation capacity. Buyers must indicate the volume each will require. The *Sample*

Contract included in the RIK sale offer has quantity provisions that allow for some flexibility to adjust the volume taken by the buyer to match the buyer's firm transportation commitments.

4) Williams also recommended that the term of the contract mirror the term usually found in industry-standard transportation contracts.

The State will consider proposals that include a provision to match the length of the contract term with the firm transportation commitment.

Phillips Alaska, Inc.

In a letter dated November 30, 2001, Phillips recommended that the RIK sale does not need to be so quickly paced. Phillips does not foresee holding an open season during the first quarter 2002. Phillips also said the Stated reasons to hold the RIK sale to backstop future gas production from unexplored leases will burden the economics of the pipeline project. Phillips argues that the RIK sale creates a situation that the owners of the proven reserves may be reduced to make room for the new production from the unexplored leases. This reduction may lead to under-utilization of the gas treatment plant and other on-lease investments made for gas sales. This reduction will mean that the known resource owners who bear the risk of building the pipeline will be insufficiently rewarded. The RIK sale will transfer the benefits of the long-term commitments to new participants without transferring the associated risk.

Phillips recommends that fair and unbiased capacity allocation and expansion procedures can be achieved through the FERC regulatory process. Future North Slope gas producers will have access to the pipeline.

The RIK sale is scheduled to allow the Legislature in its next session to vote on the sale. If an open season is scheduled any time during 2002, the RIK gas sale contract(s) must be brought to the 2002 legislative session so that the buyers have gas supplies to fill their transportation commitments.

While an RIK sale may complicate the evaluation of a pipeline project, the ability to shift from RIK to RIV is a lease right of the State that may prove to be very important to the State. Access for explorers is one of the reasons for selling RIK gas now; in-state users may also participate in the sale. The producers acknowledge that the FERC cannot compel a pipeline owner to expand capacity. It is presumed that competitive market forces will provide the necessary incentives.

As to the impact of the RIK sale on the economics of the pipeline project, Phillips has not provided to the State a quantitative analysis. Our qualitative evaluation of the explorer backstop scenario suggest that should the explorers back out RIK gas in place of gas production from their unexplored leases, the producers are provided with the benefits of producing greater equity volumes in the first few years of pipeline operation than they would produce without the sale. After the

> switch from RIK to RIV the producers will have the incentive to expand the pipeline to maintain equity volumes. An open season after initial construction could also attract new entrants including in-state users of gas. Phillips may be among those looking for space in the new expansion as its own unexplored leases begin producing.

BP Exploration (Alaska), Inc.

The language of BP's letter, dated November 30, 2001, mirrored that which appeared in the Phillips letter. BP asked that the State refrain from taking steps that would jeopardize the commercial viability of the pipeline project.

BP added that it is not opposed to the State marketing its royalty gas and suggested that it may bid in the RIK sale. BP also suggested that the RIK sale might address some of the industry's concerns about fiscal certainty for the project by providing clear and transparent pricing for royalty gas.

> The State's responses to BP's critiques are the same as those listed above for Phillips. Depending on the price structure adopted for the RIK gas sale, the State may choose to refer to the RIK gas price in its evaluation of the value of RIV gas.