

1 cannot be said to have occurred until the oil and gas is in
2 marketable form, which is at the LACT meter, or with respect to
3 gas, the LACT meter's equivalent. Further, the term "producti
4 must be so interpreted because it is mandated by the Alaska
5 Constitution which provides that the legislature, and not an
6 administrative agency, is to set the terms of oil and gas leas
7 in such a manner as to provide the maximum benefit to the citi
8 of the State. Alaska Constitution, Article VIII, Sections 2 a
9 12.

10 Defendants contend that the legislature delegated the
11 authority to determine the method of valuing royalty payments
12 the Commissioner of Natural Resources and that such authority
13 exercised when the leases for Prudhoe-Bay were issued to
14 Defendants. Those leases contain language that royalty valuat
15 occurs "at the well" when royalty is taken "in value" by the
16 State. Defendants interpret "at the well" to mean some point
17 the field before the LACT meter and before certain treatment c
18 have been incurred. - The net effect of valuation at this earli
19 point would be to allow Defendants to deduct the above-mention
20 costs prior to determining royalty payments. Defendants furth
21 contend that the lease provision controls when the State takes
22 its royalty "in kind." That provision specifically allows a
23 deduction for "cleaning and dehydrating" oil and gas prior to
24 computing royalty.

25 Chronologically, this litigation was commenced on Septemb
26 1977, when the State filed a Complaint For Declaratory Judgmen
27 as to the basis for determining the State's royalty interest i
28 oil. A Consolidated Answer was filed by lessee Defendants on
29 October 13, 1977, with demand for a jury trial.

SGI_005473

EXHIBIT 1

Page 2 of 21

30 On November 1, 1977, the State filed an Amended Complaint
31 seeking determination as to whether AS 31.05.110(h) and (i)
32 results in giving the State a royalty of one-eighth of unit pr

1 duction free and clear of unit expense. An Answer was filed on
2 November 18, 1977.

3 On November 8, 1977, Plaintiffs filed a Motion For Summary
4 Judgment on Count I of the Amended Complaint seeking judgment
5 that AS 38.05.180(a), AS 31.05.110(h) and (i), and the Alaska
6 Constitution, Article VIII, Sections 2 and 12 require that the
7 State's royalties be computed on the basis of values at the LAC
8 meter where the product is transferred to TAPS.

9 On March 1, 1978, Defendants filed a Memorandum In Opposit
10 To Plaintiffs' Motion For Summary Judgment and Cross-Motion For
11 Partial Summary Judgment, broadening the issue to include gas a
12 well as oil royalties and seeking an interpretation of the stat
13 when royalty is taken "in kind" as well as "in value." On May
14 1978, Plaintiffs filed their Cross-Motion For Partial Summary
15 Judgment responding to Defendants' additional issues on royalty
16 taken "in kind" and on royalty gas.

17 On July 2, 1978, Brief Amicus Curiae for Arctic Slope
18 Regional Corporation in Support of the State of Alaska's Motion
19 For Summary Judgment and in Opposition to Defendants' Motion Fo
20 Partial Summary Judgment was filed.

21 On August 31, 1978, Defendants filed their Reply Memorandu
22 To State's Opposition To Defendants' Cross-Motion For Partial
23 Summary Judgment, To State's Cross-Motion For Partial Summary
24 Judgment, and To Brief Amicus Curiae Of Arctic Slope Regional
25 Corporation. On September 15, 1978, the State filed a Reply
26 Memorandum In Support Of State's Cross-Motion For Summary Judgm

27 The parties presented oral argument to this Court on Dec-
28 ember 11, 1978. Deputy Attorney General Wilson L. Condon and
29 Assistant Attorney General Robert M. Maynard argued on behalf o
30 ~~the Plaintiffs. Richard O. Gantz, Esquire, argued on behalf of~~
31 the Defendants. Thomas J. Brewer, Esquire, argued on behalf of
32 the Amicus Curiae.

SGI_005474

EXHIBIT 1

Page 3 of 21

1 All parties have agreed that there is no genuine issue of
2 material fact, and that summary judgment is thus proper. The
3 "evidence" is found in appendices to each parties' memoranda,
4 Plaintiffs' consisting of ten (10) volumes of textual material
5 and over 700 documents. Memoranda and appendices exceed several
6 thousand pages. Neither party disputes any of this evidence.

7 Much of the documentary evidence is historical, rather than
8 relevant in a strict sense. In total it does present the entire
9 chronology of events, central and peripheral, bearing on the
10 issues raised. The Court has not attempted to identify all
11 documents it deemed relevant or persuasive. Undoubtedly some
12 documents of equal relevance have been omitted, and some that
13 merely peripheral included. The Court's review of documents
14 extended to the whole, rather than just to documents to which
15 attention was directed.

16 Due to the complexity of these proceedings, it is beneficial
17 to first state what has not been put in issue by the parties.
18 relevant as this stage of the proceedings is the method to be
19 employed in calculating allowable costs for royalty purposes.
20 (Counts IV, V.) Nor is the Court called upon to consider what
21 costs are properly deductible by the Defendant if it is concluded
22 that royalties are not to be based on the LACT meter. (Count
23 III.) And while the lease provisions clearly have a bearing on
24 the issues of statutory construction now before the Court, the
25 parties have not moved for an interpretation of the lease itself
26 to determine the point at which royalty is to be valued. (Count
27 II.)

28 The only issues before this Court are whether Alaska Con
29

EXHIBIT 1

Page 4 of 21

SGI_005475

30
31 The Court wishes to commend all counsel for the thoroughly professional
32 manner in which they prepared and presented this case, both in amassing and organizing the material and in analyzing the issues raised.

1 tution, Article VIII, Section 2 and 12, and AS 38.05.180(a) dis-
2 allow field cost deductions when royalty is taken "in kind" and
3 "in value", or whether AS 31.05.110(h) on unitization applies to
4 give the State an automatic one-eighth royalty free and clear of
5 field costs regardless of AS 38.05.180(a).

6 For reasons fully set forth below, this Court holds that AS
7 38.05.180(a) prohibits the field costs deductions claimed by the
8 Defendants when royalty is taken "in value." The Court further
9 holds that "cleaning and dehydration" costs are deductible with
10 "in kind" royalty but that the Commissioner is prohibited from
11 collecting royalty "in kind" if the amount realized would be less
12 than if taken "in value." Because the Court's interpretation of
13 AS 38.05.180(a) is dispositive, an interpretation of AS 31.05.110
14 (h) is unnecessary and will not be addressed.

15 At the outset, the Court notes that it is exercising its
16 independent judgment in reviewing the statute. Union Oil Co. v.
17 Dept. of Revenue, 560 P.2d 21 (Alaska 1977);

18 where...the issues to be resolved turn on statutory inter-
19 pretation, the knowledge and expertise of the agency is not
20 conclusive of the intent of the legislature in passing a
21 statute. Statutory construction is within the scope of the
22 court's special competency, and it is our duty to consider
23 the statute independently. Id. at 23, citing State v. Ale
Corp., 541 P.2d 730, 736 (Alaska 1975).

22 In this case, the Court is not called upon by either party to
23 review action taken by a regulatory agency. The Court is asked
24 to interpret a statute and the Constitution. Notwithstanding t
25 settled principles of law on cases of statutory interpretation,
26 Defendants urge this Court to adopt a reasonable basis test in
27 reviewing whether the "oil and gas lease contracts reflect a
28 permissible interpretation of .180(a)." The Commissioner of
29 Natural Resources is in no better a position than this Court to

SGI_005476

EXHIBIT 1

Page 5 of 21

30 determine the intent of the legislature when it enacted that
31 portion of AS 38.05.180(a) that provides "...such royalty...sh
32 not be less than 12-1/2 per cent in amount or value of product

1 removed or sold from the lease." Moreover, as will become clear
2 in the text of this opinion, the Court finds that the "in value
3 provisions of the lease do not have the meaning ascribed to the
4 by the Defendants, are ambiguous at best, and provide no guidance
5 to the Court in interpreting the statute. One "weighty reason"
6 for rejecting the reasonable basis standard for review, assuming
7 its applicability at all, is where, as here, the administrative
8 agency charged with interpreting the statute fails to do so.
9 Kelly v. Zamarello, 486 P.2d 906 (Alaska 1971). See also, Uda
10 v. Tallman, 380 U.S. 1, 13 L.Ed.2d 616 (1965); Pan American
11 Petroleum Corp. v. Shell Oil Co., 455 P.2d 12, 22 (Alaska 1969
12 citing Unemployment Compensation Comm'n. of Territory of Alaska
13 v. Aragon, 329 U.S. 143, 91 L.Ed 136 (1946).

14 Defendants assert that the terms of the lease which provide
15 for royalty valuation "at the well" when royalty is taken "in
16 value" and for "cleaning and dehydration" costs when royalty is
17 taken "in kind" are controlling. This argument is premised on
18 the ground that the lease embodies the Commissioner of Natural
19 Resources interpretation of AS 38.05.180(a).

20 When a statute is ambiguous, the Court may give "some weight"
21 to the administrative decision even when exercising (its) independent
22 review." Union Oil of California v. Dept. of Revenue
23 560 P.2d 21, 25 (Alaska 1977). Even though the administrative
24 interpretation is not controlling, it is of some importance if
25 the Court determines that the Constitutional and statutory provisions
26 in question do not, on their face, mandate that the
27 legislature establish royalty values. For purposes of argument
28 and to trace the historical development of these leases, it will
29 be assumed that the Defendants correctly allege that the statute

30 is ambiguous and that resort to administrative interpretation is
31 necessary.

32 The weight to be given to administrative interpretation

SGI_005477

EXHIBIT 1

Page 6 of 21

1 controlled by "the thoroughness evident in its (the department
2 consideration, the validity of its reasoning, its consistency
3 with later pronouncements, and all those factors which give it
4 power to persuade, if lacking power to control." Skidmore v.
5 Swift and Company, 323 U.S. 134, 140; 89 L.Ed. 124, 129 (1944).
6 Using this test as a measure and applying it to the facts of the
7 case, it is apparent that the lease language of "at the well" has
8 no fixed meaning and provides no assistance in interpreting the
9 statute.

10 The Department of Natural Resources gave no consideration
11 all to the phrase "at the well." The oil and gas lease form was
12 drafted during the period from September, 1958, to July, 1959,
13 the time Alaska was emerging from territorial status to statehood.
14 In late September, 1958, Evert Brown, Director of the Territorial
15 Land Board, travelled to various states for the purpose of
16 collecting sample gas and oil lease forms. (Docs. 19 to 23, 24
17 to 29.) Less than two months later, on November 15, 1958, a set
18 of proposed regulations and a draft lease form were completed.
19 The royalty provisions of this form were identical to those in
20 existence in Wyoming. There was no provision for valuing royalties
21 "at the well", nor for allowing "treating and dehydration" costs.
22 After reviewing these forms, Phil Holdsworth (later Commissioner
23 of Natural Resources) commented to a member of the Western Oil
24 and Gas Association (WOGA) that the form was "similar to the
25 federal form now in use, but somewhat simplified." (Doc. 53-1)
26 This form received general approval at December 11-12, 1958,
27 hearings held in Anchorage. The now disputed royalty provisions
28 were not mentioned at these hearings.

SGI_005478

29 On November 18, 1958, after learning of the scheduled hear-
30 ings, Henry Wright, Secretary of WOGA, volunteered his assistance
31 to the Land Board in preparing the lease forms. (Doc. 41-1.)
32 During all of the above activities, WOGA subcommittee members

EXHIBIT 1

1 were actively reviewing and recommending approximately 100 cha
2 in the State's proposed lease form. Two of these changes mark
3 the birth of the "at the well" language and an allowance for
4 "treating and dehydration" costs when royalty is taken "in kin
5 (Doc. 126-6 & 7.)

6 On April 17, 1959, just two days after a new Land Act pas
7 the legislature, Commissioner Holdsworth contacted Paul K. Hom
8 a member of the WOGA subcommittee and an employee of Standard
9 Company of California (SOCAL), asking that he recommend a qual
10 fied individual who could assist in preparing the regulations
11 leases for administration of the Alaska Lands Act. (Docs. 137
12 and 138.)

13 Acting on this request, Mr. Home prepared a memorand wh
14 was sent to Pillsbury, Madison and Sutro (Attention: Mr. Sigv
15 Nielson), a San Francisco law firm retained by SOCAL in oil an
16 gas matters. The memo, signed by W. H. Savage, read in perti
17

18 The following taken from Joseph C. Goulden's The Benchwarmers
19 (Ballantine 1974), presents a layman's view of the relationsh
20 between this firm and the oil interests:

21 'One of the pillars of the San Francisco financial distri
22 physically as well as figuratively, is the massive Stand
23 Oil Building, on Bush Street at the foot of Telegraph Hill
24 Here is headquartered one of the largest industrial corp
25 tions in the West. Standard permeates the political and
26 economic life of California. It pumps vast quantities of
27 oil from beneath California, and refines it and sells it
28 from retail outlets in every hamlet in the state. The sh
29 size of Standard means it has an inordinate number of leg
30 problems. It sometimes splashes oil where oil does not
31 belong. It gets into fights with competitors and its
32 franchised dealers. Its vehicles collide with other peop
33 vehicles. Workers are injured in its refineries and seek
34 recompence.

35 Tucked away on the upper floors of the Standard Oil Build
36 is a law firm responsible for resolving as many of these
37 legal problems as possible. Pillsbury, Madison and Sutro
38 is itself a power in California. With 180 partners
39 ciates, it is not only San Francisco's largest firm
40 its best in the opinion of many West Coast lawyers. pres
41 by association is a tenuous concept, but PMS (As Pillsbur
42 Madison is known in lawyer's shorthand) is good enough to
43 be counsel for Standard Oil and a host of other major
44 California corporations...and seldom does a day pass that
45 PMS lawyer isn't in a state or federal court somewhere in
46 California, representing one of its blue-chip clients."
47 at 42-43.

SGI_005479

EXHIBIT 1

Page 8 of 21

1 part as follows:

2 ...it is of the utmost importance that...the lease forms
3 ...be prepared by someone who has an appropriate background
4 experience, and thorough knowledge both of the requirements
5 of the State and of the industry.

6 We know of no one better qualified to fulfill such require
7 ments than a representative of your firm...In this connect
8 if it is at all possible for your to do so, we would appre
9 ciate your making the services of Mr. James Wanvig availab
10 to the State of Alaska...

11 ...All of them (WOGA representatives) are in accord with t
12 foregoing proposal and agree...that it is imperative that
13 the initial regulations and lease form with respect to oil
14 and gas matters be prepared by...someone who is more famil
15 with the requirements and necessities of the industry th
16 anyone who is presently available in Alaska for such purpo
17 (Doc. 137.) (Emphasis added.)

18 So it came to pass that Mr. Wanvig (Pillsburg, Madison &
19 Sutro?; WOGA?; SOCAL?) was retained by the State of Alaska as a
20 "technical consultant" to assist in preparing the oil and gas
21 regulations and leases. (Docs. 141, 145.) Hoping that the Sta
22 of Alaska found Mr. Wanvig as "delightful and intelligent" as c
23 Pillsbury, Madison & Sutro, he was sent off to the hinterlands.
24 (Doc. 146.) Mr. Wanvig was paid a contract price of \$5,000, p
25 travel, by the State of Alaska. Although Mr. Nielson made it
26 clear that WOGA was not paying for anything, WOGA was nonethel
27 billed for Mr. Wanvig's personal living expenses in the amount
28 \$1,778.17, which was apportioned among WOGA's sixteen (16) oil
29 industry representatives who remitted their share to WOGA, whi
30 in turn reimbursed Pillsbury, Madison & Sutro. (Docs. 195, 1
31 202.)

32 Mr. Wanvig relied on the lease draft prepared by the WOGA

3 Although Plaintiffs have been quick to point out that they ar
4 not suggesting any "bad faith" on the part of actors herein,
5 nonetheless a cynic might suggest that this arrangement was no
6 unlike the farmer asking the fox how best to protect his chick
7 when the late Joseph Rudd, then with the Attorney General's Of
8 sought comment from Mr. Wanvig regarding the state regulation
9 he had drafted and a Federal law, after receiving some comment
10 from Mr. Wanvig another partner in the firm responded that the
11 could not comment on substantive matters, since they had clie
12 interested in the issue. (Doc. 216.)

SGI_005480

EXHIBIT 1

Page 9 of 21

1 subcommittee when he began his own drafts. (Doc. 158.) It will
2 be recalled that those forms were the first to contain the phra
3 "at the well" and to create an allowance for "treating and
4 dehydration" costs when royalty was to be taken "in kind."
5 (Docs. 126, 133-2, 158-1.) These leases differed, of course,
6 from the State's draft lease which did not include "at the well
7 language and disallowed, by its silence, "treating and dehydrat
8 costs. (Doc. 72-1.)

9 Mr. Wanvig's final drafts on competitive and noncompetitiv
10 leases created separate provisions for "Royalty in Value" and
11 "Royalty in Kind", but otherwise kept the WOGA language intact.
12 Mr. Wanvig did create some additional and more specific royalty
13 provisions, and in so doing, incorporated "at the well" l as
14 into other provisions as well. (Docs. 158, 164, 165.)

15 This draft was presented at a hearing held on July 9, 195
16 before the Department of Natural Resources. The most signific
17 aspect of this hearing was that there was not one single refer
18 to the provision concerning royalty when taken "in value" by t
19 State. The phrase "at the well", which is the focal point of
20 Defendants' argument, was never even mentioned. The provision
21 allowing for "treating and dehydrating" deductions for oil and
22 gas taken "in kind" was briefly addressed and the total discus
23 was as follows:

24 HOLDSWORTH: Mr. Hoffman (El Paso Nat. Gas Prod. Co.) has
25 comment there. "It seems to me there might be situations in
26 which the requirement that royalty oil and gas delivered in ki
'shall be in good and merchantable condition' might impose an
unnecessary burden on the lessee."

27
28 SGI_005481

29 That WOGA, and not the State, was responsible for the ir
of "at the well" and "treating and dehydration" is also v.
in response to Defendants' oral argument portrayal of the stat
30 as having inserted these provisions, directed lessees to sign
and now, having found the provisions not in the State's best
31 interest, seeking to renege. Perhaps counsel is attempting to
32 apply surrealism to jurisprudence, just as it has been applic
in art and literature.

1 SHAFER: You must clean your oil; you don't have to do it
free of charge to the State.

2 HOLDSWORTH: True, but the Federal requires good and mer-
3 chantable condition, as I recall it.

4 SHAFER: I think so.

5 WANVIG: We didn't intend to impose any hardship on a less-
here.⁵ (Doc. 189-95.)

6 After the hearings, the royalty provisions of the lease we
7 changed in two respects. First, the provision allowing for
8 "treating and dehydration" deductions for royalty "in kind" was
9 narrowed in that the word "treating" was substituted by the wor
10 "cleaning." Secondly, this deduction was specifically extended
11 to gas as well as oil. No other significant change was made in
12 respect to the royalty provisions as submitted by Mr. Wanvig.

13 Despite the presence of "at the well" language in the leas
14 and its short appearance in the form regulation (dropped prior
15 issuance of the Prudhoe Bay leases), the Department of Natural
16 Resources has never permitted field cost deductions. The first
17 implementation of the leases occurred with oil and gas discover
18 off-shore in Cook Inlet, where approximately ten or more compet
19 tive lease sales were held. Field cost deductions were not
20 claimed for many field operations and never permitted as to any
21 of them. The only deductions allowed by the State were for
22 transportation charges away from the field to distant markets.
23 (App. Vol. I, p. 56; Vol. II, Supp. E.)

24 In short, neither in the creation nor in the issuance of
25 these leases did the Department ever interpret them to allow f
26

27 ⁵
28 This interchange is presented for the sole purpose of demonst
29 ing the minimal amount of discussion of the royalty provisions
It is used for no other purpose, i.e., content, because the Co
is unable to decipher to whom the parties were referring when t
acknowledge a deductible cost for treating and dehydration. M
30 ~~Wanvig's comment that "the lessee is presently allowing" a ded~~
31 tion, followed by Mr. Shafer's comment that the oil companies
do not have to clean their oil free of charge to the State, do
32 suggest that the parties were not contemplating a deduction fo
cleaning.

1 field cost deductions. The first widely distributed documenta
2 on administrative policy came in 1967 when the Department offi
3 ly announced to the oil industry that it would refuse to allow
4 field cost deductions. (Doc. 433.) Since this policy was
5 announced after the issuance of the leases, it does not help t
6 resolve what, if anything, the Department had in mind when it
7 issued those leases in 1959. For this reason, the 1967 announ
8 ment provides no meaningful guidance to the Court.

9 Finally, Defendants contend that "at the well" is the app
10 priate language to show the usual custom in the industry for
11 allowing field cost deductions. It was for purposes of "clarifi
12 cation and to conform lease provisions in the usual practice
13 in the industry" that WOGA first inserted the "at the well
14 clause. (Doc. 126-7.) A review of the practices of other jur
15 dictions shows that there is in fact no usual practice or cust
16 notwithstanding the inclusion of "at the well" in the leases.
17 Counsel for both sides have presented voluminous case citation
18 from other jurisdictions interpreting this provision. (Defen
19 Memorandum In Opposition To Motion For Summary Judgment at 57
20 Plaintiffs' Reply Memorandum at 12-21.) Some of those cases
21 stand for the proposition that the lessee is permitted to ded
22 certain field costs prior to determining royalty payments.
23 Sartor v. United Gas Public Service, 173 So. 103 (La. 1937);
24 Warfield Natural Gas Co. v. Allen, 88 S.W.2d 989 (Ky. Ct. App
25 1935); La Fitte Co. v. United Fuel Gas Co., 284 F.2d 845 (6th
26 Cir. 1960). Other cases hold that "at the well" is ambiguous
27 probably synonymous with "on the premises" and that the expen
28 claimed by the Defendants are not deductible. Skaggs v. Wear
29 172 F.Supp. 813 (E.D. Tex. 1959); Gilmore v. Superior Oil Co.
30 388 P.2d 602 (Kan. 1964). These cases would permit deduction
31 for transportation costs away from the leased premises to dis
32 markets, a cost not in issue in this case. Many of the cases

SGI_005483

EXHIBIT 1

Page 12 of 21

1 cited by Defendants permitting field cost deductions do so on
2 constituent products but not on the crude oil itself. Coyle v.
3 Louisiana Gas and Fuel Co., 144 So. 737 (La. 1932); Freeland v.
4 Sun Oil Co., 277 F.2d 154 (5th Cir. 1932), cert. denied 364 U.S.
5 826 (1960). Without resorting to a lengthy discussion of all
6 cases cited by the parties, it suffices to say that this Court
7 cannot assign any fixed definition to "at the well" on the basis
8 of interpretations given by other jurisdictions.

9 Since this Court concludes that there was no administrative
10 interpretation by Alaska officials and the parties concede that
11 there was no legislative interpretation of AS 38.05.180, it is
12 necessary to look elsewhere for guidance.

13 Where legislation is ambiguous and has not been interpreted
14 by the legislature of the enacting state, an interpretation of a
15 identical statute given by a foreign jurisdiction is persuasive
16 authority. Menard v. State, 578 P.2d 966, 971, n. 10 (Alaska
17 1978). 2A Sutherland, Statutes and Statutory Construction, sec
18 52.02 at 329-30 (Sands Ed. 1973).

19 In 1954, the Federal Mining and Leasing Act, 30 U.S.C. 266
20 was adopted. That Act provided royalty paid to the federal
21 government under competitive leasing "shall not be less than 12
22 1/2 per centum in amount or value of production removed or sold
23 from the lease." This language, which forms the basis for the
24 present litigation when gas and oil royalty is taken "in value"
25 was lifted verbatim by the Alaska legislature when it adopted the
26 Alaska Land Act in 1959, AS 38.05.180(a).

27 The Plaintiffs' contention is that oil and gas cannot be
28 deemed "produced" within the meaning of the statute until the c
29 and gas is in some marketable form. Federal cases support thi

SGI_005484

EXHIBIT 1

13 of 21

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31

32

6
The oil industry has not always disputed the State's interpretation of the term "production." When it wanted an exemption from the ad valorem tax, it offered the following definition of "pro

1 interpretation.

2 In 1957, the Acting United States Solicitor issued an opinion
3 in The Texas Company, 64 I.D. 76 (April 1957) holding that the
4 cost of compressing gas to the point where it could enter the
5 transportation pipeline was not properly deducted from royalty
6 payments. The Solicitor found that the lessee had a duty to
7 "produce" the gas and since production could not be said to have
8 occurred until the gas was in a marketable form, the costs of
9 compression could not be deducted:

10 Until the gas from the wells is in such a condition that
11 can be sold in the market, it cannot be said that the lessee
12 has fulfilled his obligations...The lessee has not shown
13 that the gas can be marketed at the pressure with which
14 comes from the wells.

15 In fulfillment of its expressed duty to market the
16 appellant had a contract for the sale thereof. It agreed
17 to deliver the gas at a given pressure presumably in order
18 to sell the gas. It cannot reasonably expect the lessor to
19 assume the costs of meeting the lessee's obligation in this
20 respect. (Quoted in California Company v. Seaton, 187
21 F.Supp. 445, 451 (D.C., D.C. 1960).)

22 6 con't

23 "production":
24 'Facilities for the Separation of the Mixture of Oil, Water
25 and Gas Produced at the Wellhead Are Part of the Process
26 of Production...'

27 '...the onshore treating facilities, including the measuring
28 devices, are integrated, interdependent and an essential
29 part of the producing operation.'

30 The above was in a memorandum prepared by Lawrence Wilson of
31 Union Oil's tax department. (Doc. 500-13, 18.) It was first
32 reviewed by Mr. Sigvold Nielson, of Pillsbury, Madison & Sutro
that same Mr. Nielson who presumably acted favorably upon WOG's
urgent request to make Mr. Wanvig available to the State of
Alaska as a Technical Consultant on oil and gas regulations and
lease forms. In reviewing the memo, Nielson made the following
changes which appear in parenthesis:

33 '...Facilities For the Separation of (the mixture of oil
34 water, and gas produced at) the Wellhead Are Part of the
35 Process of Production and Thereby Exempt from Ad Valorem
36 Tax. (Doc. 498-10.)

SGI_005485

EXHIBIT 1

Page 14 of 21

37 He too seems to have agreed with the State's interpretation of
38 "production."

39 See also 7 F.R. 4132, enacted July, 1942, and now codified in
40

1 This issue again arose under leases issued by the Federal
2 Government to the California Company for gas exploration in
3 southern Louisiana. There, in an order issued on May 21, 1957,
4 the Federal Government refused to permit a deduction for the
5 costs of gathering, compressing and dehydrating the gas. The
6 Texas Company case was specifically affirmed by the Deputy
7 Solicitor of the Department of the Interior on February 20, 1959
8 and by the Federal District Court. California Company v. Seaton
9 187 F.Supp. 445, 452 (D.C. 1960), aff'd. sub nom California
10 Company v. Udall, 296 F.2d 384 (D.C. Cir. 1961).

11 Critical to the District Court's affirmance of the adminis-
12 trative decision was an interpretation of the terms "value" and
13 "production" as used in the Federal lease form and the statute.
14 The Court reasoned that the term "value" in the context of the
15 statutory royalty provision meant "estimated or assessed worth"
16 and that the term "production" included preparation for market:

17 The stage of production was not reached by the preliminary
18 steps of exploration and discovery. Successful exploratio
19 and discovery lay the basis for marketing of gas in such a
20 stage as to have a value and to command a price. Black's
21 Law Dictionary defines 'production' in the political econo
22 as 'the creation of objects which constitute wealth.' Gas
23 or oil connected with a pipeline or other means of trans-
24 portation to market is an object which constitutes wealth.
25 California Company v. Seaton, supra, at 448-449.

26 When this case went to the Court of Appeals, it had the
27 following comment on the term "production":

28 There is no question as to the Secretary's authority to
29 require the payment of 12-1/2 per cent royalty 'value of
30 production'. The statute so provides...The heart of this
31 controversy is the meaning of 'production'. Does it mean
32 the raw product as it comes from the well, no matter what
33 its condition? Or does it mean the product ready for the
34 market in and to which it is being sold?

35 The premise for the Secretary's decision...was that, since

SGI_005486

36 30 C.F.R. 221:47 which provides that "(u)nder no circumstances
37 shall the value of production of any of said substances for th
38 purposes of computing royalty be deemed to be less than the gr
39 proceeds accruing to the lessee from the sale thereof or less
40 than the value computed on such reasonable unit value as shall
41 have been determined by the Secretary.

EXHIBIT 1

Page 15 of 21

1 the lessee was obliged to market the product, he was obliged
2 to put it in marketable condition; and that the 'production'
3 was the product in marketable condition. Theoretically, a
4 gas - any 'production' - is 'marketable'. We can assume
5 that if the price were low enough to justify capital expenditures
6 for conditioning equipment, someone would undertake to
7 buy low pressure gas having a high water and hydrocarbon
8 content. A lessee who sold unconditioned gas at such a
9 price would in a rhetorical sense, be fulfilling his obligation
10 to 'market' the gas, and by thus saving on overhead
11 might find such business profitable. There is a clear
12 difference between 'marketing' and merely selling. For the
13 former there must be a market, an established demand for a
14 identified product. We suppose almost anything can be sold
15 if the price is no consideration. California Co. v. Udall
16 supra, at 384.⁸

17 In short, oil and gas have no value until "produced", which
18 means ready for sale. In the case of the Prudhoe Bay operations
19 that point occurs at the LACT meter. That the Alaska legislature
20 was aware of the federal interpretation of the term "production"
21 is evidenced not only by the adoption of the identical Federal
22 language after it had been interpreted in The Texas Company, 6
23 I.D. 74 (April 1957), but also because that interpretation was
24 put into effect by the Federal Government at the Swanson River
25 Field prior to issuance of the Prudhoe Bay leases.

26 The Swanson River oil field was discovered in 1957 and since
27 1960 crude oil has been transported from the field via pipeline
28 (equivalent to TAPS). While the field is Federally owned, the
29 State of Alaska receives 90% of the royalties collected. At
30 the time since pipeline operations began in 1960 has the pipeline
31 company been permitted to deduct costs prior to oil entering
32 the LACT meter. This has been the consistent practice of the Federal
33 Government and one which it is reasonable to assume the Commission

34 Two oil and gas treatises cited by the State support this interpretation
35 of the term 'production'. Covenants Implied in Oil
36 and Gas Leases (2d Ed. 1942) (Merrill), section 85, states that
37 the costs of preparing the product for market are the sole responsibility
38 of the lessee and cannot be deducted from the computation
39 of royalty value. In accord is the view of Professor Kuntz,
40 3 E. Kuntz, Oil and Gas, section 39.4 (1967) (Kuntz) who concludes
41 that the lessee is obligated to produce a marketable commodity
42 and marketability should be based on the condition or quality
43 of the gas or oil and not on its location.

SGI_005487

EXHIBIT 1

Page 16 of 21

1 sioner of Natural Resources knew about when he entered into the
2 leases at Prudhoe Bay. The Commissioner repeatedly stated that
3 it was his impression Alaska was following the Federal model in
4 enacting its own statute. (Docs. 53-1, 140-2, 189-95.)

5 Thus even assuming arguendo that the statute is ambiguous,
6 Defendants' interpretation does not stand up to critical analysis.
7 However, the Court need not rely on its interpretation, premised
8 upon statutory ambiguity, in concluding that the claimed deducti
9 are impermissible. The Court is of the view that the statute is
10 not ambiguous.

11 The statute mandates that the royalty be not less than 12-
12 1/2 per cent of production "removed or sold from the lease." Th
13 Court agrees with the position of the Amicus Curiae that this
14 language has a very plain and unambiguous meaning. While the
15 term "production" indicates what is to be valued for royalty
16 purposes, the phrase "removed or sold from the lease" indicates
17 where the product is to be valued. Since no gas or oil is sold
18 directly from the Prudhoe Bay lease, valuation must occur at the
19 place where the product is removed - i.e., metered into TAPS for
20 removal from the unit.

21 This was certainly the intention of the United State Congre
22 when it added the language "removed or sold from the lease" to
23 the Mineral Leasing Act in 1946. During Senate Subcommittee
24 hearings on the bill that amended the Mineral Leasing Act, the
25 following testimony was given by the Vice-President of Seaboard
26 Oil Corporation:

27 Recently, I have been advised that the Interior Department
28 is going to change that practice (computing royalty on the
29 basis of sales); that from now on Government lessees must
account for and pay royalty not on the basis of the oil and
gas removed from the lease, but on the basis of the produc
tion at the well.

EXHIBIT 1

Page 17 of 21

31 The following recommendation was made to prevent the above-men-
32 tioned change:

SGI_005488

1 I would suggest for your consideration, therefore, the addi-
2 tion of the words "removed or sold from said lease" after
3 the word "production"... (Hearings on S. 1236 Before Subc. of
the Senate Committee on Public Lands and Surveys, 79th
Cong., 1st Sess., at 160.)

4 Congress' adoption of that language showed that it "intended to
5 insure that royalty would be due only on oil and gas "removed"
6 from the leasehold, not on total oil and gas produced at the
7 well." Gulf Oil Corporation v. Andrus, 460 F.Supp. 15, 17 (D.C.
8 Cal. 1978), (decided on unrelated grounds).

9 Finally, and probably the most significant factor in this
10 Court's decision, is that this is not simply a case of interpreting
11 AS 38.05.180(a). That legislation came in direct response to two
12 critical constitutional provisions. Article VIII of the Alaska
13 Constitution provides in pertinent part as follows:

14 SECTION 2: General Authority.
15 The legislature shall provide for the utilization, develop-
16 ment, and conservation of all natural resources belonging to
the State...for the maximum benefit of its people. (Emph^s added.)

17 SECTION 12: Mineral Leases and Permits.
18 The legislature shall provide for the issuance, types, and
19 terms of leases for coal, oil, gas...Leases and permits
giving the exclusive right of exploration...may be authorized
by law. (Emphasis added.)

20 This Court need not decide the extent of the Commissioner's
21 authority to administer the provisions of AS 38.05.180(a). It is
22 satisfied that such authority does not extend to determining the
23 amount of royalty obligations. These Constitutional provisions
24 require that the legislature set the terms of oil and gas leases
25 in such a manner as to provide the maximum benefit for its people.
26 No "term" could be more critical to its people than the monetary
27 return realized on the depletion of their natural resources. If
28 "production" under AS 38.05.180(a) does not mean what the State
29 claims it means, then the legislature has impermissibly delegated
30 a constitutional duty to an administrative agency. The legislatu
31 did not do so. When the legislature determined that the State
32 would get "12-1/2 per cent...of production" is it apparent i

1 meant 12-1/2 per cent of a product, not 12-1/2 per cent of some
2 thing that had no or negligible market value. With the excepti
3 of California's "wet oil", there is no market for crude oil in
4 its raw state. That the legislature was attempting to get the
5 best monetary deal for its people is apparent from the pricing
6 provisions from the lease itself which provide that the highest
7 of any three royalty valuations be paid. To accept the Defenda
8 argument would mean that theoretically the State could receive
9 12-1/2 per cent of nothing, in effect giving away its oil. Und
10 these circumstances, the Court has no difficulty in following t
11 rule of law that statutes must be construed so as to avoid a
12 conflict with the constitution. Crowell v. Benson, 285 U.S. 22
13 62, 52 S. Ct. 285, 296 (1932); Blanchette v. Conn. Gen. Ins.
14 Corps., 419 U.S. 102, 134, 95 S. Ct. 335, 359 (1974).

15 Nor does the Court have any difficulty in construing the
16 lease so that it conforms to the statute and the Constitution.
17 When royalty gas and oil is taken "in value", its valuation poi
18 is at the LACT meter without deductions for costs of producing
19 the product. When royalty is taken "in kind", "cleaning and
20 dehydration" costs are deductible. However, pursuant to Consti
21 tutional mandate, the State may not take royalty "in kind" unle
22 after said deductions, it will be in the best interests of the
23 State to do so, which presumably means that it will be receivin
24 an amount at least as great as it would if the royalty was take
25 "in value". This is the only interpretation which would compor
26 with the Constitutional requirement that the legislature develo
27 the natural resources "for the maximum benefit of its people."
28 This interpretation is now codified in AS 38.05.182.

29 Although the State would have this Court declare any deduc
30 void on the ground that the administration agency acted outside
31 the scope of its authority (Plaintiffs' Reply Memorandum In
32 Support Of State's Motion For Summary Judgment at 42-50), such

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EXHIBIT 1

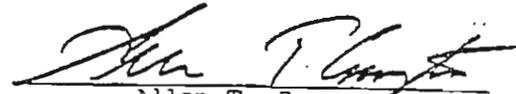
Page 19 of 21

1 holding is not necessary, for as the Plaintiffs also point out
2 "when the State takes royalty in kind it is actually a competitor
3 with the producers..." Plaintiffs' Reply Memorandum In Support
4 Of State's Cross-Motion For Summary Judgment at 8. If royalty
5 "in value" measured at the LACT meter is simply viewed as the
6 minimum 12-1/2 per cent royalty, the State is free to take its
7 royalty "in kind" and market it if it can get a better deal,
8 after the specified deductions are allowed. Its position is
9 different than when it takes royalty "in value"; it has become
10 competitor. If market conditions are such that the State's
11 return on royalty "in value" is greater than if it went out in
12 the market with its "in kind" oil, presumably it will not take
13 royalty "in kind," since that would not be in the State's
14 interests.

15 In summary, AS 38.05.180(a) is not ambiguous. The State
16 entitled to a minimum royalty of 12-1/2 per cent of "productio
17 removed or sold from the lease." Field costs incurred prior t
18 LACT meter measurement are costs not incurred prior to removal
19 sale, and are not generally deductible by lessees. Even if th
20 statute is deemed ambiguous, resort to traditional rules of
21 statutory interpretation leads to the same result. Field cost
22 are costs of production. No administrative interpretation or
23 legislative history suggests the result urged by Defendants.
24 When the State elects to take its royalty "in kind", costs of
25 "cleaning and dehydration" are deductible, the State in essent
26 having become a market place competitor in the sale of a prod
27 Constitutional and statutory limitations preclude the State fr
28 taking royalty "in kind" unless it is in the best interests o
29 the State and for the maximum benefit of its people. Th

1 mean, and can be compatibly construed to mean that the price pa
2 when the royalty is taken "in value" is the minimum or floor
3 below which the agency may not go.

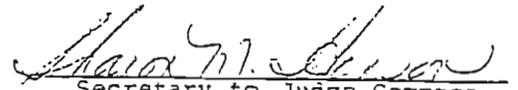
4 DATED at Juneau, Alaska, this 6 day of April, 1979.

5
6 
7 Allen T. Compton
8 Superior Court Judge

9 CERTIFICATION

10 This will certify that on this 9 day of April, 1979, I
11 mailed a true and correct copy of the foregoing Order to:

12 Wilson L. Condon, Esquire
13 Thomas Brewer, Esquire
14 Robert Maynard, Esquire
15 William B. Rozell, Esquire
16 Richard O. Gantz, Esquire

17 
18 Secretary to Judge Compton

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31 EXHIBIT 1

32 Page 21 of 21

