

McCOVEY UNIT AGREEMENT

FINDINGS AND DECISION OF THE COMMISSIONER

STATE OF ALASKA

DEPARTMENT OF NATURAL RESOURCES

August 24, 2000

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## **I. INTRODUCTION AND BACKGROUND**

On May 9, 2000, Phillips Alaska, Inc. (“Phillips”) applied on behalf of itself and Chevron U.S.A. Inc. (Chevron), for approval of the proposed McCovey Unit Agreement (“Agreement”). The proposed McCovey Unit is in the Beaufort Sea, north of the Prudhoe Bay Unit and west of Cross Island. The proposed unit area covers approximately 28,504 acres. Phillips proposed unitizing seven individual oil and gas leases including four State of Alaska leases and three Federal Outer Continental Shelf leases. Phillips submitted the McCovey Unit application for approval by the State of Alaska, Department of Natural Resources (“DNR”) and the U.S. Department of the Interior, Minerals Management Service (“MMS”). Approval of the Agreement would conform and modify the lease contracts.

The state leases in the proposed unit area were offered in State of Alaska Lease Sale 65, held on June 4, 1991. DNR issued oil and gas leases ADL 377055, ADL 377056, ADL 377059, and ADL 377066 effective August 1, 1991. The leases are on State of Alaska lease form number DNR 10-4037 (revised 9/90) which provides for a 16.66667% royalty share to the state. The ten-year primary lease terms expire on July 31, 2001. The Agreement, if approved, will extend the term of the state leases for as long as they are subject to the Agreement. 11 AAC 83.190.

MMS offered the three federal leases in the proposed unit area in Federal OCS Sale Number 124 held on June 4, 1991. MMS issued federal leases OCS-Y-1576, OCS-Y-1577 and OCS-Y-1578 on form number MMS-2005 (revised March 1986) which provides for a 12.5% royalty share to the federal government. The federal leases have an effective date of August 1, 1991 and a ten-year primary term. MMS will review the unit application and issue a separate decision.

Phillips is the proposed unit operator and holds the leases jointly with Chevron. Each company holds 50% working interest in the proposed unit area. Chevron held 100% interest in the state leases until November 1, 1998, when it transferred half of its working interest to Arco Alaska, Inc. Effective April 27, 2000, Arco Alaska, Inc. changed its name to Phillips Alaska, Inc.

## **II. APPLICATION FOR THE FORMATION OF THE McCOVEY UNIT**

A.S. 38.05.180(p), 11 AAC 83.393(b), and the *“Agreement Regarding Unitization for the Outer Continental Shelf Oil and Gas Lease Sale 124 and State Oil and Gas Lease Sale 65 between the United States of America and the State of Alaska,”* dated May 31, 1991, give DNR and MMS the authority to form a joint unit. The Agreement is based on DNR’s Multiple Royalty Owner model unit form dated September 1998 (“Model Form”). DNR, MMS and Phillips proposed various amendments to the Model Form. Changes were made throughout the Agreement to reflect the federal government’s jurisdiction to jointly manage the Agreement with DNR. Phillips, DNR and MMS continued to discuss amendments to the Agreement and Phillips submitted a revised Agreement on August 15, 2000. Phillips provided a detailed list of the proposed changes to the Model Form. Specific changes to the Model Form are discussed in Section IV below.

The proposed Agreement requires the Unit Operator to file unit plans describing the activities within the proposed unit area. The Unit Operator must consider how they can best develop the resource underlying the entire unit area, without regard to internal lease boundaries. Phillips filed a two-year Initial Unit Plan that meets the state's requirement for a Plan of Exploration. 11 AAC 83.341. The Initial Unit Plan includes a commitment to commence drilling the McCovey #1 Well before April 30, 2002. The Initial Unit Plan is discussed further in Section III b) 4.

In addition to the proposed Agreement and the Initial Unit Plan, Phillips also submitted a copy of the Unit Operating Agreement and Exhibits A and B to the Agreement, a Tract Schedule and a map of the proposed McCovey Unit boundary. Phillips also paid the \$5000.00 unit application filing fee in accordance with 11 AAC 05.010 (a)(10)(D).

On May 15, 2000, DNR determined that the McCovey Unit application was complete. DNR published a public notice of the application in the "*Anchorage Daily News*" on Sunday, May 21, 2000, and in the "*Arctic Sounder*" on Thursday, May 25, 2000, pursuant to 11 AAC 83.311. DNR provided copies of the public notice to the North Slope Borough ("NSB"), the City of Barrow, the City of Nuiqsut, Arctic Slope Regional Corporation, Kuukpik Corporation and other interested parties in conformance with 11 AAC 83.311. DNR also provided public notice to the Alaska Department of Environmental Conservation ("ADEC"), Alaska Department of Fish and Game ("ADF&G"), and the Alaska Oil and Gas Conservation Commission ("AOGCC").

The public notice invited interested parties and members of the public to submit comments by June 30, 2000. On June 23, 2000, DNR received comments from James Taalak, Cultural Guardian for the City of Nuiqsut, opposed to approval of the McCovey Unit application. Mr. Taalak is concerned about the effects oil and gas activity will have on the arctic environment and the local residents subsistence lifestyle. The concerns raised by Mr. Taalak are discussed in Section III b) 1 below.

The Agreement defines the relationship between the unit operator, the working interest owners, and the royalty owners. It describes the rights and responsibilities, in addition to those imposed by state and federal law, of the unit operator, working interest owners and royalty owners for development and exploration of the unit area. It protects the interests of the state, the federal government, and the lessees. It defines the parties' rights and responsibilities in the event of successful or unsuccessful exploration results. DNR will approve the Agreement if the available data suggests that the unit area covers one geologic formation that should be developed under a consistent plan and the proposed unit meets the other statutory and regulatory criteria.

### **III. DISCUSSION OF DECISION CRITERIA AND FACTORS CONSIDERED**

The Commissioner of DNR (the Commissioner) reviews unit applications under AS 38.05.180(p) and 11 AAC 83.303 et. seq. By memorandum dated September 30, 1999, the Commissioner approved a revision of Department Order 003 and delegated this authority to the Director of the Division of Oil and Gas ("the Director").

## **a.) Decision Criteria**

The Director will approve the proposed Agreement upon a written finding that it will: 1) promote the conservation of all natural resources; 2) promote the prevention of economic and physical waste; and 3) provide for the protection of all parties of interest, including the state. 11 AAC 83.303(a). The following evaluates the proposed McCovey Unit under these criteria.

### **1. The Conservation of All Natural Resources**

DNR recognizes unitization of the leases overlaying a reservoir as a prudent conservation mechanism. Without unitization, the unregulated development of reservoirs can become a race for possession by competitive operators. The results can be: 1) unnecessarily dense drilling, especially along property lines; 2) rapid dissipation of reservoir pressure; and 3) irregular advance of displaced fluids, all of which contribute to the loss of ultimate recovery or economic waste. The proliferation of surface activity; duplication of production, gathering, and processing facilities; and haste to get oil to the surface also increase the likelihood of environmental damage. Requiring lessees to comply with conservation orders and field rules issued by the AOGCC would mitigate some of these impacts without an agreement to unitize operations. Unitization, however, provides a practical and efficient method for maximizing oil and gas recovery, while minimizing negative impacts on other resources.

The concern of lessees competing for the reservoir is less evident in the proposed McCovey Unit where the lessees have aligned their interests across the unit area. However, the fact that there are two royalty owners also weighs in favor of the formation of a unit. The state leases have a higher royalty rate than the federal leases. The state must ensure that the working interest owners do not favor the federal leases in the development of the reservoir. Formation of the McCovey Unit and approval of the Initial Unit Plan will ensure that Phillips prudently explores and develops the entire reservoir.

The Agreement will promote the conservation of both surface and subsurface resources through unitized (rather than lease-by-lease) development. Unitization allows the unit operator to explore the area as if it were one lease. Without the Agreement the lessee would be compelled to seek permits to drill wells on each individual lease in order to extend the leases beyond their ten-year primary term. Unitization reduces both the number of facilities required to develop reserves that may be discovered and the area of land required to accommodate those facilities. Review and approval of exploration and development permits under a joint federal/state unit agreement will also assure that rational surface-use decisions are made without consideration of individual lease ownership or expense. As a result, facilities can be located to maximize recovery and to minimize environmental impacts, without regard to issues of ownership or operation of individual leases. Although Phillips has not determined the extent of any oil and gas contained in the prospective reservoirs, the Agreement will ensure exploration and maximize recovery from the leases if Phillips discovers a commercial hydrocarbon accumulation.

## **2. The Prevention of Economic and Physical Waste**

Formation of the unit will prevent economic and physical waste because the unit operator must have an equitable cost sharing formula and a coordinated development plan. An equitable cost-sharing agreement promotes efficient development of common surface facilities and operating strategies. An equitable cost-sharing agreement, and an acceptable unit operator, allows the working interest owners in the unit to rationally decide well spacing requirements, injection strategies, and the proper joint-use of surface facilities. Unitization prevents economic and physical waste by eliminating redundant expenditures for a given level of production, and by avoiding loss of ultimate recovery by adopting a unified reservoir management plan.

Unitized operations greatly improve development of reservoirs beneath leases that may have variable productivity. Marginally economic reserves, which otherwise would not be produced on a lease-by-lease basis, often can be produced through unitized operations in combination with more productive leases. Facility consolidation saves capital and promotes better reservoir management for all working interest owners. Pressure maintenance and secondary recovery procedures are much more predictable and attainable through joint, unitized efforts than would otherwise be possible. In combination, these factors allow less profitable areas of a reservoir to be developed and produced in the interest of all parties, including the state.

The overall costs of exploring and developing the McCovey Unit leases would be higher on a lease-by-lease basis than it will be under the terms of unitization. Investments in drilling and facilities costs will be minimized as a consequence of eliminating the requirement for multiple sites within the unit area. Locations of individual wells and surface facilities will be selected to optimize recovery of the resources and to minimize costs with due regard for environmental considerations.

Reducing costs through unitized operations will expedite development of any reserves discovered and will promote greater ultimate recovery of any oil and gas in the unit area. This will accelerate and extend the state's income stream from severance taxes and royalties. The revenues to the lessee may be reinvested in new exploration and development in the state.

## **3. The Protection of All Parties in Interest, Including the State**

The proposed formation of the McCovey Unit seeks to protect the economic interests of the working interest owners as well as the royalty owners. Combining interests and operating under the terms of the Agreement and McCovey Unit Operating Agreement assures each individual working interest owner an equitable allocation of costs and revenues commensurate with the value of its lease(s).

The proposed Agreement promotes the state's economic interests because exploration will likely occur earlier than without unitization. Diligent exploration under a single approved unit plan without the complications of competing operators is certainly in the state's best interest. It promotes efficient evaluation of the state's resources, while minimizing impacts to the region's

cultural, biological, and environmental resources. If Phillips makes a commercial discovery it will stimulate the state's economy from the production-based revenue, oil and gas related jobs, and service industry activity.

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

## **b.) Factors Considered**

State regulations require the commissioner to consider the following six factors in evaluating a unit application: (1) the environmental costs and benefits of unitized exploration or development; (2) the geological and engineering characteristics of the potential hydrocarbon accumulation or reservoir proposed for unitization; (3) prior exploration activities in the proposed unit area; (4) the applicant's plans for exploration or development of the unit area; (5) the economic costs and benefits to the state; and (6) any other relevant factors, including measures to mitigate impacts identified above, the commissioner determines necessary or advisable to protect the public interest. 11 AAC 83.303(b). A discussion of each factor, as it applies to the proposed Agreement, is provided below.

### **1. The Environmental Costs and Benefits of Unitized Exploration or Development**

The state's evaluation of the environmental impacts from oil and gas activity began over fourteen years ago when DNR first considered offering to lease the acreage within the proposed McCovey Unit. DNR develops lease stipulations through the lease sale process to mitigate the potential environmental impacts. Alaska Statutes require DNR to give public notice and issue a written finding before the disposal of the state's oil and gas resources. AS 38.05.035(e), AS 38.05.945, and 11 AAC 82.415. DNR offered the leases in the proposed McCovey Unit in Competitive Lease Sale 65 held on June 4, 1991. DNR first solicited public and agency comments on the sale on August 21, 1986, when we first proposed including the sale in the state's five-year leasing schedule. The state considered the comments received and in the Five-Year Leasing Program published in January 1987, DNR proposed holding Sale 65 in June 1991. On February 4, 1988, DNR issued a public notice requesting general information on the proposed sale area. Environmental groups, the oil and gas industry, state and federal agencies and the public had until June 30, 1988, to provide comments. The DNR Office of History and Archaeology, ADF&G, MMS, and industry submitted general comments in response to the public notice. Additionally, the USFWS provided data on bird use of the barrier islands, and the NSB expressed concern over protection of subsistence whaling.

On January 31, 1990, DNR issued a request for socioeconomic and environmental information regarding the proposed sale.

The Division of Oil and Gas is specifically interested in information concerning fish and wildlife populations and potential effects of the proposed sale on these resources; human uses of fish and wildlife and potential effects of the proposed sale on these users; potential effects of proposed Sale 65 on the economy, lifestyles, and well-being of the region's residents; and new programs and projects planned for or currently occurring in the proposed sale area. Data regarding potential effects of the proposed sale on air and water quality; characteristics of local communities; and the location of archaeological, historical, and recreation sites in the Sale 65 area are also requested, as are recommendations regarding potential mitigating measures.

The notice requested agencies, local governments, and the public to submit information regarding the proposed sale area by May 31, 1990.

The ADEC submitted a 77 page *Environment Analysis of State Oil and Gas Leas Sale 65 Beaufort Sea* with more than thirty recommended mitigation measures. A memo from the ADFG dated May 31, 1990, included the following recommendations:

Issues that should be addressed in this lease sale include bowhead whales and subsistence whaling, polar bears, causeways, waterbird nesting and rearing habitat, and protection of nearshore areas around anadromous fish streams. A related issue is the cumulative impacts of development on human uses of fish and wildlife in the mid-Beaufort region.

DNR also received comments from Trustees for Alaska; the United States Department of Interior, Fish and Wildlife Service ("USFWS"); and the oil industry.

DNR considered all of the comments received as well as various environmental documents and technical reports before issuing the *Preliminary Finding of the Director with ACMP Consistency Analysis Regarding Oil and Gas Lease Sale 65, Beaufort Sea* ("Preliminary Finding") on November 20, 1990. In the Preliminary Finding, DNR proposed offering to lease 489,416 acres of offshore lands in the Beaufort Sea and adjacent uplands for petroleum exploration and development and tentatively scheduled Sale 65 for May 29, 1991. The Preliminary Finding described the Sale 65 area, presented the department's review of the area's resources, and discussed the potential effects of oil and gas development within the sale area. DNR also proposed lease stipulations to mitigate the potential environmental impacts from oil and gas activity. Agencies, members of the public and the industry were invited to submit comments on the Preliminary Finding by December 24, 1990.

State and federal agencies, local governments, local residents, and the petroleum industry provided comments and information on the sale. In addition to agency and public comments, DNR considered other sources of data including the NSB's coastal management plan; the *Final Findings and Social, Economic, and Environmental Analyses* prepared for other North Slope oil and gas lease sales; the U.S. Department of Interior ("USDOl") Final Environmental Impact Statement ("EIS") for Beaufort Sea Sale 97; and the USDOl Final EIS, Beaufort Sea Planning

Area, Oil and Gas Lease Sale 124. DNR also considered technical reports and studies on sea ice dynamics, oil spill risk, offshore drilling and production, pipelines, and fish and wildlife biology.

The state's resource agencies (DNR, ADEC, ADF&G), the NSB and the state Division of Governmental Coordination ("DGC") determined that Sale 65 was consistent with the Alaska Coastal Management Program ("ACMP") and the North Slope Borough Coastal Zone Management Plan ("NSBCMP"). DNR issued a conclusive consistency determination on January 31, 1991.

On February 26, 1991, the director determined that the proposed sale was in the state's best interest and issued the *Final Finding of the Director Regarding Oil and Gas Lease Sale 65, Beaufort Sea*. ("Final Finding") DNR considered all filed comments and included lease stipulations in the Final Finding to address them. Lease stipulations and mitigation measures, developed by DNR during the lease sale process, are attached to and incorporated in the individual lease contracts. These stipulations require Phillips to take mitigation measures to protect the environment. The lease stipulations and mitigation measures address the protection of primary waterfowl areas, access to subsistence resources, site restoration, construction of pipelines, seasonal restrictions on operations, and avoidance of seismic hazards. When the lessees propose to explore the leased area and submit a lease plan of operations, DNR reviews the lease stipulations and may modify them to apply on a site-specific basis.

State regulation 11 AAC 83.303 (b)(1) requires that the Commissioner assess the environmental costs and benefits of the proposed McCovey Unit. Phillips' Initial Unit Plan describes an exploratory well, the McCovey #1 Well, to be drilled from an ice island on Tract 4, federal lease OCS-Y-1578. DNR's approval of an Initial Unit Plan is only one step in the process of obtaining permission to build an ice island and drill a well to explore the unit area. The unit operator must obtain DNR's approval of a unit plan of operations, MMS's approval of an exploration plan, and permits from various state and federal agencies before beginning operations within the unit area.

State unitization regulations require the Commissioner's approval of a unit plan of operations before the unit operator performs any field operations. 11 AAC 83.346. A unit plan of operations provides a more detailed plan for exploration of the unit area than the Initial Unit Plan. DNR's consideration of environmental issues is part of both the lease sale process and the review of a unit plan of operations. All of the state leases proposed for inclusion in the McCovey Unit are from Sale 65 and impose the same mitigation measures. The Agreement does not modify those lease terms. DNR will review the lease stipulations with respect to a proposed unit plan of operations to ensure that they mitigate adverse environmental impacts to the McCovey Unit area. In addition to protection measures adopted for the lease sale, the commissioner may impose additional conditions or limitations beyond those imposed by law. AS 38.05.035(e). If the McCovey Unit is expanded to include newer state leases, the mitigation measures attached to those newer leases may be extended to activities on any state lease in the unit area.

Phillips has just begun the permitting process to commence operations under the Initial Unit Plan and has not yet submitted a unit plan of operations to the state or an exploration plan to MMS for review. Submittal of these documents to the state and federal government will initiate an

intensive public and agency review process. DGC will organize the inter-agency review, determine which permits are required, and publish a public notice soliciting comments from federal, state and local agencies on a proposed plan of operations for the McCovey Unit. The state resource agencies and the NSB will determine if the proposed plan is consistent with the ACMP and NSBCMP. Following a public comment period, DGC will issue copies of the proposed consistency determination to all agencies that submitted comments. DNR may impose additional lease stipulations and/or mitigation measures based on the comments received. Phillips cannot proceed with construction of the ice island and drilling the McCovey #1 Well until DGC is satisfied that all permits and authorizations are in order.

MMS has separate requirements for approval of the federal exploration plan, and may also require an Oil Discharge Prevention and Contingency Plan, Geological and Geophysical Permits, and a Permit to Drill. In addition, the U.S. Environmental Protection Agency may require a Discharge Elimination System permit and an Air Quality permit. Phillips may need the U.S. Coast Guard's approval of a Shipboard Oil Pollution Emergency Plan before they can proceed with exploration of the McCovey Unit area. The U.S. Fish and Wildlife Service and the U.S. National Marine Fisheries Service will review Phillips' plans before issuing an Incidental Harassment Authorization for potential disturbance of polar bear and marine mammals. Phillips will also need a development permit from the NSB, which will likely include additional stipulations to protect the environment and subsistence access.

The Commissioner of DNR and the Regional Supervisor of MMS will consider the agency comments before they approve a state unit plan of operations and a federal unit exploration plan respectively. In addition to the permits and plans discussed above, Phillips may need a drilling permit from AOGCC. When reviewing a proposed unit plan of operations, the Division will also consider the unit operator's ability to compensate the surface owner for damage sustained to the surface estate and the plans for rehabilitation of the unit area. In addition, DNR, DEC, and AOGCC also have bonding requirements to ensure performance by the operator and reclamation of the area. 11 AAC 96.060, 20 AAC 25.025, and 18 AAC 75.235.

Any new construction or exploration activity that may occur following unitization, unless categorically approved in the ACMP ABC (General Concurrence) list, are subject to a coastal zone consistency determination, and must comply with both the state and NSB coastal zone management plans. These amendments and additions to a unit plan of operations require the same public notice and agency review through the DGC as an initial unit plan of operations. DGC will determine the intensity of the review process on a case-by-case basis. Ongoing activities such as development drilling, snow plowing, road grading and material storage at an approved site are not subject to the Coastal Zone Management review process.

The proposed McCovey Unit area is habitat for a variety of fish, waterfowl and marine mammals. Area residents use these waters for subsistence hunting and fishing. Oil and gas activity in the proposed unit area may impact some wildlife habitat and some subsistence activity. Ongoing mitigation measures such as seasonal restrictions on specific activities in certain areas can reduce the impact on bird, fish, and mammal populations. Designating primary waterfowl areas is one method of protecting bird habitat. DNR can require consolidation of facilities to minimize

surface disturbances. The regulation of waste disposal is another way to limit environmental impacts. With these mitigating measures in addition to existing oil and gas laws, the anticipated exploration and development related activity is not likely to significantly impact bird, fish, and mammal populations. The environmental impact will depend on the level of exploration activity, the effectiveness of mitigation measures, the size and location of facilities, and the availability of alternative habitat and subsistence areas. In any case, the anticipated activity under the Agreement will impact habitat and subsistence activity less than if the lessees explored and developed the leases individually.

Unitization in itself has no environmental impact. Unitization does not entail any environmental costs in addition to those that may occur as a result of issuing the permits necessary to conduct lease-by-lease exploration or development. In addition, unitized exploration, development and production minimize surface impacts by consolidating facilities and reducing activity in the field. The commissioner's approval of a unit agreement is an administrative action, which by itself does not convey any authority to conduct any operations on the leases within the unit. Unitization does not waive or reduce the effectiveness of the mitigating measures that condition the lessee's right to conduct operations on these leases. And, since the McCovey Unit is a joint state/federal unit agreement, the lessees must comply with both state and federal environmental laws and regulations.

## **2. Prior Exploration Activities in the McCovey Unit Area**

The proposed McCovey Unit is located in State and Federal waters of the Beaufort Sea approximately 3 miles east of the Northstar field and 7 miles north of the Prudhoe Bay field. The Prudhoe Bay field was discovered in 1968 and began production in 1977. The Northstar field was discovered in 1983 and is scheduled to commence production in November 2001. Three exploratory wells, Sohio Reindeer Island #1, Amoco No Name Island #1 and Gulf Cross Island #1, were drilled in the vicinity of the McCovey Unit area and are pertinent to its understanding. Sohio drilled the Reindeer Island No. 1 well in 1979 as a stratigraphic test on Tract 5 in the proposed McCovey Unit. The well drilled the entire stratigraphic section and achieved total depth in the Franklinian basement at -13,616' subsea. Sohio subsequently plugged and abandoned the well. The Gulf Cross Island #1 and Amoco No Name Island #1 wells are located outside the proposed McCovey Unit area to the east and southeast respectively. Both wells targeted prospective horizons in the Ellesmerian section and achieved total depth in the Franklinian basement. Amoco drilled the No Name Island #1 well in 1981/82 to a total depth of -11,320' subsea. After failing to encounter economic hydrocarbons, Amoco plugged and abandoned the No Name Island #1 well. Gulf drilled the Cross Island #1 well in 1983/84 to a total depth of -14,194' subsea, and plugged and abandoned it as well when it failed to encounter economic hydrocarbons. All three wells provide data on the Brookian section to be encountered in the McCovey Unit area.

### **3. The Geological and Engineering Characteristics of the Reservoir**

The State's regulations necessitate that a unit must encompass the minimum area required to include all or part of one or more oil or gas reservoirs, or potential hydrocarbon accumulations. 11AAC83.356(a). DNR technical staff evaluated all data provided by the proposed unit operator to determine if the proposed unit area met those criteria. The data provided included interpreted seismic and electric log data as well as geologic cross sections, structure and isopach maps and other geologic displays. The data are confidential and therefore are not discussed in detail here.

The state's evaluation of the subsurface geology supports the configuration of the unit area as proposed. The unit operator has demonstrated that a legitimate geologic prospect may occur in the basal Brookian interval at a depth of 13,000 feet or less. DNR's review of the geologic information supports the inclusion of all the leases identified in the unit application within the proposed unit area.

### **4. The Applicant's Plans for Exploration and Development of the Proposed Unit Area**

Phillips proposed a two-year Initial Unit Plan in the application to form the McCovey Unit. The Initial Unit Plan includes three requirements: Phillips must 1) enter into a formal drilling contract for the proposed McCovey #1 Well by April 30, 2001; 2) commence drilling or provide documentation to DNR that the lessees have committed at least \$3 million dollars toward drilling the McCovey #1 Well by July 31, 2001; and 3) commence drilling the McCovey #1 Well by April 30, 2002.

Completion of these exploration activities as scheduled will satisfy the performance standards and diligence requirements that the state and Phillips agreed to as a condition for approval of the Agreement. If Phillips fails to perform any of the activities in the Initial Unit Plan as scheduled, the plan will be in default, the Agreement will terminate, and the working interest owners will surrender the acreage in the unit area which is past its primary term. These provisions ensure that the lease extensions resulting from unitization pursuant to 11 AAC 83.336(a)(2) continue only so long as Phillips proceeds diligently with exploration and development.

Phillips must report annually on its progress under the plan, and submit another unit plan, for further exploration or for development, at least sixty days before the Initial Unit Plan expires. 11 AAC 83.341 - 11 AAC 83.343.

Unitization provides a comprehensive plan for exploration of the unit area. Phillips' Initial Unit Plan allows for earlier exploration and confirmation of the prospect in the McCovey Unit area than would occur under the individual leases.

## **5. The Economic Costs and Benefits to the State and Other Relevant Factors**

Approval of the Agreement will result in both short term and long term economic benefits to the State. The assessment of the hydrocarbon potential of the subject leases will create jobs in the short term. If Phillips makes a commercial discovery, the state will earn royalty and tax revenues in the long term.

The state leases in the proposed unit area will expire on July 31, 2001, if they are not extended by unitization. If the leases expire, the leasehold interest will return to the state. The earliest that DNR could reoffer the land, under the current Five-Year Oil and Gas Lease Sale Schedule, is November 2002. There is no certainty that anyone would bid on the tracts or pursue exploration of this speculative area distant from existing infrastructure. If DNR leased the tracts again in 2002, the state might receive bonus payments and rentals for the primary term of the new leases. However, it could be years before the new lessees would propose exploration of the area and the royalty rates at the next sale may not be as favorable as the current leases. Under the proposed Agreement, the unit operator commits to explore the area within the next two years. This commitment provides the state with the opportunity to receive royalties from the leases sooner than if the acreage was reoffered. If the well does not show commercially producible hydrocarbons, Phillips may not invest in further drilling. If Phillips does not continue to explore the unit area, the unit will terminate and the lease hold interests will return to the state. The potential long-term economic benefit of exploration and earlier development of the McCovey Unit area outweighs the short-term loss of potential bonus payments.

The state receives a 16.66667% royalty share from the state leases and 3.375% (12.5% royalty share x 27%) of the royalty from the federal leases in the unit area. On June 19, 1997, the Supreme Court of the United States delivered opinion No. 84 in the case of United States of America v. State of Alaska. The dispute was over the ownership of submerged lands along Alaska's Arctic Coast. As a result of this opinion, the federal government owns the oil and gas resources under one lease in the unit, Tract 4 OCS-Y-1578. However, the state petitioned the court for a rehearing on the issue. The ownership of Tract 4 was in dispute when Phillips submitted the McCovey Unit application. The Supreme Court of the United States issued a final decree in June 2000, upholding the earlier ruling. Therefore, the ownership of all the submerged lands within the proposed McCovey Unit area is no longer in dispute.

## **IV. AMENDMENTS TO THE MODEL UNIT AGREEMENT FORM**

Phillips, DNR and MMS requested changes in the Model Form during the development of the Agreement. Global changes were made throughout the Agreement to reflect the federal government's jurisdiction to jointly manage the Agreement with DNR. The recital section of the Agreement was amended to cite federal laws and agreements. Article 2.8 was added to define federal authority over Exhibits E and F to the Agreement. Article 8 on unit plans was rewritten to clarify state and federal approvals. Language was added to Article 8.2 at DNR's request to ensure that the mitigation measures in the most recent state lease in the unit would apply to all state leases in the unit area. Articles 8.7 and 9.11, concerning DNR and MMS authority to

modify the rate of exploration, development, and production, were revised to conform to state and federal statutes. Article 10 was amended to provide for retroactive adjustments to the allocation of production. A new Article 11 was added to address federal payment provisions. Several other changes to the Agreement cite the proper authority or party, renumber articles, correct typographical errors, or make minor clarifications to existing language. All of the proposed changes to the model unit agreement are acceptable to the state.

## **V. FINDINGS AND DECISION**

### **a.) The Conservation of All Natural Resources.**

1. The Agreement will conserve all natural resources, including hydrocarbons, gravel, sand, water, wetlands, and other valuable habitat.
2. The unitized development and operation of the leases in this proposed unit will reduce the amount of land and fish and wildlife habitat that would otherwise be disrupted by individual lease development. This reduction in environmental impacts and preservation of subsistence access is in the public interest.
3. If the exploration activities in the Initial Unit Plan result in the discovery of a commercially producible reservoir, then there will be environmental impacts associated with the reservoir development. All unit development must proceed according to an approved plan of development. Before undertaking any specific operations, the unit operator must submit a unit plan of operations to the Division, MMS and other appropriate state and local agencies for review and approval. The lessees may not commence drilling or development operations until all agencies have granted the required permits. DNR may condition its approval of a unit plan of operations and other permits on performance of mitigating measures in addition to those in the leases if necessary or appropriate. Requiring strict adherence to the mitigating measures will minimize adverse environmental impacts.

### **b.) The Prevention of Economic and Physical Waste.**

1. Phillips submitted geological and engineering data to DNR in support of the unit application. Division technical staff determined that the McCovey Unit area encompasses all or part of one or more potential hydrocarbon accumulations. The available geologic and engineering data justify including the proposed lands, described in Exhibit A, in the McCovey Unit.
2. The Initial Unit Plan meets the requirements of 11 AAC 83.303 and 11 AAC 83.341. The unit operator must conduct the proposed exploration activities in accordance with the timelines specified in the plan. The Initial Unit Plan describes the performance standards and diligence requirements to which the state and Phillips have agreed. If

the working interest owners fail to perform any of the exploration activities outlined in the Initial Unit Plan as scheduled, the plan will be in default and the Agreement will terminate.

3. Phillips must submit an annual update to the Initial Unit Plan to DNR for approval. 11 AAC 83.341. The annual update must describe the status of projects undertaken and the work completed, as well as any proposed changes to the plan. Any changes to the Initial Unit Plan, in order to be approved by the state, must comply with Article 8 of the Agreement. Phillips must submit a new exploration or development plan before the initial plan expires.
4. Phillips's Initial Unit Plan provides for the rational exploration of potential hydrocarbon accumulations in the unit area. If Phillips discovers oil or gas in commercial quantities, the Agreement will prevent the waste of oil and gas, and increase the probability of recovering more hydrocarbons from the unit area. DNR and MMS must approve a plan of development before Phillips produces any hydrocarbons in commercial quantities.
5. The Agreement will assure a fair and equitable return to the state from hydrocarbon production from the unit area.
6. The McCovey Unit will expedite exploration and potential development of the unit area. With the formation of the McCovey Unit, economic benefits to the state far outweigh the economic costs of extending the primary term of the state leases committed to the unit.

**c.) The Protection of All Parties in Interest, Including the State.**

1. The Agreement, conditioned upon the performance of its Initial Unit Plan, adequately and equitably protects the public interest, and is in the state's best interest.
2. The Agreement meets the requirements of AS 38.05.180(p) and 11 AAC 83.303.
3. DNR complied with the public notice requirements of 11 AAC 83.311.
4. The Agreement will not diminish access to public and navigable waters beyond those limitations (if any) imposed by law or already contained in the oil and gas leases covered by this Agreement.
5. The Agreement provides for expansions and contractions of the unit area in the future, as warranted by data obtained by exploration. The Agreement thereby protects the public interest, the rights of the parties, and the correlative rights of adjacent landowners.

For the reasons discussed in this Finding and Decision, I hereby approve the McCovey Unit Agreement. Under Article 14.1 of the Agreement, it shall become binding upon each party as of the date each party signs the instrument by which it becomes a party. The Agreement shall become effective as of 12:01 a.m. on the day following approval by the Commissioner and the Regional Supervisor.

A person adversely affected by this decision may appeal this decision, in accordance with 11 AAC 02, to John Shively, Commissioner, Department of Natural Resources, 550 W. 7th Avenue, Suite 1400, Anchorage, Alaska 99501-3561. Any appeal must be received at the above address, or by being faxed to 1-907-269-8918, within 30 calendar days after the date of "delivery" of this decision, as defined in 11 AAC 02.040. A copy of 11 AAC 02 may be obtained from any regional information office of the Department of Natural Resources.

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Kenneth A. Boyd, Director  
Division of Oil and Gas

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Date

cc: Jeff Walker, Regional Supervisor MMS

Attachments: Exhibit A, Tract Schedule  
Exhibit B, Map of the Unit Boundary

**EXHIBIT A**  
**McCOVEY UNIT AGREEMENT**  
**STATE OF ALASKA**  
 May 1, 2000

<b>Tract No.</b>	<b>Lease No.</b>	<b>Legal Description</b>	<b>Acres</b>	<b>Lessee of Record WI Ownership</b>		<b>Royalty Burdens</b>	
1	OCS-Y-1576 (Eff. 08/01/1991)	OPD, NR 6-3, Beechey Pt. Fractional OCS Block 474,	3,382.33	Phillips Chevron	50% 50%	MMS	12.5%
2	ADL-377066 (Eff. 08/01/1991)	Tract 65-066 T14N-R14E, U.M. T14N-R15E, U.M. T13N-R14E, U.M. Fractional OCS Blocks 473 thru 475 inclusive, as to State tide & submerged lands only,	3,832.24	Phillips Chevron	50% 50%	State	16.66667%
3	OCS-Y-1577 (Eff. 08/01/1991)	OPD, NR 6-3, Beechey Pt. Fractional OCS Blocks 475 thru 477 inclusive,	2,846.79	Phillips Chevron	50% 50%	MMS	12.5%
4	OCS-Y-1578 (Eff. 08/01/1991)	OPD, NR 6-3, Beechey Pt. Fractional OCS Blocks 475, 476, 519 & 520,	1,903.66	Phillips Chevron	50% 50%	MMS	12.5%
5	ADL-377056 (Eff. 08/01/1991)	Tract 65-056 T13N-R14E, U.M. T13N-R15E, U.M. T14N-R14E, U.M. T14N-R15E, U.M. OCS OPD NR 6-3, OCS Block 518,	5,693.29	Phillips Chevron	50% 50%	State	16.66667%
6	ADL-377055 (Eff. 08/01/1991)	Tract 65-055 T13N-R15E, U.M. T14N-R15E, U.M. Fractional OCS Block 519, as to State tide & submerged lands only,	5,604.33	Phillips Chevron	50% 50%	State	16.66667%
7	ADL-377059 (Eff. 08/01/1991)	Tract 65-059 T13N-R15E, U.M. T13N-R16E, U.M. T14N-R16E, U.M. Fractional OCS Block 520, as to State tide & submerged lands only,	5,241.36	Phillips Chevron	50% 50%	State	16.66667%

Total Acreage in the Unit Area = 28,504.00

\*More particularly described in Attachments A-1 through A-7