COMMISSIONER'S CONDITIONAL APPROVAL OF A MODIFIED OTTER UNIT AGREEMENT

SUMMARY OF DECISION

This is a decision on Cook Inlet Energy, LLC's ("CIE") appeal of a May 23, 2013 decision by the Director of the Division of Oil and Gas ("Division") denying CIE's application to form the Otter Unit ("Director's Decision").

After reviewing CIE's unit application, the Director's Decision, and CIE's appeal, the Commissioner affirms the Director's Decision denying the proposed Otter Unit. When disapproving a unit agreement, DNR has discretion to propose modifications to the unit agreement that, if acceptable to the applicant, would be approved by DNR. 11 AAC 83.316(b). The Commissioner has decided to exercise this discretion. In addition to affirming the Director's Decision, this decision approves a Modified Otter Unit Agreement.[1] The modifications have three components:

1. A unit agreement that does not include most of the proposed modifications CIE submitted with its January 16, 2013 unit application. As discussed in more detail below, the Commissioner does not find CIE's proposed modifications to be necessary for this unit.

2. A Plan of Exploration ("POE") that complies with the POE regulation. As discussed below, CIE submitted a plan with its January 16, 2013 unit application that it titled "Plan of Exploration," but purported to apply the regulation for a Plan of Development ("POD"). The Director found the plan deficient as a POD. The Commissioner would approve the exploration activities from CIE's plan, as articulated below, as a POE.

3. A performance guaranty of $1.2 million.

CIE will notify the Commissioner in writing, within 30 days of the date this decision is signed, whether it accepts or rejects the Modified Otter Unit Agreement. If CIE accepts, its notice must include a complete, signed Otter Unit Agreement, including an attached POE with the language set forth below and the necessary details included. If the unit agreement comports with this decision and the additional information provided with the POE is acceptable, the Commissioner will provide notice that the Otter Unit is approved.[2] Within 14 days of notice that the unit is

[1] In this decision, the Commissioner uses "Modified Otter Unit Agreement" as shorthand for the unit agreement the Commissioner would approve and that CIE may accept or reject under 11 AAC 83.316(b). As set forth in this decision, if CIE accepts, CIE will need to submit a signed Otter Unit Agreement that comports with this decision. That Otter Unit Agreement would remain subject to the Commissioner's review for compliance with this decision and would not become effective until the Commissioner has completed that review.

[2] DNR is not a party to the unit agreement. DNR approves the unit agreement if unit formation is in the public interest. Since CIE is the only working interest owner in the unit, there will be no agreement until another working interest owner joins the unit. Until that happens, CIE will be bound by the terms of the unit agreement.

approved, CIE will provide a bond in the amount of $1.2 million that is consistent with 11 AAC 82.600.

If CIE does not notify the Commissioner within 30 days that it accepts the modified agreement, or if CIE appeals this decision to superior court, CIE will be deemed to have rejected the Modified Otter Unit Agreement.

The Commissioner notes that if CIE rejects the Modified Otter Unit Agreement, it does have the option to apply for a one-time lease extension for three of the four leases at issue. Effective May 29, 2013, the legislature amended AS 38.05.180(m) to allow DNR to grant one-time lease extensions for leases with primary terms less than ten years. This amendment provides an option for lessees with a shorter term lease who are not yet in a position to apply for a unit to continue diligently exploring. DNR can ensure diligent exploration on an extended lease by requiring a performance bond or minimum work commitment. When a lessee wants to extend a shorter term lease, the appropriate method is by requesting a one-time lease extension; lessees should only apply for a unit if they can meet the requirements for a unit. As discussed below, CIE can meet the requirements for a unit with the Modified Otter Unit Agreement. If CIE rejects the modified agreement, it can still apply for a lease extension on three of the leases. One of CIE's leases — ADL 390579, or Tract 1 — expired before the legislature amended AS 38.05.180(m), and had already been extended by drilling operations, so it is not eligible for a one-time lease extension. CIE would need to resume operations by October 1 on this lease.

BACKGROUND

On January 16, 2013, CIE submitted an application to the Division to form the Otter Unit. The Division notified CIE by email, dated February 15, 2013, that the Application was complete. The Application included: the unit operating agreement; confidential geologic, geophysical, and engineering data; Exhibit A which was a description of the proposed unit area, its leases, and ownership interests; Exhibit B which was a map of the proposed unit; Exhibit G which was an initial unit Plan of Exploration; and the state model unit agreement with proposed modifications.

The proposed Otter Unit comprises portions of four state oil and gas leases. ADL 390579 was issued July 1, 2005 with a seven-year primary but was extended by drilling operations. ADL 390749 was issued October 1, 2006, also with a seven-year primary term, expiring September 30, 2013. CIE acquired both ADL 390579 and ADL 390749 from Pacific Energy Resource Ltd. CIE acquired ADL 391621 and ADL 391624 in the 2010 Cook Inlet lease sale. Both expire in 2018. The total area of the four leases encompasses 13,324 acres; the proposed unit is comprised of 5,855 acres. A map and details of the leases were included in Attachments 1 and 2 of the Director's Decision.

CIE owned or licensed 2-D seismic surveys and spud the Otter No. 1 on lease ADL 390579 on May 18, 2012. On June 14, 2012, the Division issued a lease extension by drilling pursuant to paragraph 4(c) of the lease agreement, AS 38.05.180(m), and 11 AAC 83.125 to extend ADL 390579 beyond its primary term. On July 17, 2012, the well reached a total depth of 5,685 feet which was roughly 1,400 feet short of the planned bottom-hole depth of 7,100 feet. CIE cited problems with the rig's mud pumps for drilling short of the intended bottom-hole location.

Throughout the fall of 2012, CIE attempted several operations to initiate gas production from the Otter No. 1 well. CIE continued to clean and test the well until freezing problems with the well required CIE to suspend drilling operations on the well.

CIE submitted the Otter Unit Application on January 16, 2013 and plugged the Otter No. 1 well the next day, on January 17, 2013. On February 15, 2013, CIE requested a suspension of operations for ADL 390579, which the Division granted on March 8, 2013. The suspension of operations was effective until March 31, 2013. Under Paragraph 4(e) of the lease, CIE has until October 1, 2013 — six months from the date the suspension was lifted — to restart operations on the lease or the lease will expire. As of the date of this appeal, CIE has not restarted operations on the Otter No. 1 well.

Following public notice and opportunity to comment, the Director issued a decision on May 23, 2013 denying the proposed Otter Unit. CIE timely appealed the Director's Decision on June 13, 2013. In its appeal, CIE included a request for a hearing. Later, though counsel, CIE withdrew its hearing request.

DECISION CRITERIA

DNR may grant a unit if it is necessary or advisable in the public interest to conserve oil and gas resources. AS 38.05.180(p). Conservation of the natural resources of all or part of an oil or gas pool, field, or like area means "maximizing the efficient recovery of oil and gas and minimizing the adverse impacts on the surface and other resources." 11 AAC 83.395(1).

DNR will approve a proposed unit if it finds that it is necessary and advisable in the public interest and unitization will: (1) promote conservation of all natural resources, including all or part of an oil or gas pool, field, or like area; (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). In evaluating the 11 AAC 83.303(a) criteria, the Commissioner will consider: (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).

Below, the Commissioner both addresses the Director's Decision and CIE's appeal points as they relate to each of the 11 AAC 83.303 criteria, and considers the criteria for purposes of approving a Modified Otter Unit Agreement.

The Commissioner notes that he is proposing the Modified Otter Unit Agreement purely as a matter of discretion. CIE argues that the "proper" response to disapproving a unit agreement is to propose a modified unit agreement for the applicant's consideration. (Appeal at 13-14.) This argument is contrary to the plain language of the regulation. When disapproving a unit agreement, the Commissioner (or Director, by delegation, in the first instance) "will, in his

discretion, propose modifications which, if accepted by the parties to the proposed unit agreement, would qualify the agreement for approval." 11 AAC 83.316(b). This language unquestionably gives the Commissioner discretion to either deny a unit or deny a unit with proposed modifications for the applicant's consideration. Under no reasonable interpretation of this regulation is the Commissioner obligated to propose modifications. Nor would any past decision proposing modifications bind the Commissioner to propose modifications here. Each unit decision is unique. Past decisions do not create rules that bind future decision-makers. The Commissioner has elected to exercise his discretion here to propose modifications for CIE's acceptance or rejection. But the Commissioner in no way is exercising this discretion as a sense of propriety or obligation, as CIE contends he must.

A. 11 AAC 83.303(b) Decision Considerations

1. 303(b)(1) - Environmental Costs and Benefits

The Director noted that the environmental benefit of unitization stems from the joint development by multiple lessees that unitization facilitates. Since CIE is the sole lessee for all of the leases in the proposed unit, CIE could jointly develop the land without unitization. The Director also noted that CIE's application did not include information that demonstrates that the environmental impact would be different if CIE developed the leases as a unit, than if CIE developed them on a lease-by-lease basis. The Director did not deny the unit based on environmental costs or benefits.

CIE argues that unitization will "lessen[] environmental impacts" because "CIE is positioned to explore and develop the Otter prospect faster than anyone else." (Appeal at 14.)

The Director is correct that unitization may provide an environmental benefit by enabling joint development by multiple lessees, and that bringing different lessees together may reduce redundant development. This advantage of bringing together multiple lessees does not exist here since CIE owns all the leases and has the ability to jointly develop the leases whether or not they are unitized. The Director is also correct that CIE's application does not include plans to explore or develop the land that it could not also do on a lease-by-lease basis. Since there is no reason to conclude that the environmental costs or benefits would be different if CIE developed these leases as a unit or on a lease-by-lease basis, the environmental costs and benefits are essentially a neutral factor in this decision. That is not to say that environmental issues are not imminently important. Minimization of environmental impacts is addressed in the lease mitigation measures and unit agreement, and will be an important consideration in future approvals, such as approval of a Plan of Operations.

CIE addresses a separate issue — the prospect of leases terminating and someone else developing the land. Unitization does extend a lease. AS 38.05.180(m). But a lessee's desire to extend a lease is not one of the enumerated criteria for DNR to consider when approving a unit. CIE's argument also fails factually. CIE does not explain how the speed of development affects the degree of environmental impact. Also, the facts here do not support the assumption that without a unit, someone other than CIE will develop this land. CIE states in its appeal that "[i]f the Otter Unit is approved 4,000 acres would expire immediately or on September 30, 2013 and

would be available in the Cook Inlet Areawide lease sale in May 2014." (Appeal at 4.) Presumably CIE meant to say leases would expire if the unit is *not* approved. In any case, it is not true that 4,000 acres would immediately expire. Two of the four leases do not expire until 2018, and a third expires on September 30, 2013. CIE could apply for one-time lease extensions under recent amendments to AS 38.05.18(m) for these three leases. The remaining lease — ADL 390579 (Tract 1) — is the lease on which DNR suspended operations until March 31, 2013. CIE has until October 1, 2013 to restart operations on the Otter No. 1 well. If CIE is drilling, the lease will remain in force.

Unitization — including the POE discussed below — does give CIE the option of choosing to drill a well in Tract 2 rather than resuming operations on the Otter No. 1 well in Tract 1. In this respect, unitization provides some different options than lease-by-lease development. But the Commissioner does not have information from which to conclude that the environmental costs or benefits would be different between unitized or lease-by-lease development by CIE.

2. 303(b)(2) - Geological and Engineering Characteristics

Based on the confidential geologic, geophysical, and engineering data CIE submitted with its application, the Director found that CIE had demonstrated a potential hydrocarbon accumulation, but did not provide evidence of a reservoir. CIE does not dispute these findings on appeal.

Instead, CIE argues that the Director improperly denied the unit because of the lack of a reservoir. This argument misrepresents the Director's findings. Nowhere in the Director's Decision does it state or even imply that the unit was denied for lack of a reservoir. The Director found a potential hydrocarbon accumulation. As CIE points out, one of the factors DNR considers is "the geological and engineering characteristics of the potential hydrocarbon accumulation or reservoir proposed for unitization." 11 AAC 83.303(b)(2). The Director's finding of a potential hydrocarbon accumulation is consistent with this regulation. CIE demonstrated nothing in this finding, or in any aspect of the Director's consideration of geological and engineering characteristics, that is contrary to law or factually incorrect.

CIE also argues that DNR "will reject a unit application only when the applicant has failed to show that the unit area is underlain by a reservoir or potential hydrocarbon accumulation." (Appeal at 7.) This argument is contrary to the plan language of 11 AAC 83.303, which sets forth many factors that DNR considers for a unit application. The characteristics of a reservoir or potential hydrocarbon accumulation is only one factor.

For the Modified Otter Unit Agreement, the modifications do not change the geological or engineering characteristics of the potential unit. The Commissioner considered these characteristics and the Director's finding and agrees with the Director's conclusions that there is a potential hydrocarbon accumulation, but currently no evidence of a reservoir.

3. 303(b)(3) – Prior Exploration Activities

As the Director described in his decision, CIE owns or has licensed approximately 45 miles of 2-D seismic compromised of seven dip and strike lines used in defining the Otter structure. Two wells have been drilled in the proposed unit area: Otter No. 1 and Pretty Creek State No. 1. CIE

spudded the Otter No. 1 well on May 19, 2012, at a location 2,081 feet FNL and 1,805 feet FEL of Sec. 12, T. 14 N, R. 10 W, SM Alaska. The Pretty Creek State No. 1 is located approximately 0.9 miles to the northwest in Sec. 2 of T. 14 N, R. 10 W. It was spud on December 16, 1974, and reached a total measured depth of 6,570 feet in the Tyonek Formation. The interval from 6,009 to 6,014 feet was perforated but upon testing failed to produce measurable quantities of gas. The Pretty Creek State No. 1 well penetrated the hanging wall of the "Otter" reverse fault, encountering different facies in the Sterling, Beluga, and Tyonek formations from the Otter No. 1 well.

The Commissioner notes the investments CIE has made to explore in this area. CIE states that it has spent more than $10 million on these leases and anticipates spending an additional $2 million to re-enter the Otter No. 1 well. The Commissioner also appreciates that CIE has been investing in other units — according to CIE, more than $13.3 million on the West McArthur River Unit and $41.5 million on the Redoubt Unit.

4. 303(b)(4) - Applicant's Plans for Exploration of the Proposed Otter Unit

A unit application must include either a POE or POD. 11 AAC 83.341(a). The plan accompanying a unit application must be a POD if the applicants are also proposing a Participating Area with the proposed unit or if the applicants have sufficiently delineated a reservoir such that a prudent operator would initiate development. 11 AAC 83.343(a). CIE has neither proposed a Participating Area nor delineated a reservoir, nor does CIE contend that it has. Nonetheless, CIE submitted a plan titled "Plan of Exploration" but cited and applied the provisions of the POD regulation, 11 AAC 83.343.

Despite the confusing title of CIE's plan, the Director's Decision shows that the Director considered the plan as a POD. The Director observed that CIE's plan had really only proposed exploration activities and that these work commitments were inadequate to develop the resources or demonstrate that a unit would lead to development. The Director ultimately found that CIE had not provided "plans for development of state resources" or committed to develop a proven reservoir — factors required for a POD.

CIE's appeal does not present facts or arguments that contradict the Director's findings. Instead, CIE presents a straw man argument by repeatedly mischaracterizing and misrepresenting the Director's findings. In particular, CIE argues the Director found "that exploration units are not permissible," that "unitization is incompatible with exploration," and that "a unit can only contain a reservoir or be formed solely for production activities." (Appeal at 8-9.) The Commissioner has carefully reviewed the Director's Decision and these alleged findings are nowhere stated or implied in that decision. By citing and applying 11 AAC 83.343 in its plan, CIE was purporting to submit a POD. The Director found the plan deficient as a POD. The Commissioner agrees. CIE's statements that it will apply for a Participating Area if it is going to develop is not a commitment to develop, it is a recitation of CIE's regulatory requirement to apply for a Participating Area prior to production.

Because the Director did not find that a unit cannot be granted unless the applicants have submitted an acceptable POD, as CIE incorrectly contends, CIE's argument that making such a finding violated the Administrative Procedures Act ("APA") is inapposite. The case CIE relies on, *Jerrel v. State, Department of Natural Resources*, 999 P.2d 138 (Alaska 2000), is not applicable here. As the Supreme Court explained in a later decision, the *Jerrel* holding that agency rulemaking must be done through the APA is limited to "a new substantive requirement" that makes a "regulation more specific." *Alaska Center for the Environment v. State*, 80 P. 3d 231, 244 n.40 (Alaska 2003). An interpretation of an existing regulation, on the other hand, does not require APA compliance. *Id.*; *see also Friends of Willow Lake, Inc. v. State, Dep't of Transp. & Pub. Facilities*, 280 P.3d 542, 549 (Alaska 2012) ("'[A] common sense interpretation of [a] regulation's applicability' is not a regulation, so long as it does not provide 'new requirements nor [make] the existing ones any more specific.'"). The Commissioner has reviewed the Director's Decision and finds no new substantive requirement that makes a regulation more specific. At most the Director was interpreting existing regulations, as the Commissioner is doing here in this decision. The Director did not find that an acceptable POD is a prerequisite to unit formation; another type of plan might suffice.

Although the plan CIE submitted is insufficient as a POD, the Commissioner would approve a Modified Otter Unit Agreement that includes a POE with the exploration commitments CIE included in its plan, as set forth below. A POE "must describe the applicant's proposed exploration activities, including the bottom-hole locations and depths of proposed wells, and the estimated date drilling will commence." 11 AAC 83.341(a). CIE's plan included exploration activities, but lacked the necessary bottom-hole locations, depths of proposed wells, and estimated date to start drilling. CIE will need to provide this information for DNR to approve a POE.

If CIE accepts the Modified Otter Unit Agreement, CIE must submit a signed unit agreement within 30 days of the date this decision is signed, and include with the unit agreement an Exhibit G that consists of the following language, with the missing information filled in:

Initial Plan of Exploration

The Initial Plan of Exploration ("POE") shall cover the period until March 31, 2015.

CIE commits to the following exploration activities:

1. CIE will complete one of the following two options:
    a. Reenter and deepen the Otter No. 1 Well to a depth of ___ feet in the Beluga formation, with a bottom-hole at **[location]**, using a coiled-tubing unit or conventional rig. CIE will begin drilling on or around **[date]** and will complete drilling by March 31, 2014.
    b. Drill an exploratory gas well to a depth of ___ feet in the Beluga formation, with a bottom-hole at **[location]**. CIE will begin drilling on or around **[date]** and will complete drilling by March 31, 2015.

As CIE proposed in the POE it submitted with its January 16, 2013 unit application, CIE will voluntarily terminate the unit and surrender all expired leases that do not immediately qualify for an automatic extension under AS 38.05.180(m) if CIE fails to satisfy at least one of the above options by March 31, 2015.

2. CIE will drill a delineation gas well to a depth of ___ feet in the Beluga formation, in either Tract 1 with bottom-hole at **[location]** or Tract 2 with a bottom-hole at **[location]**. CIE will begin drilling on or around **[date]** and will complete drilling by March 31, 2016.

   As CIE proposed in the POE it submitted with its January 16, 2013 unit application, CIE will voluntarily terminate the unit and surrender all expired leases that do not immediately qualify for an automatic extension under AS 38.05.180(m) if CIE fails to drill this well by March 31, 2016.

Nothing in this POE affects or alters DNR's discretion or authority under applicable statutes, regulations, or contracts.

5. 303(b)(5) - The Economic Costs and Benefits to the State

As the Director noted, DNR has an obligation to protect the public's interest in maximizing economic and physical recovery from the state's oil and gas resources. AS 38.05.180(a)(1)(A). Maximizing economic recovery of hydrocarbons ensures royalty revenues and increased employment opportunities over the long-term. DNR is also obligated to maximize competition among parties in oil and gas development. AS 38.05.180(a)(1)(B).

The Director observed that potential hydrocarbon accumulation here could result in increased economic benefits for the State, but only if developed, and CIE did not provide firm work commitments for development. The Director also stated that unitization would extend the lease terms, preventing others from leasing this land. Without firm development work commitments from CIE, extending lease terms goes against the public's interest in maximizing competition.

CIE contends that "CIE's successful and continued development at the proposed Otter Unit will increase competition," but does not explain how or why. (Appeal at 2).

The Commissioner agrees with the Director that the State's economic benefit of unitization comes from development when the State will recover royalties. Since CIE is the sole lessee of these leases, and since CIE has options for extending the lease terms through drilling or applying for one-time lease extensions, it is not clear that unitization will necessarily affect the probability of development. And since CIE is only beginning to explore these leases and has not provided evidence of a reservoir, it is not definite that these leases would ultimately be developed. Because development is so uncertain, and because CIE has options to develop these leases without a unit, the prospect of economic benefit to the State from unitized development is not a strong factor in this decision.

Granting the Modified Otter Unit Agreement could pose economic costs to the State in that it extends the lease terms based on a POE, not a POD. A unit application is not required to include a POD. 11 AAC 83.341(a). But a unit formed without a known reservoir or definite development work commitments could result in the leases being extended for a longer time without development than if the lessee needed to be drilling or developing to extend the lease terms. Any delay in development is a potential economic cost to the State.

6. 303(b)(6) - Other Relevant Factors

The Commissioner has discretion to consider "any other relevant factors, including measures to mitigate impacts identified above, [that] the commissioner determines necessary or advisable to protect the public interest." 11 AAC 83.303(b)(6).

a. Performance Guaranty

As discussed above, a unit agreement with a POE and no firm development work commitments is less certain to result in development than a unit agreement with a POD and firm development work commitments. A unit agreement with a POE and no firm development work commitments could also result in the leases being extended for a longer time without development than if a lessee was extending the leases by drilling or development under AS 38.05.180(m). The resulting uncertainty of development and potential for delay is a potential economic cost to the State through lost or deferred royalties.

To mitigate this risk and protect the public interest in developing oil and gas resources to maximize economic and physical recovery, competition, and use of Alaska's human resources, the Commissioner has determined that it is necessary to require a performance guaranty from CIE. If CIE accepts the Modified Otter Unit Agreement, CIE will submit a bond in the amount of $1.2 million.[3] The bond must comply with 11 AAC 82.600, and will be payable to DNR in the event of default of the unit agreement, including the POE.

b. Mitigation Measures

Each of the leases in the proposed Otter Unit are subject to mitigation measures that minimize adverse impacts from exploration and development activities. These measures include provisions to minimize harm from pollution and hazardous substances, waste, noise, oil spills, restrictions on facilities in wetland and sensitive habitat areas and requirements for locating facilities away from rivers and streams, and provisions to minimize the number and extent of improvements, including roads and facilities. DNR also has discretion to impose additional measures as conditions change and as DNR obtains more specific information about proposed surface impacts by requiring amendments to a Plan of Operations. 11 AAC 83.346(e).

[3] This amount is lower than the estimated loss to the State if CIE accepts the modified unit agreement but fails to follow through on the work commitments, based on delay in bonus bids and return of the lease properties to the state.

The mitigation measures and DNR's ongoing review of their sufficiency and discretion to impose additional measures help mitigate the potential environmental impacts and promote conservation of the natural resources.

B. 11 AAC 83.303(a) Decision Criteria

Considering each of the factors discussed above, the Commissioner will approve a unit if he finds that it is necessary or advisable to protect the public interest and that the unit agreement (1) promotes conservation of all natural resources; (2) prevents economic and physical waste; and (3) provides for the protection of all parties in interest, including the State.

1. 303(a)(1) – Promote the Conservation of All Natural Resources

As the Director noted, Alaska statute authorizes DNR to approve an agreement among multiple lessees that hold separate leases overlying a common reservoir to jointly develop the leases for the purpose of conserving the natural resources of all or a part of an oil or gas pool, field, or like area. AS 38.05.180(p). In this context, "conservation" means "maximizing the efficient recovery of oil and gas and minimizing the adverse impacts on the surface and other resources." 11 AAC 83.395(9).

The Director found that CIE's unit application did not demonstrate that unitization would promote conservation because, as the sole lessee, CIE could develop the leases jointly, including drilling to obtain lease extensions, without unitization. The Director also noted that CIE's application, by including only exploratory work commitments, did not include a plan for maximizing efficient recovery.

CIE contends that unitization will conserve natural resources because CIE will explore and develop "faster than anyone else," because CIE has "up-to-date data, a drill rig in the area, and commercial alignment," because the area is close to the Beluga pipeline, and because CIE has secured a gas pipeline right of way lease. (Appeal at 14).

CIE's arguments pertain to its willingness and ability to explore the leases. The Commissioner values CIE's interest and ability to explore the land, but these factors do not address whether unitization, as opposed to lease-by-lease development, promotes the conservation of natural resources. CIE mischaracterizes the Director's discussion of lease-by-lease development as a "preference" for lease-by-lease development. (Appeal at 12). Merely pointing out the differences or lack thereof as the Director has done, neither states nor implies a preference for lease-by-lease development.

The Commissioner agrees with the Director that unitization is generally not necessary to facilitate joint development when all leases are owned by the same lessee. The Commissioner also agrees that CIE's application does not provide firm development work commitments that would demonstrate a minimization of impacts from development or promotion of natural resources. The POE set forth above does give CIE an option for drilling in Tract 2 before Tract 1, whereas without a unit CIE would need to resume operations in Tract 1 by October 1, 2013 to avoid lease termination. If CIE pursued this option and a well in Tract 2 is successful — and if

Otter No. 1 well in Tract 1 proves unsuccessful — it is conceivable that being able to drill in Tract 2 first could result in fewer wells being drilled.

Unitization would not decrease the opportunities for efficient recovery or increase the potential adverse impacts from development as opposed to lease-by-lease development. The lease mitigation measures will remain in force if the leases are unitized, and will remain subject to review and modification by DNR with Plans of Operations, under 11 AAC 83.346(e).

The differences between unitized and lease-by-lease development here are minimal, but there is enough of a possibility of conserving natural resources through unitization, and no increased risk to natural resources, that the Commissioner finds that the Modified Otter Unit Agreement will promote conservation of all natural resources.

2. 303(a)(2) - Prevention of Economic and Physical Waste

As the Director noted, unitization may prevent economic and physical waste by preventing the drilling of wells in excess of the number necessary for efficient recovery, preventing drilling in a manner that results in improper use of or unnecessary dissipation of reservoir energy, and reducing redundant expenditures. The Director found that CIE's application did not explain how CIE would develop the leases differently as a unit or on a lease-by-lease basis and thus CIE had not shown that unitization would prevent economic and physical waste.

CIE argues that without unitization it will "drill to hold acreage instead of prudently and responsibly exploring and developing" and this will result in "wasteful expenditures." (Appeal at 12). At the same time, CIE threatens to not drill at all unless DNR grants a unit. (Appeal at 1).

The work commitments CIE included in its application, and that the Commissioner has set forth in the POE above, bare little difference to the exploration CIE could do without unitization. But as discussed above, there is an option for CIE to drill in Tract 2 before Tract 1 under the POE, whereas CIE would need to resume operations in Tract 1 by October 1, 2013 without unitization. This difference, though small and dependent on CIE electing the option to drill first in Tract 2, has the potential to prevent economic and physical waste. Accordingly, the Commissioner finds that the Modified Otter Unit Agreement has some potential to prevent economic and physical waste.

3. 303(a)(3) - Protection of All Parties of Interest, Including the State

As the Director noted, the people of Alaska have an interest in the development of the State's oil and gas resources to maximize economic and physical recovery, competition, and use of Alaska's human resources. AS 38.05.180(a)(1). The State's best interest is in assessing its oil and gas resources while minimizing adverse impacts from exploration and development. AS 38.05.180(a)(2). Unit formation can protect the economic interests of the Working Interest Owners and the State by promoting development through firm commitments leading to increased production.

The Director found that unitization did not protect the State's interest because it would extend the lease terms without firm development work commitments by CIE, and because CIE could extend the expiring Tract 1 by resuming operations.

The Commissioner agrees that the development plan CIE submitted with its application did not include firm development work commitments to protect the State's interests. As a POE and in the form set forth above, the proposed work commitments can protect the State's interests in assessing its oil and gas resources. The Modified Otter Unit Agreement also includes a performance guaranty requirement of $1.2 million, which mitigates the State's risk of economic cost by approving the unit.

The Modified Otter Unit Agreement also protects CIE's interests in continuing to explore the land, regardless of the need to take actions that would automatically extend leases under AS 38.05.180(m). CIE thus has the flexibility to explore in the places and in the order that is appropriate for the resource over the five-year term of the unit.

The five-year terms of units provides predictability that may assist CIE in attracting the investors it reportedly needs to fund its activities. CIE's ability to secure necessary capital is important to both CIE and the State in their common goal of progressing efficiently towards production. The five-year term also protects the State by ensuring that CIE diligently work towards production or risk the unit expiring.

Accordingly, the Commissioner finds that the Modified Otter Unit Agreement protects the parties of interest, including the State.

C. CIE's Proposed Modifications to the Model Unit Agreement

CIE submitted several proposed modifications to the model unit agreement. DNR may approve a modification to its standard unit agreement only if "the modification is reasonably required to meet the needs and requirements of the particular unit considering the facts and conditions found to exist with respect to that unit, and the proposed modification meets the provisions of 11 AAC 83.303." 11 AAC 83.326(b). The Director found that CIE's proposed modifications are inconsistent with CIE's obligations and DNR's management authority. CIE mentions this finding in its appeal, but offers no argument to dispute it.

The Commissioner has reviewed each of CIE's proposed modifications and evaluated whether it is reasonably necessary for this unit and meets the provisions 11 AAC 83.303. The Commissioner finds that the following proposed modifications are not necessary for the unit:

- CIE proposes deleting Paragraphs 1.5, which sets forth the definition of "Exploration Block, and Paragraph 13.2, which allow Plans of Exploration or Development to be divided into Exploration Blocks. CIE's explanation for these proposed modifications is that "all acreage being included in unit are on the same structure" and "CIE is proposing no Exploratory Blocks and other language does not conform to 11 AAC 83.140 and Leases." Whether or not the current POE is divided into Exploration Blocks does not affect whether future POEs or PODs could be divided into Exploration Blocks under the

unit agreement. Thus CIE's current POE does not necessitate this modification. Language in Paragraph 13.2 regarding voluntary removal of acreage from a unit and subsequent surrender is not contrary to 11 AAC 83.140, which addresses elimination of acreage by order of DNR. Paragraph 13.2 is not inconsistent with lease language regarding voluntary surrender of all or part of a lease. Accordingly, this proposed modification is not necessary for this unit.

- CIE proposes adding language to Paragraph 3.2 regarding severance of a lease with a well capable of production and portions of leases committed to a Participating Area, and states that the agreement "does not conform with 11 AAC 83.373(e)" without this modification. 11 AAC 83.373(e) addresses leases that contain a certified well prior to inclusion in a unit, but not portions of leases committed to Participating Areas. Regardless, what CIE is proposing to add to the agreement is a recitation of regulatory requirements. A unit agreement does not need to repeat every applicable regulation for those regulations to be binding on a lessee or unit operator, and not repeating a certain regulation does not make a unit agreement "inconsistent" with that regulation. Accordingly, this proposed modification is not necessary for this unit.

- CIE proposes deleting Paragraph 4.3, which states that the operator will minimize and consolidate facilities to minimize surface impact and provide bonds as approved by the Commissioner. CIE states that this language "conflicts with the Mitigation Measures in the Leases and 11 AAC 83.346(e)." 11 AAC 83.346(e) specifies that DNR will impose amendments to proposed Plans of Operations that are necessary to protect the State's interest. The Paragraph 4.3 language does not relate to Plans of Operations or DNR's authority to impose amendments. Thus the proposed modification is not necessary to be consistent with this regulation. A review of the applicable mitigation measures — which include more specific requirement to minimize surface impact from facilities — reveals no inconsistency with Paragraph 4.3 either. Accordingly, this proposed modification is not necessary for this unit.

- CIE proposes deleting language in Paragraph 8.2 that states that Plans of Operations must be consistent with mitigation measures and lessee advisories for the most recent lease sale, as deemed necessary by the Commissioner. CIE contends that this language "is not consistent with 11 AAC 83.346(e)." But 11 AAC 83.346(e) gives DNR authority to require amendments to a Plan of Operations that are necessary to protect the public interest. DNR can, and regularly does, require amendments to incorporate the most recent mitigation measures with a Plan of Operations under 11 AAC 83.346(e). The Paragraph 8.2 language merely reiterates this authority. The language is not inconsistent with the regulation and thus this proposed modification is not necessary for this unit.

- In Paragraph 12.6, CIE proposes changing the time to give notice of production from "at least six months" before anticipated commencement of production to "at least 90 days," and states that this change is "[t]o be consistent with Article 9.1." Paragraphs 12.6 and 9.1 address different requirements. Paragraph 9.1, consistent with 11 AAC 83.351, requires a Participating Area application at least 90 days before sustained production. Paragraph 12.6 requires notice of production six months before the anticipated date for

commencement of production. So at least six months before an operator anticipates production, the operator needs to notify DNR, and at least 90 days before actual sustained production, the operator needs to apply for a Participating Area. These are two separate obligations, and it is not necessary for this unit for the two time periods to be the same. Accordingly, the proposed modification is not necessary for this unit.

- CIE proposes adding a Paragraph 20.4 that includes statements about default when there is a well capable of producing in paying quantities "to conform with 11 AAC 83.374(d) and the Leases." What CIE is proposing is to recite the provision in 11 AAC 83.374(d). As stated above, it is not necessary for every regulation to be repeated in a unit agreement, nor does a unit agreement fail to conform to a regulation by not repeating it in the body of a unit agreement. The same is true of lease provisions. This proposed modification is not necessary for this unit.

If CIE accepts the Modified Otter Unit Agreement described in this decision, CIE will submit a signed version of the model unit agreement that does not include its proposed modifications, as described above.

FINDINGS AND DECISION

A. Findings

1. The Director's primary reason for denying CIE's Otter Unit application was because CIE's POD did not provide the firm development commitments necessary for an acceptable POD. The Commissioner agrees and affirms the Director's findings.

2. CIE's proposed modifications to, or deletion or addition of, Paragraphs 1.5, 3.2, 4.3, 8.2, 12.6, 13.2, and 20.4 of the model unit agreement are not necessary for this unit. If CIE accepts the Modified Otter Unit Agreement, it will submit a signed Otter Unit Agreement that does not include these proposed modifications.

3. The Commissioner would approve a Modified Otter Unit Agreement with the following modifications:

    a. The POE set forth above, assuming CIE provides the missing bottom-hole, depth, and start date information and that the additional information is acceptable to the Commissioner;

    b. An Otter Unit Agreement that does not include CIE's proposed modifications to, or deletion or addition of, Paragraphs 1.5, 3.2, 4.3, 8.2, 12.6, 13.2, and 20.4 of the model unit agreement; and

    c. A performance guaranty of $1.2 million that complies with 11 AAC 82.600 and is payable to DNR upon default of the unit agreement, including the POE.

4. Considering the potential environmental costs and benefits, the geological and engineering characteristics, prior exploration activities, the POE, potential economic costs and benefits to the State, the performance guaranty, and the mitigation measures, the Modified Otter Unit Agreement can promote conservation of all natural resources.

5. Considering the potential environmental costs and benefits, the geological and engineering characteristics, prior exploration activities, the POE, potential economic costs and benefits to the State, the performance guaranty, and the mitigation measures, the Modified Otter Unit Agreement can prevent economic and physical waste.

6. Considering the potential environmental costs and benefits, the geological and engineering characteristics, prior exploration activities, the POE, potential economic costs and benefits to the State, the performance guaranty, and the mitigation measures, the Modified Otter Unit Agreement protects the parties of interest, including the State.

B. Decision

The Director's denial of CIE's Otter Unit application is affirmed. The Commissioner would, however, approve the Modified Otter Unit Agreement as described in this decision. CIE will notify the Commissioner in writing within 30 days of the date this decision is signed whether it accepts or rejects the Modified Otter Unit Agreement. If CIE accepts, its notice must include a complete, signed Otter Unit Agreement, excluding CIE's proposed modifications to the model unit agreement and including the POE set forth above with the bottom-hole locations, depths, and start dates filled in. If the Otter Unit Agreement comports with this decision and the additional information for the POE is acceptable to the Commissioner, the Commissioner will notify CIE that the Otter Agreement is approved. Within 14 days of notice that the Otter Unit is approved, CIE will provide a bond in the amount of $1.2 million that is consistent with 11 AAC 82.600.

This Commissioner's Decision is the final administrative order and decision of the department for the purpose of an appeal to the superior court. An appellant affected by this final administrative order and decision may appeal to superior court within 30 days in accordance with the Alaska Rules of Court and to the extent permitted by applicable law.

8/30/13
Date

Joseph Balash
Acting Commissioner
Department of Natural Resources