

MEMORANDUM

State of Alaska
Department of Natural Resources
Office of the Commissioner

TO: David W. Marquez
Attorney General
Dept. of Law

FROM: Thomas E. Irwin
Commissioner

DATE: October 20, 2005

SUBJECT: Request for Legal Advice Regarding Negotiations with the Producers (BP, ConocoPhillips, and ExxonMobil) under the Alaska Stranded Gas Development Act

For close to two years this Administration has been engaged in negotiations with the Producers, comprised of BP Exploration (Alaska) Inc., ConocoPhillips Alaska Inc., and ExxonMobil Alaska Production Inc., under the Alaska Stranded Gas Development Act. Over the course of this period the Governor's Office, together with the Departments of Revenue, Natural Resources, and Law, have become increasingly familiar with the Alaska Stranded Gas Development Act. Additionally, we have obtained extensive knowledge that we did not have at the beginning of these negotiations through the use of outside consultants and our modeling of the various alternatives available to the State for the commercialization of its North Slope gas resources. Moreover, over the course of negotiations, we have seen the positions taken by and terms acceptable to the Administration evolve. As a consequence, we now find ourselves in a position that is causing some members of the Department of Natural Resources—myself included—to seek advice on whether this Administration is operating within the limits of current law as it pushes for the conclusion of negotiations with the Producers. All our concerns may be further complicated by any split among the Sponsor Group into individual companies and whether an individual company meets the statutory requirement to be a qualified applicant with a qualified project. For these reasons, I ask that you provide the Department of Natural Resources (DNR) advice at your soonest opportunity on the matters discussed below.

I am not an attorney, and therefore cannot perform the same analysis as an attorney. However, I am concerned whether members of the DNR are being asked by the Administration to operate outside current law by our continuing participation in negotiations with the Producers under the Alaska Stranded Gas Development Act. Consequently, I would like either assurance that we are

operating within the confines of law or advice on how to bring our actions into conformance with current law.

I am concerned about the legality of those negotiations in the following eight areas. First, the Alaska Stranded Gas Development Act is intended to facilitate development of this State's "stranded" gas. "Stranded gas" is defined in AS 43.82.900(13) to mean gas "that is not being marketed due to prevailing costs or price conditions as determined by an economic analysis by the commissioner [of the department of revenue] for a particular project." While it understandably took some time for the Administration and its outside consultants to complete the analysis needed to draw conclusions about whether Prudhoe Bay and Point Thomson gas—if developed as part of the project proposed by the Producers—meets the statutory definition of "stranded gas," that analysis is now complete and, as Governor Murkowski acknowledged in his recent speech before the State Chamber of Commerce in Valdez, that gas must now be considered "unstranded." This conclusion is supported by modeling performed by various staff and economic consultants to the Administration and Legislature. My first question, then, is whether this Administration is operating within the confines of current law by continuing with negotiations with the Producers under the Alaska Stranded Gas Development Act when all analyses indicate that the project gas as a whole—and particularly Prudhoe Bay and Point Thomson gas—does not meet the definition of "stranded gas" contained within that Act. And, if it is permissible to continue with the Producer negotiations, what liability might I or my staff personally face and what damage could be done to the State should I sign a preliminary fiscal interest findings and determination under the Act that concludes Prudhoe Bay and Point Thomson gas is "stranded gas" when the available data indicates that it is not.

Second, it appears that under AS 43.82.130(2) the Administration should not consent to terms in a proposed contract that materially conflict with the obligations of an oil and gas lessee to the State under an existing lease or unit agreement between that lessee and the State. However, I am concerned that the proposed Article 5 provisions on Work Commitments—especially when read together with Article 35.1, and even in spite of the potentially mitigating language proposed in Article 38—are terms that materially conflict with the obligations of lessees BP, ConocoPhillips, and Exxon Mobil under their existing North Slope lease agreements and the Prudhoe Bay and Point Thomson Unit Agreements. This is also complicated because there are other lessees not participating in the Stranded Gas negotiations whose interests would be affected. Furthermore, substantial and continuing pressure is being exerted on the DNR to endorse terms governing Point Thomson development that are

inconsistent with and materially weaker than the Producers' current obligations to develop Point Thomson in accordance with the Point Thomson Unit Agreement and the plans of development approved under that unit agreement. Thus, I ask whether the intent and literal language of the Alaska Stranded Gas Development Act is being honored in the Producer negotiations if the Producers' obligation to diligently develop Prudhoe Bay and Point Thomson gas reserves is less under a contract proposed under the Act than under the existing lease and unit contracts with the Producers.

Third, AS 43.82.220 governs proposed contract terms relating to royalty. Subsection (a) appears to permit the Administration to make a long-term commitment to take its royalty gas in-kind and forego its current contractual right to switch to taking some or all of its royalty in value. The proposed Producer contract requires that the State make a multi-decade commitment to take all of the State's royalty gas in-kind without proof or compelling evidence that the viability of the project proposed by the Producers is dependent upon the State taking its royalty gas in-kind. Therefore, my third question is whether it will be legal for me to support/sign a preliminary fiscal interest findings and determination at this time when I believe that the State will assume significant risk without substantially improving the Producer's incentive to develop the pipeline.

Fourth, AS 43.82.400 requires a preliminary finding that the proposed contract terms are in the long-term fiscal interests of the State. DNR is concerned that no modeling can show the need for the proposed fiscal support from the State to the Producers and the need for a guarantee of fiscal certainty extending three decades from the pipeline's in-service date. Based on the Administration's project modeling (which is generally consistent with the modeling discussed publicly by others), I do not believe that the economic viability of the project requires the State's "give" nor that the prospect of long-term changes to the fiscal system are necessary. Therefore, my question here is whether current law permits me to support/sign a preliminary fiscal interest findings and determination endorsing contract terms that runs counter to the best data within the possession of the Administration.

Fifth, AS 43.82.445 instructs the Administration to include terms in any proposed contract which apply in certain events, such as a Producer's breach of a material provision of the contract, failure to comply with the approved qualified project plan, or intentional misrepresentation made in the course of negotiating the contract. It appears that the Act intends to require a commissioner's decision in the event of any such grievance, with appeal to the Alaska Superior Court. Further, the State's right to act on such a grievance by

administrative decision (with appeal to the court system) is to continue up until the time the Producers commit to full project funding. However, the procedures spelled out in Article 5 (regarding lack of diligence in pursuing a qualified project plan), Article 22 (mandatory dispute resolution), and Article 24 (administrative termination), as well as the definition of "administrative termination period" in Article 1, seem to contradict AS 43.82.445. My question is whether the proposed contract terms are legal under current law as reflected in the Alaska Stranded Gas Development Act, and whether I can legally support/sign a preliminary fiscal interest findings and determination accompanying a proposed contract containing such terms.

Sixth, AS 43.82.010(1) calls for the development of a proposed contract that does not significantly alter tax methodologies and rates on existing oil infrastructure and production. As you know, for a long time the Administration resisted the Producers' invitation to negotiate oil taxes in conjunction with gas pipeline matters. However, this summer the Administration embarked on extensive analysis and discussion of oil taxes under the umbrella of the Producers' application filed under the Alaska Stranded Gas Development Act. Therefore, my question is whether a commissioner can sign a preliminary fiscal interest findings and determination under the current provisions of the Alaska Stranded Gas Development Act if the proposed contract terms or the likelihood of the gas pipeline project itself are tied in any way to an agreement with the Producers regarding alteration of tax methodologies or rates on existing oil infrastructure or production.

Seventh, while I recognize that the Administration has developed a plan to address some portion of the legal impediments discussed above, I am not sure that the plan itself is sufficient or permissible. The plan, as I understand it, is to propose legislation amending current law as needed to bring the law into conformance with the proposed Producer contract. However, the Administration does not intend to introduce the proposed legislation until after the preliminary fiscal interest findings and determination is signed, which raises the issue of the legality of my actions at the time of signature as well as of the actions of this Administration at this time. Moreover, the Legislature may choose not to enact some or all of the legislation to be proposed by the Administration. Furthermore, the Stranded Gas Development Act invited potentially interested applicants to apply and negotiate with the Administration under the terms of the Act as it now reads. Changing the rules of the game at this late stage is much like changing the rules by which proposals received in response to a Request for Proposal (RFP) are evaluated so as to allow the award of a contract to a favored party on terms other than as advertised. This, too,

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strikes me as potentially improper, and I would like the Department of Law's advice on the issues raised in this paragraph as well.

Finally, DNR staff are assisting the departments of Revenue and Law in preparing the preliminary fiscal interest findings and determination under AS 43.82 (SGDA). In doing so we have been advised by the department of Revenue that the findings and determination will not include a quantitative evaluation of alternatives, such as other applications submitted under AS 43.82. Therefore, I would ask the Department of Law to evaluate whether the proposed preliminary findings and determinations meets the AS 43.82 requirements as well as the Administrations responsibility to provide a full disclosure/comparison which allows the public to adequately evaluate any proposed contract.

The requests for legal advice contained in this letter are not made lightly but with recognition of the serious and long-lasting ramifications of any proposed contract and preliminary fiscal interest findings and determination issued under the Alaska Stranded Gas Development Act. My concerns over the legality of current and anticipated actions are great and I respectfully request receiving a legal opinion on the subjects raised in this letter. Furthermore, I must point out that putting members of the Department of Natural Resources in a work environment where they seriously question the legality of administrative actions they are asked to participate in is so troubling that it could result in the resignation of exceedingly valuable members of our gas pipeline team, which would be a great loss to both the short and long-term interests of the State. For these reasons, I ask for your or your agencies immediate counsel on these issues.

In advance I would like to thank you for your assistance.

cc: Governor Frank H. Murkowski
Jim Clark, Chief of Staff
Marty Rutherford, Deputy Commissioner, DNR
Dick LeFebvre, Deputy Commissioner, DNR
Mark Myers, Director, Division of Oil & Gas, DNR