Background on the Point Thomson Unit and Litigation History and Status

Testimony of DNR before Special Session of Alaska Legislature

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1) Background on Point Thomson Unit-The efforts to encourage development have been ongoing for years.

   a) The essence of an oil and gas lease is timely production. The state agrees to lease its land to a developer in exchange for a share of the production; which is paid as royalties. Oil and gas leases contain a commitment that the lessee will diligently explore and develop the property. When a lessee fails to fulfill this duty, the lease is forfeited. Article 8, Section 8 of the Alaska Constitution mandates that a lessee's breach of his duty to develop results in forfeiture.

   b) An oil and gas lease is a temporary (commonly 5 to 10 years) right to explore for and develop hydrocarbon resources. The purpose of the primary term of a lease is to allow the Lessee sufficient time to explore, delineate, and produce the hydrocarbon resources. Leases expire at the end of their primary term unless the lease is producing oil or gas or the lease has become part of a unit.

   c) Units are formed when a group of lessees apply to the state to form a unit because their leases overlay a common geologic formation that holds recoverable oil or gas. There are about 48 units in Alaska, 14 on the North Slope and 34 in Cook Inlet. Unitization extends the term of lease so that the discovered resources can be produced in an efficient and coordinated manner that will maximize recovery and minimize waste.

d) ExxonMobil acquired several leases in the Point Thomson area in 1965. ExxonMobil and Chevron acquired 14 more leases in 1969 and 1970. The majority of the remaining leases were acquired in the 1980s and early 1990s.

e) The Point Thomson Unit was formed in 1977 with 18 leases comprising approximately 41,000 acres of state land. The boundaries have been expanded and contracted several times in the last 30 years. Unit boundaries can be expanded to include lands proven to overlay a producible resource. Unit boundaries are periodically contracted to exclude leases the unit operator fails to develop. The state's form unit agreement requires that all lands not included in a participating area (a process used to allocate production for royalty accounting purposes) within five years of formation of the unit contract out of the unit.

f) The Point Thomson Unit included 45 leases with approximately 106,000 acres of state land when Commissioner Menge issued his decision to terminate it in November 2006. The leasehold interests were held by ExxonMobil-52%, BP-29%, Chevron-14%, Conoco 2.8% and other minor interest holders. [1]

g) The working interest owners elect a unit operator to manage the unit's business; ExxonMobil has been the unit operator throughout this unit's history. Under the Unit Agreement, ExxonMobil was primarily responsible

[1] The working interest owners agreed amongst themselves several years ago to cross-assign leasehold interests, but did not file the assignments with the state until the day before the leases were to expire. Under DNR's regulations, the cross-assignments are not valid until filed with DNR and approved. Because of the impending lease terminations, DNR did not process the assignments. The impact of the assignments would be to decrease EM's interest in the unit and increase Chevron's.

for exploring and developing the unitized lands. In the recent remand hearing, the working interest owners submitted amendments to the unit operating agreement to change the voting percentages with the stated purpose of preventing one of the major owners from blocking an action the other two agreed upon. Those amendments were contingent on DNR's acceptance of the 23rd POD and not agreed to by ConocoPhillips, thus their current status is not clear.

h) During the first five year of the unit's existence, ExxonMobil submitted five one-year PODs and drilled several exploration wells. The first POD promised"[i]f oil is discovered in sufficient quantities to warrant future development, the Prudhoe Bay to Valdez oil pipeline will be the probable marketing outlet for the area." Since the early 1980s, ExxonMobil has known about the existence of significant quantities of oil and gas condensate, but has not produced anything.

i) Despite significant uncertainty about the unit's resources, the unit operator drilled no more wells after 1982. New wells would yield geophysical data that would resolve the remaining uncertainties about the reservoir. Two wells were drilled by BP and Chevron in the 1990s and several other wells were drilled by other producers on lands outside of the unit boundary.

j) The unit agreement originally provided that it would expire after five years if Lessees failed to form a participating area. Participating areas are formed before production begins to allocate the production to the appropriate lease. Thus, when the parties signed the unit agreement, they expected that the unit would begin production by 1983. Because ExxonMobil was unable to commit to production by then, DNR agreed to remove the PA formation requirement to prevent the unit from terminating. The amendment extended rather than removed the obligation to produce. When DNR agreed to amend the unit agreement it expected that production would begin by the late 1980s.

k) The years since 1983 can be characterized as a struggle between the state and the unit operator, with DNR demanding development activity and ExxonMobil either insisting that it was not economic or promising to drill wells that were never drilled. The remand decision and decision on reconsideration detail the history.

l) In 1985 and 1990, DNR contracted leases from the unit because Lessees failed to drill promised wells. In 1995 DNR rejected the 12th POD because it did not include a development commitment.

m) Significant quantities of oil were discovered by ExxonMobil in 1975, and by BP and Chevron in 1994. The unit plans have never included development of this oil.

n) By the time the 13th POD was due, the Division of Oil and Gas had a new director who accepted ExxonMobil's promise to develop the unit lands with "farm-out" agreements. Then Director Boyd clearly stated the Division's objective: "Most importantly the division wants a fair and honest attempt to get this acreage explored and be appraised of efforts to develop and produce the Pt. Thomson sands accumulation itself."

o) When the negotiations over the Stranded Gas Development Act became active in 1997, ExxonMobil linked Point Thomson development with construction of a gas pipeline. ExxonMobil suggested that before the construction of a gas line, it would produce the hundreds of millions of barrels gas condensates through a gas cycling program. In 2001, Exxon also promised that the PTU's considerable oil reserves would be produced starting in 2010. From the late 1990s until 2005, DNR approved PODs with the expectation that wells would be drilled to further delineate the unit's resources and that ExxonMobil was progressing towards production with

development drilling to begin by 2006. During this period, ExxonMobil drilled no wells.

2) Unit Litigation-DNR has been successful so far and the litigation will probably continue to the Alaska Supreme Court.

   a) The basis for the litigation was the 2001 2nd Expansion agreement and the 18th though 22nd PODs that were designed to implement the commitments made in that agreement.

   b) In 2001 ExxonMobil asked DNR to expand the unit and filed the 18th POD. They repeated their commitment to develop the land by saying "The Owners have endeavored in the attached response to unambiguously demonstrate our commitment to the development of the Point Thomson Unit. We are committing to an aggressive work program and the expenditure of substantial funds that will put us in a position to initiate project execution activities as early as possible." That "unambigous' commitment was to expedite permitting and engineering studies, drill an exploration well by 2003, a production well by 2006 and seven more production wells by 2007. DNR agreed to expand the unit based on these commitments, but none of the proposed development activity occurred. ExxonMobil eventually paid a penalty of $20 Million, plus interest, for failure to perform the promised work.

   c) Since the 21st POD expired in September of 2005, this unit has not been operated under an approved plan of development. The first proposed 22nd POD was submitted and rejected because it did not contain adequate work commitments. Intense negotiations ensued, but the revised POD submitted months later was also rejected. The unit was put in default. The working interest owners asked for reconsideration and appealed to the Commissioner. At the end of the Murkowski administration, Commissioner Menge terminated the unit because ExxonMobil submitted a POD that did

not comply with Director Myers' criteria for what an acceptable POD must contain. Acting Commissioner Rutherford affirmed Commissioner Menge's decision when the lessees asked for reconsideration after the new Governor was sworn in.

d) The litigation began with lawsuits filed in Superior Court that were eventually consolidated before Judge Gleason. ExxonMobil also separately filed an action for damages and injunctive relief that was dismissed by Judge Michalski. ExxonMobil appealed the dismissal, but never filed their brief with the Alaska Supreme Court.

e) Judge Gleason ruled in December 2007 that DNR properly rejected the 22nd POD and that it had the legal authority to terminate the unit, but remanded the case to the agency because she found that DNR had not given the parties enough notice that the unit might terminate and the opportunity to argue about other alternative remedies.

f) DNR had a hearing earlier this year on the 23rd POD, the remedy proposed by ExxonMobil. Commissioner Irwin found that the proposal did not meet the statutory criteria for approval and did not protect the state or public interests. Commissioner Irwin also found that the Lessees' failed to explain why termination was not an appropriate remedy given the unit's history. When asked to reconsider, he came to the same conclusion. The remand record will soon be sent back to Judge Gleason.

g) Judge Gleason has not set a hearing or told the parties whether she would like briefs and/or oral arguments on DNR's decision. It is likely that her final decision will be appealed to the Alaska Supreme Court.

3) Lease Actions-The timing and process for reclaiming the 45 leases varies according to the historical level of activity on those lands.

a) Almost all of the leases are beyond their primary terms, and thus held because they were a part of the unit. After the initial unit termination decision, DNR began the process of terminating the leases in February 2007 and the leaseholders appealed. Further action on the lease appeals was delayed until the status of the unit was resolved. Thus, agency action on the status of all 45 leases is pending.

b) 18 of the leases have no wells and are beyond their primary terms and therefore expire when they are no longer part of a unit.

c) On the leases with wells that were once “certified” there is a factual dispute about whether the wells are still capable of production that is likely to be litigated.