IN THE SUPERIOR COURT FOR THE STATE OF ALASKA

THIRD JUDICIAL DISTRICT AT ANCHORAGE

EXXON MOBIL CORPORATION, Operator of the Point Thomson Unit; BP Exploration (Alaska) Inc.; Chevron U.S.A., Inc.; and ConocoPhillips Alaska, Inc.,	))))Case No. 3AN-06-13751 CI) (Consolidated))Case No. 3AN-06-13760 CI)Case No. 3AN-06-13773 CI
Appellants,	)Case No. 3AN-06-13799 CI)Case No. 3AN-07-04634 CI
v.	)Case No. 3AN-07-04620 CI)Case No. 3AN-07-04621 CI
STATE OF ALASKA, Department of Natural Resources,	)))
Appellee.	)

DECISION ON APPEAL

This case is before the superior court in its capacity as an appellate court on appeal from administrative determinations by the Department of Natural Resources (DNR) with respect to the Point Thomson Unit Agreement. *See* AS 22.10.020(d).

Factual and Procedural Background

In 1977, the Point Thomson Unit Agreement (PTUA) was entered into between Exxon (now ExxonMobil) and the Commissioner of the Department of Natural Resources for the State of Alaska for the purpose of facilitating the production of oil and gas at Point Thomson. [R. 1253-1271] ExxonMobil, which holds the largest percentage of leasehold interests at Point Thomson, is

identified in the PTUA as the Unit Operator. The other appellants in this action all have leasehold interests within the unit.

The following paragraphs of the unit agreement are particularly relevant to this appeal:

> 1. ENABLING ACT AND REGULATIONS. The Alaska Land Act (AS 38.05.005--370) and all valid and pertinent oil and gas statutes and regulations including the oil and gas operating statutes and regulations in effect as of the effective date hereof or hereafter issued thereunder governing drilling and producing operations, not inconsistent with the terms hereof or the laws of the State of Alaska, are hereby accepted and made a part of this agreement.
>
> ...
>
> 10. PLAN OF FURTHER DEVELOPMENT AND OPERATION. Within six months after completion of a well capable of producing unitized substances in paying quantities, the Unit Operator shall submit for the approval of the Director an acceptable plan of development and operation for the unitized land which, when approved by the Director, shall constitute the further drilling and operating obligations of the Unit Operator under this agreement for the period specified therein. Thereafter, from time to time before the expiration of any existing plan, the Unit Operator shall submit for the approval of the Director a plan for an additional specified period for the development and operation of the unitized land. The Unit Operator expressly covenants to develop the unit area as a reasonably prudent operator in a reasonably prudent manner.
>
> Any plan submitted pursuant to this section shall provide for the exploration of the unitized area and for the diligent drilling necessary for determination of the area or areas thereof capable of producing unitized substances in paying quantities in each and every productive formation and shall be as complete and adequate as the Director may determine to be necessary for timely development and proper conservation of the oil and gas resources of the unitized areas, and shall:
>
> (a) specify the number and location of any wells to be drilled and the proposed order and time for such drilling; and,
>
> (b) to the extent practicable, specify the operating practices regarded as necessary and advisable for the proper conservation of natural resources. ...

Said plan or plans shall be modified or supplemented when necessary to meet changed conditions, or to protect the interests of all parties to this agreement. Reasonable diligence shall be exercised in complying with the obligations of the approved plan of development. ...

16. CONSERVATION. Operations hereunder and production of unitized substances shall be conducted to provide for the most economical and efficient recovery of said substances without waste, as defined by or pursuant to state law or regulation.

...

20. EFFECTIVE DATE AND TERM. This agreement shall become effective upon approval by the Commissioner or his duly authorized representative as of the date of approval by the Commissioner and shall terminate five (5) years from said effective date unless:
    (a) such date of expiration is extended by the Commissioner, or
    (b) it is reasonably determined prior to the expiration of the fixed term or any extension thereof that the unitized land is incapable of production of unitized substances in paying quantities in the formations tested hereunder ... or
    (c) a valuable discovery of unitized substances has been made or accepted on unitized land during said initial term or any extension thereof, in which event the agreement shall remain in effect for such term and so long as unitized substances can be produced in quantities sufficient to pay for the cost of producing same from wells on unitized land ~~within any participating area established hereunder~~ and, should production cease, so long thereafter as diligent operations are in progress for the restoration of production or discovery of new production and so long thereafter as the unitized substances so discovered can be produced as aforesaid ...

21. RATE OF PROSPECTING, DEVELOPMENT AND PRODUCTION. The Director is hereby vested with authority to alter or modify from time to time in his discretion the quantity and rate of production under this agreement when such quantity and rate is not fixed pursuant to state law or does not conform to any statewide voluntary conservation or allocation program which is established, recognized and generally adhered to by the majority of operators in such state, such authority being hereby limited to alternation [sic] or modification in the public interest, the purpose thereof and the public interest to be served thereby to be stated in the order of alternation or modification. Without regard to the foregoing, the Director is also hereby vested with

authority to alter or modify from time to time at his discretion the rate of prospecting and development and the quantity and rate of production under this agreement when such alternation or modification is in the interest of attaining the conservation objectives stated in this agreement and is not in violation of any applicable state law.

Powers in this section vested in the Director shall only be exercised after notice to Unit Operator and opportunity for hearing to be held not less than ~~fifteen (15)~~ *thirty (30)* days from notice, *and shall not be exercised in a manner that would (i) require any increase in the rate of prospecting, development or production in excess of that required under good faith and diligent oil and gas engineering and production practices; or (ii) alter or modify the rates of production from the rates provided in the approved plan of development and operations then in effect or, in any case, curtail rates of production to an unreasonable extent, considering unit productive capacity, transportation facilities available, and conservation objectives; or (iii) prevent this agreement from serving its purpose of adequately protecting all parties in interest hereunder, subject to applicable conservation laws and regulations.*

The language that is struck out in Sections 20 and 21 above was deleted, and the italicized language in Section 21 was added in 1985 amendments to the PTUA. [R. 794, 1253-1268, 9448]

As set forth in Section 1 of the unit agreement, the regulations in effect at the time of the agreement's inception were "accepted and made a part of [the unit] agreement." *See also Exxon Corp. v. State*, 40 P.3d 786 (Alaska 2001).

Three of those regulations have particular bearing on this case.

Former 11 AAC.83.315 provided as follows:

> RATES OF PROSPECTING AND PRODUCTION. The director [of the former State Division of Lands] may require that any unit agreement contain a provision vesting authority in the director or other person, committee, or agency as may be designated in the agreement and satisfactory to the director, to alter or modify from time to time the rate of prospecting and development and the quantity and rate of production under the agreement.

Former 11 AAC 83.340 provided in relevant part as follows:

> APPROVAL OF UNIT AGREEMENT. A unit agreement will be approved by the director if he determines that the agreement is necessary or advisable in the public interest, is for the purpose of more properly conserving natural resources, and adequately protects all parties in interest including Alaska ...

Former 11 AAC 83.345 provided as follows:

> MODIFICATION OF UNIT AGREEMENTS. Any modification of an approved unit agreement is subject to the director's approval in the same manner and upon the same determination as the original agreement.

In addition to the above-quoted regulations, there was also a chapter of procedural regulations that were in effect in 1977 that applied to unit agreements. This chapter, entitled "Practice and Procedure," applied to several other chapters of the natural resources regulations, including the unitization chapter. It contained several provisions regarding administrative adjudications, including a provision for judicial appeals to the superior court of administrative decisions and actions.[1] But these former regulations did not contain any provision that required or authorized a unit termination or default action to be initiated by judicial proceedings. Former 11 AAC 88.100 – .185 (Eff. 9/20/74)

There are two subsections of the Alaska Land Act as it was in effect in 1977 that relate to unit agreements:

> Former AS 38.05.180(m) provided as follows:
>
> To conserve the natural resources of all or a part of an oil or gas pool, field, or like area, (whether or not the part is then subject to a cooperative or unit plan of development or operation), lessees and their representatives may unite with each other, or jointly or separately with others, in collectively adopting or operating under a

[1] Former 11 AAC 88.160 (Eff. 9/20/74).

> cooperative or a unit plan of development or operation of the pool, field, or like area, or a part of it, whenever determined and certified by the commissioner to be necessary or advisable in the public interest. The commissioner may, with the consent of the holders of the leases involved, establish, alter, change, or revoke drilling, producing, rental minimum royalty, and royalty requirements of the leases and make regulations with reference to the leases, with like consent on the part of the lessees, in connection with the institution and operation of a cooperative or unit plan as he determines necessary or proper to secure the proper protection of the public interest. The commissioner may provide that oil and gas leases issued under this section shall contain a provision requiring the lessee to operate under a reasonable cooperative or unit plan, and he may prescribe a plan under which the lessee shall operate. The plan shall adequately protect all parties in interest, including the state.
>
> Former AS 38.05.180(n) provided in relevant part as follows:
>
> A plan authorized by (m) of this section, which includes lands owned by the state, may contain a provision vesting the commissioner, or a person, committee, or state agency with authority to alter or modify from time to time the rate of prospecting and development and the quantity and rate of production under the plan ...

The Alaska Land Act also accords broad authority to the Commissioner of the Department of Natural Resources. Specifically, AS 38.05.020 provides that "[t]he commissioner may establish reasonable procedures and adopt reasonable regulations necessary to carry out this chapter," and the commissioner may "exercise the powers and do the acts necessary to carry out the provisions and objectives of this chapter." These statutory provisions were in effect in 1977 and remain in effect today.

Overlying the entire statutory and regulatory construct is Article VIII, Section 2 of the Alaska Constitution, which provides, "[t]he legislature shall

provide for the utilization, development and conservation of all natural resources belonging to the State, including land and waters, for the maximum benefit of its people."

Several current regulations have been discussed by the parties extensively in this appeal, including 11 AAC 83.303; 11 AAC 83.336; 11 AAC 83.361; and 11 AAC 83.374. None of these regulations was in effect when the PTUA became effective in 1977. They were all originally adopted in 1981.

The history of the Point Thomson Unit has been thoroughly set out in the record before this court, including in the decisions issued at the administrative level. [*See, e.g.,* R. 629-635] Since the unit's formation in 1977, eighteen exploration wells have been drilled within and around the PTU. At the request of the Unit Operator, the Division of Oil and Gas of the Department of Natural Resources (Division) certified seven wells within the PTU as capable of producing hydrocarbons in paying quantities. [R. 640] With one exception, all of those certifications were issued, and the wells all then abandoned, prior to 1987. [R. 5681] The last well was certified in 1994 and abandoned the following day. [Id.][2]

The PTU Lessees are required to submit Plans of Development (PODs) at specified intervals to the Division that set out their development plans for the unit. The current controversy arises from the Department of Natural Resources'

[2] However, the certification letter for the last well dated April 26, 1994 indicated, "It should be noted, however, that the well is not capable of producing in paying quantities as that phrase is defined in section 9 of the Point Thomson Unit Agreement." [R. 5681]

refusal to approve the Lessees' proposed 22nd Plan of Development for the Point Thomson Unit. [R. 1966-1976] The Division rejected the Lessees' first proposed 22nd Plan of Development in a decision dated September 30, 2005. [R. 12282] That proposed 22nd Plan, as described by the Division, conditioned PTU development on amending the State's existing tax and royalty structure and construction of a North Slope gas pipeline. [R. 12297] The Division found "the current PTU Owners have had the leases for far beyond their primary term, and their conclusion today is simply that they cannot make enough money to justify development. It is time for the PTU Owners to develop and produce or give new lessees ... a chance to develop the known hydrocarbon resources within the PTU." [R. 12303] That initial decision held that "[f]ailure to submit an acceptable plan of development is grounds for termination of the PTU." [R. 12305] The initial decision then referenced Section 21 of the PTUA, and held that "the PTU Operator shall commence development operations within the PTU by October 1, 2007. The PTU Owners shall have an opportunity for hearing regarding this notice to modify the rate of PTU development." [*Id.*] The initial decision also required that "the PTU Operator shall begin commercial production of unitized substances from the PTU by October 1, 2009." [R. 12304]

Shortly after the issuance of the September 2005 decision, the Division issued an Amended Decision on October 27, 2005. [R. 12282] The Amended Decision removed all references to Section 21 of the PTUA, because, according to the Amended Decision, that section does "not apply to the Division's

evaluation of the Unit Operator's proposed plans for development of the Point Thomson Unit." [*Id.*][3] The Amended Decision of October 2005 accorded the Unit Operator 90 days within which to submit an acceptable POD. The Amended Decision also modified the initial decision to provide that the development and production deadlines previously specified in the initial decision were "*an example* of an acceptable PTU plan of development." [R. 12304; emphasis added] The Amended Decision eliminated the reference to the opportunity for a hearing regarding the proposed modification of the rate of PTU development. [R. 12305] But the Amended Decision retained the language from the initial decision that "[f]ailure to submit an acceptable plan of development is grounds for termination of the PTU." [R.12305]

The initial decision and the Division's Amended Decision of October 2005 both noted that the Division had certified seven wells on the unit as capable of producing hydrocarbons in paying quantities. [R. 12295] Nothing in either the initial decision or the Amended Decision of the Division purported to decertify those wells. To the contrary, the Division's Amended Decision stated, "the PTU contains wells certified as capable of production in paying quantities." [R. 12302]

The Division's October 2005 Amended Decision recognized that negotiations between State representatives and some of the PTU Lessees for

[3] *See also* State's Br. at 49, n. 56. There, the State asserts that Section 21 "relates to the Director's authority to change the rate of prospecting and development once Lessees are operating under an approved POD," and is not applicable with respect to the approval of the POD itself, which the State asserts is governed solely by Section 10 of the PTUA. *But see* Section 21 as amended, paragraph 2, and the reference there excluding applicability of portions of that section to approved plans of development. [R. 794]

the construction of a gas pipeline were ongoing at that time, but clearly indicated that such negotiations would not serve as a basis to delay PTU development: "At this point in time, the PTU Owners do not control if or when a North Slope gas pipeline will ever be operational. Reliance on third parties, beyond the control of the PTU Owners, is not grounds for the delay of PTU development and production." [R. 642]

The ninety-day deadline for submission of an acceptable modified 22nd POD was extended by the Division until October 20, 2006, during which time negotiations continued with respect to the development of a gas pipeline. The resultant proposed Fiscal Contract for a gas pipeline included certain provisions dealing with the PTU. Specifically, the proposed Fiscal Contract provided that if certain PTU Lessees undertook designated actions with respect to the development of a gas pipeline, the State agreed not to terminate the PTU. [App. 125]

In May 2006, the proposed Fiscal Contract was submitted to the Alaska Legislature for its consideration as required by the Stranded Gas Development Act. [App. 125] On October 18, 2006, while the Fiscal Contract was still under legislative consideration, ExxonMobil submitted a modified 22nd POD to the Commissioner. [R. 3089-3105] The modified 22nd POD did not propose to put the unit into production by 2009, a commitment that had been delineated by the Division as a component of an acceptable plan of development in the Division's Amended Decision of October 2005. [R. 667] The Lessees have asserted that

the modified 22nd POD was consistent with the terms of the proposed Fiscal Contract. [App. 126] However, the Fiscal Contract had not been approved by the Legislature at that time, and indeed, has not ever been approved by the Legislature.

Oral argument before the Commissioner on the modified proposed 22nd POD was held on November 20, 2006. No participant requested an evidentiary hearing. However, approximately 5,000 pages of documents regarding the modified proposed POD were submitted to the Commissioner prior to the November 2006 hearing. [R. 5672]

The Commissioner issued a Decision on Appeal on November 27, 2006. [R. 5670-5689] As summarized in the decision itself, the Decision on Appeal:

> (1) denies the request for modification of the 2001 Expansion Agreement, as amended, which affects only the expansion leases; (2) affirms the Director's Decision in all respects to the extent it is consistent with this Commissioner's Decision, but the Director's Decision is disapproved to the extent that it can be read to mean the PTU contains certified wells; (3) adopts and incorporates into the Commissioner's Decision the findings and rationale of the Director's Decision as modified by this Decision; (4) rejects the cure or revised 22nd PTU POD submitted by the Lessees on October 18, 2006; and (5) terminates the PTU.

[R. 5671]

The Commissioner rejected the Lessees' contention that the modified proposed 22nd POD should be evaluated pursuant to the Reasonably Prudent Operator Standard. He characterized the "lessees' appeal [as] based on the premise that they do not have to produce because a Reasonably Prudent Operator would not produce." [R. 5684] The Commissioner acknowledged that

Section 10 of the PTUA included a covenant by the Lessees to "develop the unit area as a reasonably prudent operator in a reasonably prudent manner." But he added, "Section 10 says much more." [*Id.*] He noted the PTU was not in production even though "massive PTU reserves were found in the early 1980s." [R. 5686] Then he added,

> I specifically find that the Reasonably Prudent Operator standard does not apply to this Commissioner's Decision involving a long standing unit with leases far beyond their primary term and Lessees which unambiguously refuse to adequately explore, delineate, or produce massive known hydrocarbon reserves. The Reasonably Prudent Operator language of section 10 of the unit agreement does not supersede the other provisions of that section, or the applicable statutes, regulations or leases. Section 10 contains significant detail on what an acceptable POD must contain and the Director's Decision asked the Lessees to comply. Instead, they ask for the protection of the RPO standard, but on these facts, it matters not what a Reasonably Prudent Operator would do, the state is entitled to terminate the PTU.

[R. 5686-87]

In his decision, the Commissioner noted that seven wells in the PTU had been previously certified by DNR as "capable of producing in paying quantities." But he then held as follows:

> Whatever the merits of the certifications when they were originally issued, the suggestions in the Director's Decision that certified wells exist today or that the prior certifications of now non-existent exploration wells indefinitely extend the term of the leases upon which they were drilled or that the PTU should be treated as a unit with certified wells is disapproved and reversed in this Commissioner's Decision. Those suggestions are not supported by the facts. There are no certified wells in the unit capable of producing in paying quantities. All wells which were certified have been plugged and abandoned. Inconsistent findings and statements in the Director's Decision on certified wells are hereby disapproved.

[R. 5682]

The Commissioner affirmed the Director's Amended Decision "in all respects to the extent it is consistent with this Commissioner's Decision, but it is disapproved to the extent it can be read to mean the PTU contains certified wells." [R. 5688] The Commissioner rejected the revised 22nd POD because it did "not commit to put the unit into production." He concluded that "[t]he PTU is terminated." [R. 5688, 5689]

Some of the PTU Lessees sought reconsideration of the Commissioner's Decision. The primary issue on reconsideration addressed the propriety of the Commissioner's determination that the PTU contains no wells certified as capable of producing in paying quantities. From there, the Lessees asserted that since the wells remained certified, the unit could only be terminated through judicial proceedings, citing 11 AAC 83.374(d). The Lessees also asserted that they did not receive fair notice that the certified well status of the PTU wells was at issue, and requested that DNR reopen the administrative proceedings for that reason. [R. 9287]

On December 27, 2006, Acting Commissioner Marty Rutherford issued an 11-page Decision on Reconsideration, which affirmed the Commissioner's Decision of November 27, 2006 in all respects. [R. 9286-9298] The Reconsideration Decision expressly distinguished between the well decertification component of the November 2006 decision and the termination component of that same decision. The Reconsideration Decision characterized

the certified well status as a "collateral finding" to the termination decision. [R. 9288] Specifically, the Reconsideration Decision found:

> The certified well finding is not the basis of the November 27, 2006 unit termination decision. The unit termination decision is based primarily on two independent grounds neither one of which regards certified wells.
>
> One ground for unit termination is that DNR is entitled to terminate a unit which has been known to contain massive hydrocarbon reserves for more than 30 years, but which has never been put into production, when the lessees of the state oil and gas leases making up the unit unequivocally state that they still cannot find a way to put the unit into production. DNR is entitled to terminate a unit because the purpose of forming a unit is to effect production. Units are not formed for the purpose of simply holding properties until such time as the Lessees think production will be profitable enough to commence. On these facts, when the Lessees say they cannot put the unit into production, DNR can terminate the unit as a matter of law.
>
> The second primary ground for unit termination is the failure to submit an acceptable Plan of Development. . . .

[R. 9289-90]

The Reconsideration Decision also addressed, but did not directly resolve, the Lessees' argument that 11 AAC 83.374(d) requires the agency to pursue unit termination through court proceedings, and not by administrative determination. In this regard, the decision notes, "[e]ven if the PTU contains certified wells, the November 27, 2006 Decision is an appropriate DNR action which facilitates court review." [R. 9292] The Reconsideration Decision acknowledges that it is undisputed that the decertification approach "reverses longstanding DNR Oil and Gas Director's Decisions that certify non-existent or non-production wells." [R.

9295] But the Acting Commissioner indicates that the longstanding policy was "poor policy" which it was incumbent on the Commissioner to correct. [R. 9296]

The Reconsideration Decision also held that the Lessees' own submissions to the Commissioner demonstrated that the Lessees had adequate notice that decertification was an issue before the Commissioner. [R. 9294-95] The Acting Commissioner also found that the State was not estopped from decertifying the wells and that it had not breached the covenant of good faith and fair dealing under the Unit Agreement. [R. 9296-97]

Four of the PTU Lessees appealed the Commissioner's Decision and the Reconsideration Decision. The appeals were all consolidated to this court, sitting in its appellate capacity pursuant to AS 22.10.020(d).

In March 2007, the Appellants filed a motion with this court seeking to stay the administrative determinations pending appeal. They asserted that because the Division had certified wells in the unit as capable of producing hydrocarbons in paying quantities, subsection (d) of 11 AAC 83.374 applied such that the Division was required to "seek to terminate the unit agreement by judicial proceedings," and was precluded from administratively terminating the unit. By order dated May 1, 2007, this court denied the stay. While this court found that the Appellants had made a "clear showing of probable success on the merits" that the administrative termination of the unit did not comply with 11 AAC 83.374(d), this court also found that granting the stay would be contrary to the public interest, and particularly the benefit of according to DNR the opportunity to

appropriately address the related lease termination proceedings in the first instance. However, this court did query the parties at the end of those proceedings whether there was any significance to the fact that 11 AAC 83.374 was adopted in 1981 – after the PTUA was entered into in 1977 – an issue that was not the focus of the parties' briefing on the stay motion.

In a separate order issued on May 7, 2007, this court held that Alaska Gasline Port Authority and Jim Whitaker would not be considered parties to this appeal. However, they were permitted to, and did submit amicus curiae briefing to this court.

Oral argument on the appeal was held on October 5, 2007. At oral argument, the Appellants each indicated they were not pursuing an appeal with respect to the Commissioner's decision on the expansion leases. Thereafter, ExxonMobil and Chevron USA filed a motion to dismiss those claims on appeal. The State filed a limited objection, focused primarily on the language of the proposed order of dismissal of that portion of the appeal. That motion is addressed below.

Standard of Review

Four different standards apply to a court's review of the merits of an agency's rulings: "(1) the 'substantial evidence test' for questions of fact; (2) the 'reasonable basis test' for questions of law involving agency expertise; (3) the 'substitution of judgment test' for questions of law involving no agency expertise,

and (4) the 'reasonable and not arbitrary test' for review of administrative regulations." *ConocoPhillips v. DNR*, 109 P.3d 914, 919 (Alaska 2005)(footnote omitted).

While the issue of contract interpretation "generally presents a question of law,"[4] where a contract specifies that certain determinations are to be made through an administrative process, then the court's review of those determinations "would need to be appropriately deferential"[5] such that the reasonable basis test would apply. *See also Usibelli Coal Mine, Inc., v. State, Dept. of Natural Res.*, 921 P.2d 1134, 1146 (Alaska 1996). Under the reasonable basis standard of review for administrative decisions involving complex issues involving agency expertise, the court is to give deference to the agency's determination so long as it is reasonable, supported by evidence in the record as a whole, and there is no abuse of discretion. *Ellis v. State, Dept. of Natural Resources*, 944 P.2d 491, 493 (Alaska 1977).

In this case, the parties generally agree that the regulations that DNR adopted in 1981 are applicable to the PTUA to the extent those regulations are "not inconsistent with the ... unit agreement or regulations in effect on the effective date of the lease or unit agreement." 11 AAC 83.301(b). Section 1 of the PTUA expressly provides:

> The Alaska Land Act (AS 38.05.005--370) and all valid and pertinent oil and gas statutes and regulations including the oil and gas operating statutes and regulations in effect as of the effective

[4] *ConocoPhillips, 109 P.3d.* at 920.
[5] *Id.*

> date hereof or hereafter issued thereunder governing drilling and producing operations, not inconsistent with the terms hereof or the laws of the State of Alaska, are hereby accepted and made a part of this agreement.

See also Exxon Corp. v. State, 40 P. 3d 786, 796-797. Where the parties to this appeal disagree is as to which of the 1981 regulations are consistent with the PTUA and which are inconsistent.

In *Exxon Corp. v. State*, 40 P.3d 786 (Alaska 2001), the Alaska Supreme Court addressed the Prudhoe Bay Unit Agreement (PBUA), which, like the PTUA, became effective in 1977. Although the issue the court confronted in that case – whether the lessees had an absolute right to expansion of that unit – is dissimilar to that here, many of the legal principles discussed there by the Supreme Court are applicable when analyzing the legal issues presented in this case.

In the Prudhoe Bay case, Exxon asserted that the PBUA eliminated DNR's discretion to refuse to expand the Prudhoe Bay Unit (PBU). The Department argued that it had the authority to consider the State's best interests in making a decision on whether to expand the PBU. DNR relied not only on the contract language, but also on the regulations in effect at that time, and specifically former 11 AAC 83.340 and former 11 AAC 83.345 – regulations which the court held "required the director's approval, based on a determination of necessity or advisability in the public interest, for a modification of an approved unit agreement." 40 P.3d at 795 (footnote omitted). Exxon then asserted that DNR had agreed to contract terms that were binding upon the agency even if

those terms violated DNR's regulations. But the Supreme Court held that an agency does not have the authority to contract outside of its own regulations. "To allow such activity would be arbitrary; parties not contracting with the department would not be held to the same regulations that non-contracting parties were required to comply with." 40 P. 3d at 796.

The Prudhoe Bay *Exxon* case teaches that the interpretation of the PTUA contract in this case must be governed by the language of the contract itself, as well as the regulations and statutes that were in place when the contract was adopted. Thus, to the extent that Section 1 of the PTUA could be read to limit the applicability of regulations that were in effect at the time of the PTUA's adoption, that reading is contrary to Alaska law and must be rejected. All of the applicable regulations in effect at the time of the PTUA's adoption apply to the PTUA agreement. Secondarily, the current regulations and statutes apply to the PTUA "where not inconsistent with the ... unit agreement or regulations in effect on the effective date of the ... unit agreement." 11 AAC 83.301(b).

Discussion

There are two primary administrative determinations that are before the court in this appeal – (1) the Department's rejection of the Lessees' proposed modified 22nd Plan of Development for the Point Thomson Unit, and (2) the Department's termination of the Point Thomson Unit.

I. DNR's rejection of the proposed 22nd Plan of Development

A. DNR has the authority to administratively determine whether a proposed plan of development should be accepted or rejected.

The PTUA, when read in conjunction with the regulations in effect in 1977, clearly accorded to DNR the ability to administratively determine whether the Unit Operator is in compliance with Section 10 of the Unit Agreement. That section provides, among other statements, that any development plan submitted by the Unit Operator "shall be as complete and adequate *as the Director may determine* to be necessary for timely development and proper conservation of the oil and gas resources of the unitized areas." [R. 1260, emphasis added] Moreover, former 11 AAC 88.160 accords to the Unit Operator the right to appeal to the superior court a "decision or other action" by DNR. To the extent that the Appellants are asserting that the more recently adopted regulation 11 AAC 83.374 requires that rejection or acceptance of a proposed POD must be made in the first instance in judicial proceedings, as opposed to by DNR, that regulation would be inconsistent with the PTUA and former regulation and is accordingly inapplicable to this agreement.

B. What is the appropriate standard for the Department to apply when determining the adequacy of a plan of development?

The Appellants' primary assertion with respect to DNR's rejection of the proposed modified 22nd Plan of Development is that the agency applied the wrong legal standard when reviewing the proposed POD. The Appellants assert that as a matter of law, DNR is required to apply a reasonably prudent operator

(RPO) standard. They assert this standard is mandated based on the following sentence in Section 10 of the PTUA: "The Unit Operator expressly covenants to develop the unit area as a reasonably prudent operator in a reasonably prudent manner." [R. 1260] The Appellants assert that this contractual language, in conjunction with applicable statutes, "makes clear that DNR may not require the Operator to carry out a plan that is not reasonable from the perspective of the Operator, because it does not adequately protect the lessees' interests."[6]

The State asserts that the PTUA's reference to the reasonably prudent operator "acts primarily as a covenant *by the lessee* to act as a RPO and does not alter how DNR is to administer the PTUA. It defines the Lessees' commitment rather than limiting DNR's authority." [State's Br. at 46, emphasis in original] Accordingly, the State asserts that this court should affirm DNR's determination which rejected the 22nd Plan of Development because, as found by the Commissioner, both the original plan and the revised plan "suffered from the same defects" as each proposal did not commit to put the unit into production but instead contained the "unequivocal statement that the lessees cannot find a way to put the unit into production." [R. 9290, 9291]

Generally, issues of contract interpretation are legal issues as to which a court is to apply its independent judgment. But here, the disputed section of the PTUA – Section 10 – expressly confers upon the Division the authority to require a plan from the Lessees that "shall be as complete and adequate as the Director

[6] Jt. Br. at 54, *citing* AS 38.05.180.

may determine to be necessary for timely development and proper conservation of the oil and gas resources of the unitized area . . ." [R. 1260] Accordingly, this court's review of those determinations "would need to be appropriately deferential" such that the reasonable basis test should apply. *ConocoPhillips v. DNR*, 109 P.3d 914, 919 (Alaska 2005)(footnote omitted); *see also Usibelli Coal Mine, Inc., v. State, Dept. of Natural Res.*, 921 P.2d 1134, 1146 (Alaska 1996); *Pan American Petroleum Corp. v. Shell Oil Co.*, 455 P.2d 12, 22-23 (Alaska 1969).

Adoption of the Appellants' interpretation of the contract to mandate the RPO standard would run counter to the regulatory and statutory provisions that were in effect at the time of the contract's creation. The applicable effective regulation at the time of contracting in 1977 required a determination by the State "that the agreement is necessary or advisable in the public interest... and adequately protects all parties in interest including Alaska." Former 11 AAC 83.340. Likewise, former 11 AAC 83.345 provides that this same standard applied to modifications of approved unit agreements. To interpret Section 10 of the PTUA to focus on the Lessee's perspective, so as to preclude rejection of any plan of development that the Lessees asserted was unreasonable for them, irrespective of the public interest, would be inconsistent with this regulatory directive. *See also* former AS 38.05.180(m).

In this regard, the current regulation, 11 AAC 83.303, is not inconsistent with Section 10 of the PTUA or the former regulations. That regulation requires

the DNR Commissioner to approve a proposed plan of development upon a written finding that it will "(1) promote 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), (c)(3). In evaluating these criteria, the regulation specifies that the Commissioner is to consider several factors, including "the geological and engineering characteristics of the potential hydrocarbon accumulation," "prior exploration activities in the proposed unit area," and "the applicant's plans for exploration or development of the unit area." 11 AAC 83.303(b). DNR thoroughly addressed these criteria when it rejected both of the Lessees' proposed 22nd Plans of Development. [*See, e.g.,* R. 12297-12303] DNR consistently rejected the fundamental tenet of both of the 22nd PODs that the Lessees proposed – that unit development should be conditioned upon the construction of a North Slope gas pipeline. [R. 12299]

Accordingly, this court finds that DNR did not err when it declined to review the modified POD under a reasonably prudent operator standard. In evaluating the POD, DNR also considered whether the proposed POD provided adequate protection of the public interest in light of the history of limited development in the unit area over its 30-year history. DNR's approach was consistent with Section 10's grant of authority to the Director to require a plan of development "as complete and adequate as the Director may determine to be necessary for timely development and proper conservation of the oil and gas

resources of the unitized areas," and complies with the applicable statutes and regulations.[7]

C. Substantial Evidence Supports DNR's Determination to Reject the 22nd POD

The Appellants also assert that even if judged by a different standard that the RPO, the modified 22nd POD should have been approved. They note that their modified plan called for an appraisal well to be drilled for the winter of 2008-2009. [Jt. Br. at 61] But with regard to this proposed well, DNR responded that under the Appellants' modified POD, they would pay the State $40 million if they did not drill the well as planned. [R. 3096] The Commissioner found "the value of the well to the state greatly exceeds $40,000,000 because a well or wells are needed to adequately appraise the PTU." [R. 5678] DNR, looking at the history of the unit, determined that "[t]he proposed payment is no substitute for adequate delineation of the PTU hydrocarbon accumulations, now long overdue and repeatedly requested by DNR." [R. 5683]

Further, the 22nd modified plan indicated that production would require a gas pipeline. [R. 3093] In rejecting that plan, DNR concluded that "neither the oil nor the gas condensate [within Point Thomson] require a gas pipeline to produce" -- a finding that is not directly refuted by the Appellants. [R. 9296]

---

[7] *But see* Section 21, second paragraph, of the PTUA as modified in 1985. [R. 794] That revision specifies that the Department may not require any increase in the rate of production or development "in excess of that required under good and diligent oil and gas engineering and production practices." This section may well have applicability when determining the appropriate remedy when DNR rejects a proposed plan of development. *See* discussion, *infra.*

In sum, there is substantial evidence in the record as a whole to support DNR's determination to reject the modified 22nd Plan of Development based on DNR's finding that the plan contained "no commitment to develop the unit and no firm commitment to adequately delineate the reservoirs." [R. 5677-78]

D. The Impact of the Fiscal Contract Negotiations

The Appellants that participated in the gas pipeline negotiations[8] have asserted that the DNR Commissioner acted in bad faith in rejecting the modified POD in light of the State's course of conduct during the negotiations for the Fiscal Contract for a gas pipeline. The Appellants also assert that the DNR Commissioner "breached the obligation of subjective good faith" based on the Commissioner's statements at a press conference that occurred the day he issued his November 2006 decision in this case. [App. 130-31] And these Appellants assert these same facts support a claim of estoppel against the State. Specifically, they assert that they relied on those provisions of the proposed Fiscal Contract that relieved the Lessees of submitting PODs for so long as the fiscal contract was in place. [R. 2247]

The State asserts that any reliance by the Appellants that is based on the proposed Fiscal Contract is unreasonable because that contract was never finalized when legislative approval was not forthcoming. The Appellants point to no assertion outside the context of the Fiscal Contract negotiations in which the State indicated that it would accept a modified POD that did not commit the unit

[8] Chevron was not a participant in these negotiations. [Exxon Br. at 62, n. 122]

into production. For example, the Commissioner's letter to Exxon of August 31, 2006, which accorded to Exxon the final extension of the appeal period, made no reference at all to the Fiscal Contract. [R. 3081]

The parties agree that this court should consider these claims de novo, since technically these is no administrative determination on these issues for this court to review. *See generally Danco Exploration v. State*, 924 P.2d 432, 434 (Alaska 1996).

To the extent the Appellants relied upon the proposed Fiscal Contract when they presented the modified POD, such reliance was unreasonable. Although the Fiscal Contract, had it been accepted by the Legislature, would have permitted the PTU to be developed in conjunction with the construction of a gas pipeline, the Fiscal Contract was never approved. DNR made no definitive statements that the Appellants would be relieved of their obligations under the PTUA even if the Fiscal Contract was not approved. To the contrary, DNR advised the Appellants that the agency would not delay a drilling commitment for so long as the Fiscal Contract negotiations were occurring. [R. 1958] In these circumstances, DNR is not estopped from rejecting the 22nd POD based on its determination that the POD did not propose an adequate development plan for the unit. *See, e.g., Mortvedt v. State, Dept. of Natural Res.*, 941 P.2d 126, 130 (Alaska 1997).

Nor can the Appellants maintain their claim for breach of the covenant of good fair and fair dealing. This covenant is intended to effectuate the reasonable

expectations of the parties under an existing contract. It "cannot be interpreted to prohibit what is expressly permitted" in the contract. *Casey v. Semco Energy, Inc.*, 92 P.3d 379, 384-385 (Alaska 2004), *quoting Ramsey v. City of Sand Point*, 936 P.2d 126, 133 (Alaska 1997). Here, the covenant cannot be applied to preclude DNR's rejection of the modified 22nd Plan of Development, because the authority to insist on a plan of development that is "as complete and adequate as the Director may determine to be necessary" is expressly accorded to DNR under the PTUA. [R. 1260]

Based on the foregoing analysis, DNR's rejection of the modified proposed 22nd Plan of Development is affirmed.

II. Did DNR have the authority to administratively terminate the PTUA?

The Director's Amended Decision of October 27, 2005 rejected the 22nd POD, but it did not purport to terminate the unit agreement. Rather, it stated that "the PTU Agreement is in default," and listed certain commitments that represented "an example of an acceptable PTU plan of development" to cure the default. [R. 12304] The Director's Amended Decision also indicated that "[f]ailure to submit an acceptable plan of development is grounds for termination of the PTU." [R. 12305]

The Commissioner's Decision and Decision on Reconsideration, issued one year later and after a modified POD proposal had been submitted to DNR by the Lessees, not only rejected the modified 22nd POD proposal – it terminated

the unit. The Appellees have asserted that DNR does not have the authority to administratively terminate the unit, but must instead seek to terminate the agreement through judicial proceedings.

The State has asserted several bases to support its authority to administratively terminate the PTUA when it has rejected a proposed Plan of Development for the unit. Each of these bases is discussed below.

A. Section 20(c) of the PTUA is not applicable.

One potential basis for the PTUA's administrative termination is pursuant to Section 20 of the agreement itself. This section of the PTUA, termed a "habendum clause," specifies certain bases upon which the unit agreement automatically terminates. There is no reference to this specific clause of the PTUA in any of the agency determinations in this matter. Moreover, at oral argument before this court in October 2007, counsel for the State made clear that the State was not seeking to invoke this clause to support the agency's termination decision. [*See* Transcript of Oral Argument of 10/5/07 at 34] Accordingly, any authority to administratively terminate or cancel the unit agreement must derive either from other provisions within the PTU Agreement itself or the regulations and statutes that are applicable to this particular agreement.

B. Other sections of the PTUA regarding termination

Section 9 of the PTUA delineates the parties' obligations prior to the discovery of hydrocarbons at the unit. Since hydrocarbons were discovered at

the unit decades ago, it is inapplicable to the current controversy. But Section 9 of the agreement is noteworthy in that it expressly provides that if the Unit Operator fails to diligently drill until hydrocarbons are discovered, "the Commissioner may, after 15 days notice to the Unit Operator, declare this unit agreement terminated." [R. 1259] In contrast, Section 10 of the PTUA, which applies after a well capable of producing unitized substances in paying quantities has been completed, is silent on the rights of either party to terminate or cancel the contract. It does not expressly accord to the DNR a right to administratively terminate the unit – nor does it eliminate any such right.

Section 20, discussed above, specifies when the PTUA shall *automatically* terminate. This court does not interpret that habendum clause and Section 9 of the PTUA to preclude the cancellation or termination of the contract under any other circumstance apart from those listed there. *See generally Law of Federal Oil and Gas Leases*, Vol. 1 at §14.19[1](1992)(distinguishing cancellation through affirmative agency action from automatic termination by operation of law). Indeed, the parties in this action recognize that the State could seek to cancel the contract based on an alleged breach of Section 10 by the Lessees. [*See, e.g.,* Jt. Reply at 9] At issue is whether that cancellation proceeding would need to be initiated in state court or if the agency could seek to cancel the contract in an administrative proceeding. This court does not read the PTUA to preclude an administrative cancellation proceeding when the Director has determined that a

proposed plan of development is incomplete or inadequate under Section 10 of the PTUA.

C. The Statutes and Regulations in Effect in 1977

A fundamental question thus arises – did DNR have the implied authority to administratively terminate the PTUA under the statutes and regulations in effect when the PTUA was entered into in 1977? The Appellants assert that no such authority existed, such that the State "like parties to contracts generally, [must] seek relief by way of a claim of default in court." [CPA at 21] The State and the Port Authority assert that when the PTUA is silent, the agency has the inherent authority to administratively terminate the unit unless judicial action is specifically required by statute or applicable regulation. [Port Auth. Supp. at 1]

"Administrative agencies rest their power on affirmative legislative acts. They are creatures of statute and therefore must find within the statute the authority for the exercise of any power they claim." *McDaniel v. Cory*, 631 P.2d 82, 88 (Alaska 1981). The Alaska Land Act, as cited above, accorded broad authority to DNR's Commissioner to "establish reasonable procedures" and "exercise the powers and do the acts necessary to carry out the provisions and objectives" of the Act. AS 38.05.020(b). Those powers included the ability to authorize and certify unit agreements "whenever determined and certified by the

Commissioner to be necessary or advisable in the public interest." Former AS 38.05.180(m).[9]

The State and the Port Authority both cite to the United States Supreme Court case of *Boesche v. Udall*, 373 U.S. 472, 478 (1963), which held that the Department of Interior had a "traditional administrative authority" to cancel a federal lease unless such authority had been specifically withdrawn by federal law. Similarly, in *White v. State, Dept. of Natural Resources*, 14 P.3d 956 (Alaska 2000)(*White II*), the Alaska Supreme Court held that a lessee's breach of contract claim against the State "fit[s] comfortably within the scope of an ordinary administrative claim" and should be pursued before the administrative agency. 14 P.3d at 960. *See also Danco Exploration v. State*, 924 P.2d 432, 434 (Alaska 1996)("Oil and gas lessees and lease bidders which have grievances with the State must pursue the administrative procedures provided by [regulation]." Although there was no express statutory grant to DNR to terminate unit agreements in 1977, this court finds that this specified procedure falls "within the scope of an ordinary administrative claim" that is within the agency's broad statutory powers. *White v. State,* 14 P.3d at 960.

As discussed above, there were two chapters of regulations that were in effect in 1977 that applied to unitization agreements on state lands. One of these

[9] When the unit agreement included lands owned by the state, the Alaska Land Act provided that the unit agreement "may contain a provision vesting the commissioner ... with authority to alter or modify from time to time the rate of prospecting and development and the quantity and rate of production under the plan." Former AS 38.05.180(n). Section 21 of the PTUA corresponds to this statutory grant of authority.

chapters addressed only unitization agreements. Former 11 AAC 83.300 *et seq.* (Eff. 9/20/74). The other chapter, entitled "Practice and Procedure," applied to several chapters of the natural resources regulations, including the unitization chapter. It contained several provisions regarding administrative adjudications, including a provision for judicial appeals to the superior court of administrative decisions and actions.[10] These former regulations neither required nor authorized that a unit termination be initiated by judicial proceedings. Former 11 AAC 88.100 – 145 (Eff. 9/20/74).

Under the regulatory scheme as it was in existence in 1977, the administrative authority to terminate the unit agreement had not been restricted or withdrawn. And the statutory regimen accorded broad powers to the commissioner to manage state land. As correctly noted by the Port Authority, "[a]t the time the PTUA was adopted, no statute or regulation abrogated the Department's authority to administratively cancel a unit ..." [Port Auth. Supp. at 2] Instead, the procedural regulations in effect at that time expressly contemplated agency determination and judicial review of all issues. This court finds that DNR possessed the authority to administratively terminate the Point Thomson Unit Agreement when that agreement was adopted in 1977 under the statutory and regulatory structure as it existed at that time.

[10] Former 11 AAC 88.160 (Eff. 9/20/74).

D. To what extent are the current regulations applicable to the Point Thomson Unit Agreement?

In 1981, the State adopted several regulations that more comprehensively address unitization. With some modifications, most of these regulations remain in effect today. The parties in this action dispute both the interpretation of the current regulations and the extent to which those later-adopted regulations apply to the PTUA. Under Alaska law, the later-enacted regulations do not apply to the PTUA to the extent they conflict with either the terms of the PTU Agreement or with regulations that were in effect in 1977, when the PTUA was adopted. *Exxon v. State,* 40 P.3d 786 (Alaska 2001). While the parties to this appeal all generally agree with this principle, they have considerable disagreement as to which of the current regulations are consistent, and which are inconsistent, with the PTUA and former regulations.

1. 11 AAC 83.374 is not applicable when the basis for termination is the rejection of a plan of development, as opposed to failure to comply with an approved unit agreement.

One regulation at issue that was adopted after the PTUA, 11 AAC 83.374(d), specifies that if the Division determines that a default has occurred with respect to a unit in which there is a certified well, "the commissioner will, in his discretion, seek to terminate the unit agreement by judicial proceedings." This regulation was the focus of the stay proceedings in this case earlier this year, although at that time the parties had not addressed the fact that this regulation was adopted in 1981, after the PTUA's effective date of 1977.

This regulation is cited in the agency's decisions in this case only in the Decision on Reconsideration. There, the Acting Commissioner referenced the regulation, but indicated that the unit termination "is an appropriate DNR action which facilitates court review" and could be undertaken "[r]egardless of whether the unit contains certified wells." [R. 9292] Although the parties have provided extensive analysis of this statute in their briefing to this court, it does not appear that DNR relied upon this regulation as the basis for its termination decision.

11 AAC 83.374(a) provides that the "failure to comply with ... any plans of exploration, development or operation which are a part of the unit agreement, is a default under the unit agreement," thereby making the balance of that regulation applicable. As Exxon noted in its briefing to the agency on appeal of the Director's Amended Decision in November 2006, "failure to receive DNR approval of a plan of development does not constitute default under DNR regulations. . . " Instead, as noted by Exxon, "11 AAC 83.374(a) provides that failure to comply with the terms of an *approved* plan of development is a default under the unit agreement, not the failure to obtain approval." [R. 705, emphasis added]

Similarly, the Alaska Gasline Port Authority, in its amicus brief, has asserted that Section 374 should not apply in this case, where the issue is the agency's rejection of a proposed plan of development, as opposed to a lessee's failure to comply with an approved plan of development. [Amicus Br. at 29] In this court's view, upon close reading of the regulation, that position, espoused

both by Exxon in 2006 and by the Port Authority before this court, has merit. 11 AAC 83.374(a) does not apply to cases such as this in which DNR has rejected a proposed plan of development.

Moreover, even if the rejection of a modified plan of development were to constitute a "default" under Section 374, then that regulation would be inconsistent with the unit agreement, to the extent that this more recent regulation imposes a requirement of judicial termination proceedings that was not administratively or statutorily required in 1977.

The Appellants assert, however, that even if inconsistent with the PTUA, the 1981 regulation should nonetheless apply to the PTUA, because this later-enacted regulation impairs only DNR's rights, not the private parties to the PTUA, and is thus binding on the State so as to require judicial termination proceedings. In response to this court's request for supplemental briefing, the Appellants have asserted that under Alaska law, "[r]egulations that benefit those who are regulated are applied retroactively even if inconsistent with previous regulations." [CPA Supp. at 4] In support of this proposition, the Appellants cite to Atlantic Richfield Company v. State, 705 P. 2d 418, 424, n. 17 (1985). But in this court's view, the Appellants are reading the cited footnote in the *Arco* decision too broadly. In that case, the retroactive interpretation of a regulation was the only way in which that newly enacted regulation could be "meaningfully applied," such that the Supreme Court found an intent by the Department for that regulation to have retroactive effect. *Id.* Absent such unique circumstances, which are not

present here given the expected continuing creation of unit agreements throughout Alaska, neither the State nor the Appellants should be bound by subsequent regulations that are inconsistent with the State's prior contractual agreement or regulations in effect at the time of contracting.

Because this court finds that 11 AAC 83.374 is inapplicable to this case, this court will not issue a final determination with respect to DNR's purported "decertification" of the wells. As noted in the Commissioner's Decision on Reconsideration, [t]he certified well finding [was] not the basis of the November 27, 2006 unit termination decision." [R. 9289] In light of this court's rulings as set forth above, a decision on the decertification question is no longer essential to resolving the issues presented in this particular appeal. The Supreme Court instructs that an appellate court should generally not resolve legal issues when they are rendered moot. *Clark v. State, Dept. of Corrections*, 156 P.3d 384, 347 (Alaska 2007). Accordingly, apart from this court's statements on the decertification issue as set forth in the Order re Motion for Stay dated May 1, 2007, no further opinion on the propriety of the purported decertification of the seven wells is expressed by this court.

2. Does 11 AAC 83.336(a)(1) apply?

The State and Port Authority have advanced a different current regulation to support DNR's termination decision -- 11 AAC 83.336(a)(1). This regulation, adopted in 1981, provides as follows:

> A unit agreement becomes effective upon approval by the commissioner and automatically terminates five years from the

> effective date unless (1) a unit well in the unit area has been certified as capable of producing hydrocarbons in paying quantities, in which case the unit agreement will remain in effect for so long as hydrocarbons are produced in paying quantities from the unit area, or for so long as hydrocarbons can be produced in paying quantities and unit operations are being conducted in accordance with an approved unit plan of exploration or development, or, should production cease, for so long after that as diligent operations are in progress to restore production and then so long after as unitized substances are produced in paying quantities...

This regulation is not referenced anywhere in the Commissioner's termination decision or in the Decision on Reconsideration. But the State asserts on appeal that although the specific reference to the regulation to support the unit termination was not made at the agency level, the requisite elements of the regulation to support termination are all "contained within the findings made by the Commissioner." [10/5/07 Oral Arg. Transcript at 36]

On appeal, the State and the Port Authority assert that Section 336 is "essentially a habendum clause," such that if a plan of development is not approved, "the failure means [the] Unit Agreement simply terminated." [State's Br. at 95] In response, the Appellants assert that Section 336(a) "is inconsistent with the PTU Agreement and the effective date regulations and thus cannot apply in this case." The inconsistency, in their view, is that Section 336 would "graft onto the PTU Agreement a new event of termination: DNR approval of a plan of development." [CPA Reply at 28; *see also* Jt. Reply at 25] The Appellants correctly note that Section 20(c) of the PTUA contains no reference to an agency-approved plan of development as a condition for the unit agreement to remain in effect.

DNR notes that Section 20(c) of the Agreement was modified in 1985, and asserts that "because the PTUA modification occurred after the promulgation of section 336, Article 20(c) [of the PTUA] must conform to the [1981] regulation" [State's Br. at 98, n. 172; *see* R. 787-795] But the Appellants note that Section 1 of the PTUA was not amended in 1985. That section precludes the application of inconsistent regulations enacted after the effective date of the PTUA. This court finds the Appellants' assertion on this point persuasive. [Jt. Reply at 26] The 1985 amendments did not graft onto the PTUA the provisions of 11 AAC 83.336(a).

Section 336, as interpreted by the parties in this case, would result in the *automatic* termination of the PTUA whenever a proposed unit plan was rejected by the DNR. As such, it is inconsistent with the PTUA and the regulations that were in effect when the PTUA was executed in 1977. For although, as discussed by this court in the preceding portion of this opinion, DNR may seek to administratively terminate the PTU, neither the PTUA nor the applicable regulations and statutes in effect in 1977 permitted an automatic termination whenever a POD was unacceptable to the State. At oral argument, counsel for the State asserted that Section 336 was not inconsistent with the PTUA, because "[a]n acceptable plan of development is an express condition contained with the Point Thomson Unit Agreement." [10/5/07 Oral Arg. at 48] The State noted that Section 10 of the PTUA accords to the Director the authority to specify a plan of development that "shall be as complete and adequate as the Director may

determine to be necessary for timely development and proper conservation of the oil and gas resources of the unitized area." [R. 1260] As discussed above, this court has found that this provision of the contract accords to DNR the administrative authority to reject proposed plans of development. But rejection of a proposed plan of development does not result in automatic termination under the PTUA. Rather, a separate administrative determination as to the appropriate remedy is required in such instance. To the extent Section 336 would permit the automatic termination of the PTUA whenever a POD was rejected by the State, it is inconsistent with the PTUA and inapplicable to this unit.

E. The Appellants' Right to Due Process

The right to due process, under both the state and federal constitutions, prohibits the State from depriving any person of "life, liberty, or property, without due process of law." U.S. Const. amend. XIV, § 1; Alaska Const. Art. I, §7. The State acknowledges that the Appellants are entitled to due process with respect to their interests at Point Thomson. [State's Br. at 99]

The Appellants assert that their due process rights were violated when the Commissioner terminated the PTU on appeal from the Director's Decision. They assert that the only issues over which the Commissioner had jurisdiction were whether the Director had properly rejected the 22nd POD and whether the modified POD should be approved. [Exxon Br. at 47] The Appellants maintain that the Director's Decision, which stated simply that "[f]ailure to submit an acceptable plan of development is grounds for termination of the PTU," was

inadequate to notify the Appellants that the Commissioner would terminate the PTU in the administrative appeal. [*Id.* at 50]

The State maintains that the Appellants were accorded adequate notice and an opportunity to be heard. It notes that the Commissioner indicated to the Lessees that his review would "cover both the appeal from the October 27, 2005 decision and the proposed cure." [R. 664; State's Br. at 101] It asserts that the Appellants "knew that a rejection of the POD and an affirmation of the default finding could lead to the determination of what remedy was appropriate as a result of the affirmation." [State's Br. at 101] And yet the State has also acknowledged that termination of the unit is only "one possible remedy" when a proposed POD is not acceptable to the Director. [*Id.* at 105]

The State also asserts that any alleged due process violations in connection with the unit termination decision were cured by the reconsideration process before the Commissioner that was pursued by two of the Appellants, ExxonMobil and ConocoPhillips. In support of this argument, the State cites to *State, Dept. of Natural Res. v. Greenpeace*, 96 P.3d 1056 (Alaska 2004), in which the Alaska Supreme Court held that any alleged procedural due process violations in that case were cured by according the objecting party an opportunity to be heard on reconsideration. Yet as Appellants note, BPXA and Chevron did not seek reconsideration before the Commissioner. [Jt. Reply at 19]. And, unlike the situation in *Greenpeace*, the Appellants here were not accorded an opportunity to fully contest the challenged decision on reconsideration. [*Id.* at 20]

Instead, the reconsideration motion and decision were primarily focused on the decertification issue, not the termination decision. [*See* R. 9288, 9291]

The Alaska Supreme Court's decision in *White v. State, Dept. of Natural Resources*, 984 P.2d 1122 (Alaska 1999)(*White I*) is instructive on these issues. In that case, White had requested a hearing before DNR on a disputed factual issue with respect to an oil and gas lease. DNR refused to grant him a hearing on the issue. The Supreme Court reversed and remanded, and held that the due process clause accorded to White the opportunity for a hearing on that issue before an agency determination was made that precluded the automatic extension of the lease. 984 P.2d at 1128.

Likewise, albeit in a quite different context, the Supreme Court found that a trial court had violated a parent's right to due process when the trial court entered a *permanent* child custody order after conducting a hearing that had been scheduled to determine *interim* custody. *Cushing v. Painter*, 666 P. 2d 1044, 1046 (Alaska 1983). Due process requires that parties are accorded "sufficient written notice, specifying the nature of the dispute and the relief requested." *Hickel v. Halford*, 872 P.2d 171,180 (Alaska 1994).

Here, the State did not seek termination under Section 20(c) of the PTUA. Rather, it sought to terminate the unit after it rejected the Appellants' proposed Plan of Development. Nothing in the PTUA nor the regulatory framework in place in 1977 mandated or authorized automatic termination of the unit when DNR rejected the proposed POD. And while this court has concluded that the

PTUA and then-existing regulations did not preclude DNR from pursuing termination at the administrative level, the Appellants were constitutionally entitled to a clear written notice that DNR was considering this remedy when it rejected the POD, and should have been accorded the opportunity to be heard with respect to the appropriate remedy when the modified 22nd POD was rejected. *See generally* former 11 AAC 88.155. The Director's statement that "[f]ailure to submit an acceptable plan of development is grounds for termination of the PTU" is not constitutionally adequate notice that a termination would be administratively declared by the Commissioner on appeal of the Director's Decision rejecting the 22nd POD.

Accordingly, this matter is remanded to the DNR for the purpose of according to the Appellants a hearing on the appropriate remedy to the State upon DNR's rejection of the proposed 22nd Plan of Development. On remand, the agency should also consider the import of Section 21 of the PTUA, as amended in 1985, in determining the appropriate remedy.

III. The Expansion Leases

A separate component of the administrative determinations focused on the Expansion Agreement entered into in 2001 between the Appellants and the State. That agreement expanded the PTU on the condition that the PTU Lessees performed certain work at the PTU and put the unit into production with at least seven development wells by 2008. [R. 5678] The agreement also provided that

if the Lessees failed to perform the work in a timely manner, the expansion leases would automatically contract out of the unit and the Lessees would owe DNR certain sums of money. [*Id.*]

The Appellants did not complete the work contemplated under the Expansion Agreement. Instead, in October 2006, ExxonMobil proposed a modification of the Expansion Agreement. DNR characterized the proposed modification as allowing it "to retain the most valuable portions of the Expansion Acreage without putting the unit into production." [R. 5680]

In the Commissioner's November 2006 decision, the Lessees' request to modify the Expansion Agreement was denied. The Commissioner's decision also stated that "the state is entitled to have the Expansion Leases back and to receive payment." [R. 5688-89]

The Appellants originally appealed this aspect of the Commissioner's decision, but later abandoned this particular claim and in June 2007 paid the State the $20,000,000 payment plus interest then due as specified in the Expansion Agreement. On October 19, 2007, the Appellants filed a motion to dismiss the claims on appeal with respect to the Expansion Agreement. The State filed a partial opposition to the motion, disputing the language in the proposed order on these claims. Specifically, the Appellants' proposed order simply provided that all claims regarding the Expansion Agreement "are hereby dismissed as expressly abandoned by all Appellants and, in the alternative, as moot." The State's proposed order was broader, and sought to affirm a final

agency decision, effectively returning the expansion leases to the State. In reply, the Appellants asserted that the language from the Commissioner's decision that "the state is entitled to have the Expansion Leases back" should be considered dicta, and not a final agency determination with respect to the underlying leases in the expansion acreage. [R. 5689]

This court agrees with the Appellants that the validity of the leases encompassed within the expansion acreage was not directly before the Commissioner in this administrative proceeding, and thus is not properly before this court on appeal. With respect to mootness, this court agrees with the State's position that the claims related to the Expansion Agreement are more properly characterized as dismissed rather than moot.

Accordingly, with respect to the Expansion Agreement claims, all of the Appellants' claims concerning the Expansion Agreement are hereby dismissed as they have been expressly abandoned by all Appellants.

//

//

//

//

//

//

//

//

Conclusion

DNR's rejection of the Lessees' proposed modified 22nd Plan of Development, including DNR's interpretation of Section 10 of the Point Thomson Unit Agreement, is affirmed.

DNR's determination as set forth in the Commissioner's Decision and the Decision on Reconsideration that terminated the Point Thomson Unit is reversed and remanded, so as to accord to the Appellants notice and an opportunity to be heard before the agency as to the appropriate remedy when the Department has rejected the proposed modified 22nd Plan of Development for the Point Thomson Unit.

All of the Appellants' claims concerning the Expansion Agreement are dismissed as they have been expressly abandoned by all Appellants.

Dated this 26th day of December, 2007.

Sharon Gleason
Judge of the Superior Court

I certify that on 12-26-07 a copy of the above was mailed/faxed to each of the following at their addresses of record

Judicial Assistant

AG- Todd
Ashburn / crosby
or crosby
Keithley
Serdahely
Rozell

Dawn
Ellis
Ballew / Ashley / Haynes / Phillips
Sneed

Exc. 000580