STATE OF ALASKA

DEPARTMENT OF NATURAL RESOURCES
550 W. 7th Avenue, Suite 1400
Anchorage, Alaska 99501



In re Remand Proceedings Pursuant to December 26, 2007 Order of Superior Court Regarding Point Thomson Unit Agreement

# BRIEF OF EXXON MOBIL CORPORATION, BP EXPLORATION (ALASKA) INC., CHEVRON U.S.A. INC. AND CONOCOPHILLIPS ALASKA, INC. ON REMAND BY SUPERIOR COURT ORDER DATED DECEMBER 26, 2007

## I. INTRODUCTION

Judge Gleason ruled that DNR violated the Owners' due process rights in terminating the PTUA. Op. 39-42. She remanded to 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." Op. 42. She specifically instructed DNR to "consider the import of Section 21 of the PTUA, as amended in 1985, in determining the appropriate remedy." *Id.* DNR, however, has given notice only that it "is considering the appropriate remedy for failure to submit an acceptable plan" and "is specifically considering the remedy of termination of the Point Thomson Unit."[1]

As a matter of law, termination is not an "appropriate remedy to the State upon DNR's rejection of the proposed 22nd Plan of Development." Op. 42. There has been no default under the PTUA, and even if DNR rejection of the proposed 22nd POD were a default, it would not be a material default. Absent a material default, termination is not

[1] Commissioner's January 3, 2008 letter.

an appropriate remedy. Lessees are ready, willing, and able to perform their obligations under the PTUA. Moreover, even if there were a material default, Alaska law requires DNR to select a remedy that avoids forfeiture of the Owners' interests in the PTUA and the PTU leases. Such alternatives are available to DNR.

One proper remedy would be for DNR to accept the new development proposal[2] the Owners have submitted with this filing. Approval of the development proposal would resolve a number of serious procedural issues, and would achieve the delineation and production that DNR has stated are its primary objectives.

Alternatively, if DNR rejects or proposes modifications to the Owners' development proposal because DNR seeks to further accelerate the rate of prospecting and development, DNR must (i) specify criteria of acceptability consistent with the PTUA and applicable law, and (ii) permit the operator to accept the proposed modifications, or submit within a reasonable time a plan for PTU development and operation that satisfies those criteria. DNR must, however, "consider the import of Section 21 . . . in determining the appropriate remedy." Op. 42. If DNR's criteria would alter or modify the rate of PTU prospecting and development, then DNR must comply with Section 21 procedural requirements and DNR's acceptability criteria must conform to Section 21 substantive limitations.

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2 *See* "Point Thomson Plan of Further Development and Operations for the Period October 1, 2005 to December 31, 2014," appended hereto as Attachment "A."

The Owners respectfully submit that Alaska law and Judge Gleason's opinion prohibit termination when a lesser remedy is available and, therefore, compel DNR to implement one of these two remedies – accept the Owners' new development proposal or commence Section 21 proceedings to alter the rate of prospecting and development. Ordering administrative termination of the PTUA is not in the public interest and would lead only to years of delay and uncertainty.

## II. DNR HAS NOT FOLLOWED THE SUPERIOR COURT'S DIRECTIONS

### A. The Procedures Set Out in the Commissioner's January 3, 2008, and January 28, 2008 Notices Do Not Comply With Either the Superior Court's Decision or Section 21

Judge Gleason found that DNR's rejection of a POD does not constitute a default by the Owners under the PTUA (Op. 34), and that termination is neither an automatic nor a mandatory remedy when a POD is rejected. Op. 41. Instead, she specifically instructed DNR to "consider the import of Section 21 of the PTUA, as amended in 1985, in determining the appropriate remedy[,]" and rejected DNR's contention that Section 21 does not apply.[3] Op. 42.

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[3] Judge Gleason's opinion notes:

> 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. Op. 9 n.3.

Section 21 provides in pertinent part:

> [T]he Director is also hereby vested with authority to alter or modify from time to time at his discretion the rate of prospecting and development . . . under this agreement when such alteration 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.
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> 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 thirty (30) days from notice . . . .

Section 21 thus imposes on DNR, as a condition of exercising its power to modify the rate of PTU development, the duties: (i) to give notice to the Unit Operator of the Director's intent to exercise his power to modify the rate of PTU development, (ii) to provide an opportunity to be heard on that intended exercise of power, and (iii) to provide not less than 30 days notice of that opportunity to be heard.

Section 21 does not require the Operator to submit a new POD. Rather, it obligates the Director to provide notice and a hearing on specific prospecting and development activity and the timing of it. To the extent that it was intended to comply with Section 21, the Commissioner's recent indication that an acceptable POD must "fully delineate all PTU reservoirs[,]" and "commit to full and timely development of all PTU reservoirs, including gas, gas condensate, and oil"[4] is not sufficient notice to the Owners of what DNR proposes. It gives the Owners no meaningful guidance regarding what DNR would require them to do and when they would be expected to do it. This

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[4] Commissioner's January 28, 2008 letter at 3.

deficiency is compounded by the Commissioner's statement that any reliance the Owners place on prior DNR statements and proceedings would be "unreasonable."

The Director's September 30, 2005 Initial Decision purported to comply with the procedural requirements of Section 21. It acknowledged the need for notice and an opportunity to be heard on the Director's intent to modify the rate of PTU development:

> This decision provides notice under Article 21 of the PTU Agreement that Exxon must initiate development operations within the PTU by October 1, 2007. The Division will contact Exxon to schedule a hearing on this issue, which will be held not less than 30 days from the date of this decision.[5]

The Director also provided a specific list of the changes in the rate of prospecting and development that he believed would be included in an acceptable POD.

The Director reversed course less than a month later in his Amended Decision, in which he dismissed Section 21 with the cryptic assertion that "all references to [Section] 21 . . . do not apply to the Division's evaluation of the Unit Operator's proposed plans for development of the Point Thomson Unit[,]"[6] but he still acknowledged that he was changing the rate of prospecting and development:

> The Director has the authority to modify the rate of development to achieve the conservation objectives under the PTU Agreement, and I find that increasing the rate of development in the PTU is necessary and advisable.[7]

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5 Initial Decision at 2 [R. 12334].

6 Amended Decision at 2 [R. 12282].

7 Amended Decision, Finding B ("Promote the Prevention of Economic and Physical Waste"), at page 21.

The Superior Court recognized that DNR's Initial Decision correctly acknowledged the applicability of Section 21. Op. 9 n.3. Accordingly, the proper remedy here is either to approve the Owners' new development proposal or to fashion a remedy that conforms to the procedural and substantive requirements of Section 21.

Absent consent of the parties, Alaska statutes provide DNR no statutory authority to change the rate of prospecting and development outside of Section 21:

> The commissioner may, with the consent of the holders of leases involved, establish, change, or revoke drilling, producing, and royalty requirements of the leases and adopt 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 the commissioner determines necessary or proper to secure the proper protection of the public interest.[8]

However, when a unit agreement covers lands owned by the State, AS 38.05.180(p) allows the State to include a provision vesting itself with authority to modify from time to time the rate of development:

> A plan . . . which includes land owned by the state, may contain a provision vesting the commissioner . . . with authority to modify from time to time the rate of prospecting and development . . . under the plan.[9]

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[8] AS 38.05.180(p) (emphasis added). Aside from minor revisions not pertinent here, this provision of the Alaska Land Act was in effect on the effective date of the PTU Agreement, August 1, 1977, as former AS 38.085.180(m), and dates back to statehood. § 3(7), art. VIII ch 169 SLA 1959. See *Exxon Corp. v. State*, 40 P.3d 786, 796 (Alaska 2001) ("[Exxon] also notes that the department has no statutory authority to alter a unit agreement without consent by the contracting parties[,]") (citing AS 38.05.180(p)).

[9] AS 38.05.180(q) (formerly AS 38.05.180(n)). A subsequently repealed regulation granted the Commissioner the same authority. Former 11 AAC 83.315, Register 51, (see Attachment 1), repealed 1981, Register 78.

The PTUA provision "vesting the commissioner . . . with authority to modify from time to time the rate of prospecting and development" is Section 21. To invoke Section 21, DNR must conduct a hearing and carry its burden of going forward with the evidence, as well as its burden of ultimately proving that its intended acceleration of PTU development "is in the interest of attaining the conservation objectives stated in the [PTUA] and is not in violation of any applicable state law," and that it does not violate the substantive requirements of the 1985 amendment to Section 21.[10] Since Judge Gleason has rejected DNR's contention that Section 21 does not apply in these circumstances, and has directed DNR to consider it, the appropriate remedy is for DNR to approve a new POD, using its powers under Section 21, if necessary.

The Commissioner's January 3, 2008 letter, and subsequent January 28, 2008 letter do not initiate a process under Section 21 to change the rate of prospecting and development, even though the desire to force a change was an asserted basis for DNR's rejection of the PODs submitted by the Operator. The Commissioner's letters do not state that DNR is considering a remedy through the exercise of its authority under Section 21, as the Superior Court instructed, or what that remedy would entail. And they do not state the reasons, if any, that DNR

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10 *See State, Alcoholic Beverage Control Bd. v. Decker*, 700 P.2d 483, 485 (Alaska 1985) ("Ordinarily the party seeking a change in the status quo has the burden of proof.") (citing 2 K. Davis, Administrative Law Treatise, § 14.14 (1958)); *Sloan v. Jefferson*, 758 P.2d 81, 83 (Alaska 1988) ("The party asserting a fact generally bears the burden of proving that fact.").

refuses to implement a remedy under Section 21. This is contrary to the Superior Court's instruction to DNR to consider a Section 21 remedy, regardless of any briefing by the Owners. In response to that instruction, DNR has instead constructed a procedure that ignores Section 21.

### B. DNR's Hearing Procedures Do Not Meet the Requirements of Due Process

Under both the Alaska Constitution and the United States Constitution, the Owners are entitled to procedural due process during the administrative hearing on remand, particularly where that proceeding may involve administrative termination of vested property rights. *See State, Dept. of Health & Social Services v. Valley Hosp. Ass'n, Inc.*, 116 P.3d 580, 583 (Alaska 2005) ("The requirements of the Alaska Constitution's due process clause, Article I §7, apply in an administrative setting."). The Alaska Supreme Court also has held that "the crux of due process is the opportunity to be heard and the right to adequately represent one's interests." *Groom v. State, Dept. of Transp.*, 169 P.3d 626, 635 (Alaska 2007). Given these standards, DNR's notice and procedures deprive the Owners of their due process rights because DNR is providing the Owners no meaningful opportunity to be heard and to adequately represent their interests.

### C. DNR's Notice is Insufficient

As Judge Gleason stated in holding that DNR's unit termination decision violated the Owners' due process rights: "Due process requires that parties are accorded 'sufficient written notice, specifying the nature of the dispute and the relief requested.'" Op. 41, citing *Hickel v. Halford*, 872 P.2d 171, 180 (Alaska 1994). DNR's notice here,

which consists of the Commissioner's January 3, 2008 and January 28, 2008 letters, informs the Owners only that DNR is considering the remedy of termination. It does not provide the Owners with notice of the legal or factual basis DNR relies upon for any potential unit termination, or alleged breach or default, the standard DNR will apply in deciding whether termination is proper or necessary, or the reasons DNR is considering termination in the remand proceedings. Nor does it give notice of other remedies DNR may be considering, if any. These failings are particularly stark in light of the Superior Court's specific instruction that DNR consider the impact of PTUA Section 21.

The Alaska Supreme Court has held that the "crux of due process" is "the right to adequately represent one's interests,"[11] and that a three-part balancing test must be applied to determine whether administrative procedures satisfy due process. *See Valley Hosp. Ass'n, Inc.*, 116 P.3d at 583. The factors to be considered are: the private interest affected, the risk that the procedures used will cause erroneous deprivation of that interest, and the Government's interest, including the burdens that a different procedure would entail. *Id.* Under this balancing test, DNR's notice is insufficient.

First, the private interest that will be affected is the Owners' interest in the Unit. This is a property right in which the Owners have made a substantial investment. *See ConocoPhillips Alaska, Inc. v. State, Dept. of Natural Res.*, 109 P.3d 914, 924 (Alaska 2005). Second, DNR's failure to give notice of the potential basis of a termination decision creates a substantial risk that the Owners will be erroneously deprived of their

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[11] *Groom v. State, Dept. of Transp.*, 169 P.3d 626, 635 (Alaska 2007).

interests. That is, DNR has placed the Owners in the untenable position of speculating as to the reasons DNR may deem termination (or some other relief) to be the appropriate remedy. Finally, the burden of giving adequate notice is minimal or non-existent. Presumably, if DNR proceeds with administrative termination, it will at some point disclose the standard it is applying and the legal and factual basis for its decision. Providing that information in advance of the hearing on remand, as due process requires, imposes no additional burden on DNR and is essential if the Owners are to have a meaningful opportunity to be heard.

### D. DNR's Refusal to Provide a Complete Record or Permit Cross-Examination Deprives the Owners of Due Process

DNR's refusal to provide the basic information requested in the Owners' January 18, 2008 letter violates the Owners' due process rights. The Owners must be able to obtain complete information from DNR regarding the basis for the proposed termination decision. The Alaska Supreme Court has held that "a fair and meaningful hearing, as required by due process, does require that the parties be given adequate access to information requested in discovery." *Dougan v. Aurora Elec. Inc.*, 50 P.3d 789, 796 (Alaska 2002).

The DNR notices state that DNR intends to consider whether termination is an appropriate remedy. Yet, the notices do not even identify, let alone support, any alleged breach or contractual basis for termination. Further, DNR's procedure indicates that DNR will not present any case of its own, and that it intends only to hear the Owners on the reasons termination should not occur. This reverses the burden of proof and also fails

to comport with minimum due process.[12]

The Owners also should be permitted to cross-examine DNR staff about their opinions, conclusions and recommendations that they have provided, or intend to provide, to the Commissioner. The Alaska Supreme Court has recognized that the right of cross-examination can protect substantial rights without a significant burden on the state. *See ConocoPhillips Alaska, Inc.*, 109 P.3d at 924. Depriving the Owners of their right to represent their interests through cross-examination of DNR staff deprives the Owners of their due process rights.

## III. THE PROPOSED DEVELOPMENT OPTION SATISFIES DNR'S STATED OBJECTIVES AND SHOULD BE ADOPTED

Despite the serious procedural issues discussed above, the Owners have made extraordinary efforts in the time available, and are presenting a new development proposal for the PTU. DNR should adopt this proposal. It is consistent with the Owners' obligations under PTUA Section 10, and meets the requirements of Section 21, as amended. Adoption of the Owners' development proposal would resolve all of the procedural issues discussed above.

## IV. SECTIONS 10 AND 21 OF THE PTUA IMPOSE SUBSTANTIVE AND PROCEDURAL LIMITS ON ANY MODIFICATIONS TO THE DEVELOPMENT PROPOSAL DNR MAY ORDER

If DNR adopts the new plan that the Owners have proposed, there will be no need to consider the issues discussed here: the Owners agree that the new plan submitted meets

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[12] *See supra* note 9.

the requirements of Sections 10 and 21. But if DNR should order modifications to the Owners' plan to further increase the rate of development, then the legal issues discussed in this section would become important. As demonstrated below, both Section 10 and Section 21 of the PTUA provide explicit limits on what development DNR may order.

### A. Section 21 Places Substantive Limitations on DNR's Power to Impose Modifications to a Development Proposal

The Superior Court specifically directed DNR to consider Section 21 of the PTUA when determining the appropriate remedy. Op. 42.

Section 21 authorizes DNR to direct the Operator and other lessees "to alter or modify . . . the rate of prospecting and development" in the Unit, under specified circumstances. However, DNR's authority is limited in three important ways: (1) DNR may only alter the rate where it "is in the interest of attaining the conservation objectives stated in [the PTUA] . . . [;]" (2) DNR may not "require any increase in the rate of prospecting, development or production in excess of that required under good and diligent oil and gas engineering and production practices . . . [;]" and (3) DNR may not "prevent [the PTUA] from serving its purpose of adequately protecting all parties in interest." R. 1448. The last two limitations were added in 1985, when DNR agreed to an amendment of the PTUA. R. 15426

*Conservation Objectives.* Section 21 distinguishes those changes that DNR may impose either in the public interest, or in the interest of conservation objectives, from those that DNR may impose only in the interest of conservation objectives:

> The Director is hereby vested with authority to alter or modify . . . the quantity and rate of production under this agreement . . . such authority being hereby limited to alteration or modification in the public interest . . . . [T]he Director is also hereby vested with authority to alter or modify . . . the rate of prospecting and development and the quantity and rate of production under this agreement when such alteration or modification is in the interest of attaining the *conservation objectives* stated in this agreement . . . ."[13]

While Section 21 allows DNR to alter the rate of *production* in the public interest or in the interest of conservation objectives, the only basis on which the Director may modify the rate of *prospecting and development* of the PTU is "in the interest of attaining the conservation objectives stated in [the PTUA]." Those conservation objectives are stated in Section 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.[14]

DNR thus can impose an involuntary increase in the rate of prospecting and development only as necessary to attain the most economical and efficient recovery of unitized substances without waste. This limitation exists because such an undertaking would be for the benefit of the State, but the resulting substantial costs would be at the sole risk of the Owners.

In the record to date, DNR has justified accelerated exploration and development as "in the interest of attaining the conservation objectives stated in [the PTUA]" only by

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13 R. 1268 (emphasis added).

14 The term "waste" is in turn defined in AS 31.05.170(15)(A).

its observation that "[g]as cycling theoretically allows the recovery of significantly more liquids than would be recovered in a pure gas blow down projection" and its conclusory statement that "delaying timely production also constitutes waste."[15] This hardly begins to meet DNR's burden of proving the conservation justification for accelerated prospecting and development.[16] That burden requires DNR to prove that its modified rate of prospecting and development "provide[s] for the most economical and efficient recovery." PTUA Section 16.

*Good and diligent oil and gas engineering and production practices.* DNR must establish that any increases in the rate of prospecting and development it requires are consistent with good and diligent oil and gas engineering and production practices. PTUA Section 21. It must also demonstrate that any remedy "provides[s] for the most economical and efficient recovery." PTUA Section 16. It has not even purported to identify, let alone support, such a remedy.

In short, while DNR may, following proper notice, direct lessees to increase the rate of prospecting, development, and production, DNR may not require lessees to take steps that a reasonably prudent operator would deem unreasonable. But regardless of whether DNR purports to apply the reasonably prudent operator standard, DNR must establish that any increases in the rate of prospecting and development it requires are

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15 Amended Decision, Finding B ("Promote the Prevention of Economic and Physical Waste"), at 21 [R. 647].

16 *See supra* note 9.

consistent with good and diligent oil and gas engineering and production practices.

*Adequately Protecting All Parties in Interest.* Section 21 also prohibits the Director from exercising the authority it provides in a manner that would prevent the PTUA from "serving its purpose of adequately protecting all parties in interest [to the PTUA]."[17] This safeguards the Owners against the risk that DNR, as the decision-maker under Section 10, may impose a rate of prospecting and development that may benefit DNR, as holder of the royalty interest, but at the sole risk of the Owners, who alone bear the large expense incident to oil and gas prospecting and development, as well as the risks of operations, reservoir performance, and market pricing.

This contractual limitation on DNR's power to accelerate the rate of prospecting and development serves the same purpose as common law limitations on the lessee's duty to develop under an oil and gas lease:

> The large expense incident to the work of exploration and development, and the fact that the lessee must bear the loss if the operations are not successful, require that he proceed with due regard to his own interests, as well as those of the lessor. No obligation rests on him to carry the operations beyond the point where they will be profitable to him, even if some benefit to the lessor will result from them. It is only to the end that the oil and gas shall be extracted with benefit or profit to both that reasonable diligence is required. . . .

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17 [R. 15426] This contractual limitation conforms with statutory limitations on the Director's authority to impose exploration and development requirements under a unit agreement. When the PTUA was first entered into, the only statute or regulation that mentioned plans of development was former AS 38.05.180(m), which was essentially identical to current AS 38.05.180(p). This statute provides that DNR may require the operator of an oil or gas unit to operate in accordance with a "reasonable" unit plan of operation, which must "adequately protect all parties in interest, including the state."

> Whatever, in the circumstances, would be reasonably expected of operators of ordinary prudence, having regard to the interests of both lessor and lessee, is what is required.

*Brewster v. Lanyon Zinc Co.*, 140 F. 801, 814 (8th Cir. 1905). Just as the lessee must protect both its own and the lessor's interests in determining its duty to develop under an oil and gas lease, so too under Section 21 must DNR protect the lessees' interests, as well as its own, when altering the rate of development in the interest of attaining conservation objectives. This is the balance DNR must strike to adequately protect the interests of all parties.

This contractual limitation is buttressed by statutory limitations on the Director's authority to impose exploration and development requirements under a unit agreement. When the PTUA was first entered into, the only statute or regulation that mentioned plans of development was former AS 38.05.180(m), which was essentially identical to current AS 38.05.180(p). This statute provides that DNR may require the operator of an oil or gas unit to operate in accordance with a "reasonable" unit plan of operation, which must "adequately protect all parties in interest, including the state." The statute prohibits DNR from requiring a rate of exploration or development that does not adequately protect the Owners' interests, as well as those of the State.

Accordingly, by statute as well as contract, DNR can mandate an accelerated rate of prospecting and development only if it protects the interests of the Owners, as well as those of the State. Those interests include the economical and efficient recovery of unitized substances. To date, DNR has disregarded the Owners' interests. In his

Amended Decision, the Director considered only the interests of the State in accelerated prospecting and development.[13] DNR must prove that any modified rate of prospecting or development it may impose protects the Owners' interests as well as those of the State.

### B. Section 10 of the PTUA Requires That Any POD Imposed by DNR Must Meet the Reasonably Prudent Operator Standard

Judge Gleason agreed with DNR that the Commissioner is not required to apply the reasonably prudent operator standard in disapproving a POD that does not adequately protect the public interest. Op. 23-24. She based this ruling on Section 10's requirement that a proposed plan "shall be as complete and necessary as the Director may determine to be necessary for timely development and proper conservation . . . ."

The only issue before Judge Gleason, of course, was the Director's power to *reject* a proposed POD. The court did not rule that DNR has the power to impose a POD or rate of development in disregard of the reasonably prudent operator standard. Section 10 says that an approved POD "shall constitute the further drilling and operating obligations of the Unit Operator under this agreement," and it also expressly requires the Unit Operator to "develop the unit area as a reasonably prudent operator in a reasonably prudent manner." It follows that any approved plan must comply with the reasonably prudent operator standard. Both of these Section 10 provisions must be given effect. As the Alaska Supreme Court, interpreting the Prudhoe Bay Unit Agreement, explained, "[a] court should not interpret an agreement in a manner which would give meaning to one

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[13] Amended Decision, Finding C ("Provide for the Protection of All Parties of Interest, Including the State"), at 21 [R. 000647].

part of an agreement at the cost of annulling another part."[19] The "complete and adequate" provision, as interpreted by Judge Gleason, must be reconciled with the reasonably prudent operator standard by requiring not only that a POD be "complete and adequate," but also that it impose only reasonably prudent duties to develop.

The Owners do not contend here that any proposed plan that satisfies the reasonably prudent operator standard must be approved. They acknowledge that Judge Gleason has rejected that position.[20] What the Owners do contend, however, is that, should DNR order modifications to either of the PODs as a condition for approval, the resulting POD must satisfy the reasonably prudent operator standard and, to the extent that such POD alters the rate of prospecting and development, the requirements of Section 21.

In other words, Judge Gleason held that DNR's decision to reject a proposed POD cannot be reversed merely because the rejected POD satisfied the reasonably prudent operator standard. That is because DNR is entitled to reject such a plan if it does not adequately protect the public interest. But it does not follow that DNR may reject a POD that meets the objective standard of the reasonably prudent operator, and then impose modifications that result in a plan that does not. That would contradict the plain language

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19 *Exxon v. State*, 40 P.3d 786, 793 (Alaska 2001) (citing *Betz v. Chena Hot Springs Group*, 657 P.2d 831, 835 (Alaska 1982)); *Earth Movers, Inc. v. State, Dept. of Transp. & Pub. Facilities*, 824 P.2d 715, 717-18 (Alaska 1992) (interpreting contract based on document as a whole).

20 The Owners reserve their rights to appeal the Superior Court's December 26, 2007 Decision on Remand in its entirety, and do not waive such rights of appeal by participating in this proceeding in a manner consistent with the court's ruling.

of Section 10, as well as the Section 21 requirement that the interests of all affected parties receive adequate protection.

If DNR does not accept the Owners' new development proposal, it must prove at a hearing held on proper notice that any proposed modifications result in a plan that: (i) promotes conservation; (ii) is consistent with good and diligent oil and gas engineering production practices; and (iii) adequately protects the interests of both the State and the Owners.

## V. THERE HAS NOT BEEN A MATERIAL BREACH OF THE PTUA CONTRACT AND, AT A MINIMUM, DNR MUST CONSIDER THE OWNERS' DEVELOPMENT PROPOSAL

### A. The Owners Did Not Breach the PTUA by Proposing PODs That DNR Rejected

The PTUA is a contract between the State and the Working Interest Owners. *Exxon Corp. v. State*, 40 P.3d 786, 788 (Alaska 2001) ("A unit agreement is a contract between the department and lessees"). It has been in force for over 30 years, and it involves numerous reciprocal duties between and among the parties.

DNR's rejection of the proposed 22nd POD and the Modified POD does not establish a contractual breach. Section 10 of the PTUA calls for the Unit Operator to submit for approval of the Director "an acceptable plan of development and operation for the unitized land" within six months after completion of a successful discovery well under Section 9. That was done long ago. Thereafter, the Unit Operator is required to submit "a plan for an additional specified period" before the expiration of the then-current plan. The Owners did that over and over again.

Since 1977, twenty-one PODs for additional specified periods were submitted timely by the Unit Operator, and each was approved by the Director. The 22nd POD was timely submitted, but was rejected by the Director in 2005. But that rejection was an action taken by DNR and is not a contractual breach by the Owners.

In Section 10 the Unit Operator expressly covenants "to develop the unit area as a reasonably prudent operator in a reasonably prudent manner." DNR has never contended, and the Commissioner never found, that in submitting the proposed 22nd POD, the Owners did not meet the reasonably prudent operator standard. Instead, the Commissioner stated that he was disregarding the reasonably prudent operator standard, and that the Owners' interests in economics, adequate returns, and risk played no role in his November 27, 2006 decision. R. 5685.

Judge Gleason also did not discuss whether the proposed Modified POD satisfied the reasonably prudent operator standard, which was the Owners' contractual burden. Instead, she found that DNR could reject any POD submitted by the Owners that does not provide "adequate protection of the public interest . . . ." Op. 23. She further held that DNR rejection of the 22nd POD did not give rise to a default under 11 AAC 83.374(a). Op. 34. That regulation broadly defines "default":

> Failure to comply with any of the terms of an approved unit agreement, including any plans of exploration, development, or operations which are a part of the unit agreement, is a default under the unit agreement.

DNR rejection of the 22nd POD thus did not mean that the Owners had failed to comply with the terms of the PTUA. Accordingly, DNR's rejection of the Owners' proposed PODs does not place the Owners in breach.

### B. Any Delay Resulting From the Owners' Appeal of the Rejection Decision Did Not Result in a Breach

The Commissioner's decision not only affirmed the Director's rejection of the proposed POD, but decertified all existing PTU well certifications, and terminated the PTUA. Given those draconian actions, the Owners pursued an appeal to the Superior Court.

Ultimately, the Commissioner's decision on unit termination was reversed, while the decision rejecting the proposed Modified POD was affirmed. But during those proceedings DNR did not contend, nor did the Superior Court find, that the Owners had breached the PTUA.

There is no legal basis for contending that a contractual breach or a default resulted from any delay caused by the Owners' exercise of their legal rights to appeal the Commissioner's decision to the Superior Court precisely as Alaska law, including DNR's own regulations, allows.[21]

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[21] *Barby v. Cabot Petroleum Corp.*, 944 F.2d 798, 799 (10th Cir. 1991) (lessors' challenge to lessee's rights under the lease suspended the lessee's obligation to perform under the lease until that challenge was resolved, and this suspension of duties continued throughout the course of the litigation until the challenge was finally resolved). *See* PTUA Section 10 (after a valuable discovery, "no further wells . . . shall be drilled except in accordance with a plan of development approved as herein provided").

### C. Judge Gleason's Decision Clarifies When Termination Is an Appropriate Remedy

Judge Gleason's opinion established for the first time that DNR has discretion under Section 10's "complete and adequate" provision to reject a proposed plan even if formulated in accordance with the reasonably prudent operator standard. Implicit, if not explicit, in the opinion is the delicate interplay of responsibilities of the parties to the PTUA, and the judiciary, in that circumstance.

Clearly under Section 10, the unit operator has the initial burden to timely submit a plan for any additional period, and must act as a reasonably prudent operator in doing so. Under the "complete and adequate" provision of Section 10, DNR has discretion to reject such a proposal if it determines the proposal must be modified to effect "timely development and proper conservation." However, when DNR exercises its right of rejection, DNR has a corresponding responsibility to specify the modifications required (or possibly to give notice and a hearing regarding an increased rate of prospecting and development under Section 21) prior to undertaking administrative termination. The unit operator must then decide whether to accept DNR's modifications or challenge them through an appeal to the Superior Court. If DNR's position is challenged, but upheld by the courts, the Owners must then comply or be subject to a claim that their failure to comply is a material default justifying termination. That simply has not happened.

### D. Judge Gleason's Decision Recognizes That Termination at This Stage Is Neither Necessary Nor Appropriate

Judge Gleason's findings and explicit directions with respect to the remand

proceedings reflect a recognition that DNR has procedural options available to it that fall far short of the complete and final termination of the Owners' property rights. Since DNR has other options, termination is not legally permissible.

First. The Court rejected the proposition that Section 20(c) of the PTUA gave DNR any authority to determine whether the PTUA should be terminated. Op. 28. Rather, it is a habendum clause that specifies when the PTUA might *automatically* terminate. Equally, the Court held that, to the extent that 11 AAC 83.336 could be interpreted as providing for automatic termination because a POD had not been approved, it could not be applied because it is inconsistent with Section 20(c), which defines the circumstances where automatic termination may occur. Op. 39.

Second. The Court held that disapproval of a proposed POD did not amount to a "default" under the PTUA within the meaning of 11 AAC 83.374. DNR rejected that plan pursuant to its Section 10 authority to accept or reject plans. While any acceptable plan must satisfy the operator's express covenant to develop the PTU in a reasonably prudent manner, DNR may, according to Judge Gleason, reject a plan even if it meets that standard of reasonable development. Accordingly, there is no default. Absent a default, termination is not an available remedy.[22]

Third. The Court directed DNR to consider the import of Section 21 of the PTUA. Op. 42; *see* Op. 24 n.7. Section 21 provides DNR with limited authority to alter the rate

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[22] Nor is termination an automatic or mandatory remedy when DNR rejects a plan. Op. 41.

of prospecting and development in the unit. DNR's purpose in making any such change must be "in the interest of attaining the conservation objectives stated in [the PTUA] . . . ." And DNR's power under this section must be exercised consistent with "good and diligent oil and gas engineering and production practices[,]" and in such a way that protects the interests of all of the parties, not just the State's interests.

### E. DNR is Obligated to Consider Adopting the Owners' Development Proposal as a Possible Remedy

Without conceding the existence of any legal obligation, the Owners have submitted a new development proposal. It satisfies the good and diligent oil and gas engineering practices standard, adequately protects all parties in interest, and meets the concerns identified by DNR in rejecting the prior proposed PODs. Under these circumstances, at a minimum, DNR must either approve the Owners' new development proposal or order modification of the rate of prospecting and development under Section 21 procedures.

## VI. EVEN IF DNR'S REJECTION OF A POD COULD BE CONSIDERED A BREACH OF THE PTUA BY THE OWNERS, TERMINATION IS NOT LEGALLY JUSTIFIABLE

### A. Basic Principles of Alaska Contract Law Establish That There Has Been No Material Breach

Alaska law is entirely consistent with the law everywhere in holding that "termination" of a contract is permissible only if there has been a "material" breach (sometimes called a "total") breach of the contract. *Conam Alaska v. Bell Lavalin, Inc.*, 842 P.2d 148, 158 (Alaska 1992) (termination is justified only in the event of a total

breach"); *Cent. Alaska Broad., Inc. v. Bracale*, 637 P.2d 711, 713 (Alaska 1981) ("it is well established" that "only a material breach of contract justifies termination"). For a breach other than a material or total breach (often called a "partial" breach), "the injured party can maintain action at once, but he is not permitted to stop further performance." *Alaska Energy Auth. v. Fairmont Ins. Co.*, 845 P.2d 420, 424 n.3 (Alaska 1993).[23] Indeed, DNR has conceded that a material breach is a prerequisite to termination.[24]

A "material" breach that will justify termination or rescission of a contract is one that "destroys the essence" of the bargain between the parties. *Estate of Lampert v. Estate of Lampert*, 896 P.2d 214, 219 (Alaska 1995); *see also Am. Computer Inst., Inc. v. State of Alaska*, 995 P.2d 647, 653 n.14 (Alaska 2000) ("goes to the essence"); *Dickerson v. Williams*, 956 P.2d 458, 463 n.7 (Alaska 1998). It must significantly "defeat the [non-breaching party]'s reasonable expectations under the contract, *Dutton v. State of Alaska*, 970 P.2d 925, 928 (Alaska Ct. App. 1999), and result in the other party not receiving substantially what [that party] bargained for. *Machado v. State of Alaska*, 797 P.2d 677, 683 (Alaska Ct. App. 1990). The determination of whether a breach is material must be made on the totality of circumstances. *Id.* This Alaska law reflects fundamental

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23 *See generally* Arthur L. Corbin, CONTRACTS § 946 (1951); RESTATEMENT (FIRST) OF CONTRACTS §§ 274(1), 313, comment c (1932); RESTATEMENT (SECOND) OF CONTRACTS §§ 237, 243, comment a (1979) (only "uncured material failure . . . to render performance" will discharge other party).

24 Brief of Appellee at 58 (citing *Machado v. State of Alaska*, 797 P.2d 677, 683 (Alaska Ct. App. 1990)).

principles that are common to the law of contracts everywhere.[25]

For 28 years, the Owners duly carried out their obligation to the State under these provisions. They submitted 21 PODs. Each of those Plans called for making significant expenditures and performing substantial work, all looking toward the exploration, development, and eventual production of the Unit. Each of those PODs was approved by the Director. Each was duly implemented by the Owners. There was never any contention, in this proceeding or elsewhere, that the Owners materially failed to comply with any aspect of any of the approved Plans – and it would be years too late for DNR now to allege a material breach of any previous POD. Once the Director had approved a Plan, the Plan came to "constitute the drilling and operating obligations" of the Owners, and defined the scope of the Owners' duties. PTUA, Sec. 10. Accordingly, as long as there was compliance with whichever of the 21 PODs was in effect at a particular time, there cannot have been any breach of any contractual duty relevant here.

### B. Alaska Law Regarding Installment Contracts Analogous to the PTUA Establish That There Has Been No Material Breach

Even if proposing a 22nd POD that DNR then rejected could be considered a breach of the Owners' obligations under the PTUA, the precise legal question presented would be whether this can plausibly be treated as a "material" breach justifying termination. It cannot.

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[25] RESTATEMENT (FIRST) OF CONTRACTS § 275, comment a (1932); RESTATEMENT (SECOND) OF CONTRACTS §§ 241-42 (1979).

Installment contracts present an analogous situation. In an installment contract, one party has duties to perform over time: at specified intervals the party must deliver a set of goods meeting particular standards, or must make payments in particular amounts, or must perform some other agreed action. Exactly so here. The value of the PTUA to the State at the time it was entered into was that it induced the Owners to explore the Point Thomson field, and provided the State with the expectation that when production occurred, the State would collect enormous sums in royalties and taxes. DNR's rejection of the most recent POD proposal, after 21 submissions of PODs the Director approved, does not impair any of that value, let alone impair it substantially. When production commences, the State will collect the revenues it anticipated.

Further, the State now has a new development proposal which looks forward to production from the Unit. If DNR desires to modify this plan, consistent with the terms of Sections 10 and 21 of the PTUA, the Owners are prepared to accommodate DNR in any reasonable way. Once DNR has approved a new POD, the prior rejection will prove to have had few, if any, long term consequences, much less the "substantial impairment" that the cases require to terminate an installment contract. *See, e.g., Arkla Energy Resources v. Roye Realty & Developing, Inc.*, 9 F.3d 855 (10th Cir. 1993) (19% shortfall in gas delivered not substantial impairment of value of contract); *Bayer Corp. v. DX Terminals, Inc.*, 214 S.W.3d 586 (Tex. App.-Houston [14th Dist.] 2006, pet. denied) (38% reduction in value of installments not substantial impairment of contract value).

The law governing a second type of installment contract also makes plain that a material breach may not be found when a party makes 21 conforming tenders but the 22nd tender is non-conforming. Alaska courts have regularly considered the rights of purchasers under land sale contracts, where a purchaser of real property agrees to pay the purchase price in a series of payments over time. These contracts typically include provisions that any default by the buyer will entitle the seller to terminate the entire contract, while keeping whatever has been paid to date. Despite these express termination provisions, Alaska courts have generally refused to find a material breach allowing termination by the seller, notwithstanding some fairly egregious breaches by the buyer. Allen v. Vaughn, 161 P.3d 1209, 1213 (Alaska 2007) ("When the principles of equity and justice so require, we may refuse to enforce even an express forfeiture provision in a land sale contract."); Dillingham Commercial Co. v. Spears, 641 P.2d 1, 6-8 (Alaska 1982); Moran v. Holman, 501 P.2d 769, 771 (Alaska 1972); McCormick v. *Grove*, 495 P.2d 1268, 1269 (Alaska 1972); *Jameson v. Wurtz*, 396 P.2d 68, 73-75 (Alaska 1964); *Williams v. DeLay*, 395 P.2d 839, 846 (Alaska 1964).

### C. Alaska Law Establishes That Forfeiture Is a Disfavored Remedy

Alaska courts have consistently applied the principle that "equity abhors a forfeiture." As the Supreme Court has said:

> Forfeitures are not favored and never enforced in equity unless the right thereto is so clear as to permit no denial. Equity's goal is to do substantial justice to both parties, and where no injustice would be visited upon the injured party, equity will award him compensation rather than decree a forfeiture against the offending party. . . . The court must

> weigh the equities and fashion a decree to meet the requirements of the situation and to conserve the equities of the parties. The factor which has often been of greatest importance to the court in determining whether a forfeiture should be ordered is the financial loss suffered by the parties. Where severe financial loss would be incurred by the lessee, the courts have been less likely to order forfeiture of the lease.

*Hendrickson v. Freericks*, 620 P.2d 205 212 (Alaska 1980); *see also Allen*, 161 P.3d at 1213 (citing *Strack v. Miller*, 645 P.2d 184, 187 (Alaska 1982) ("It is well settled in this jurisdiction that equity abhors a forfeiture, and we have frequently relieved a party therefrom.")).

DNR has argued that *Hendrickson* does not apply to oil and gas leases or unit agreements and relies upon two isolated and aberrational cases as support.[26] But the virtually unanimous opinion of courts in oil and gas producing states is that equity abhors forfeiture by termination of an oil and gas lease. *See, e.g., Lapeze v. Amoco Prod. Co.*, 655 F. Supp. 1, 9 (M.D. La., 1987) (quoting *McLaurin v. Shell Western E. & P., Inc.*, 778 F.2d 235, 237 (5th Cir. 1985) ("[t]he law disfavors forfeitures . . . and the cancellation of an oil, gas and mineral lease is nothing less than a forfeiture of a recognized protected property interest.")); *Sinclair Oil & Gas Co. v. Bishop*, 441 P.2d 436 (Okla. 1967) (reversing cancellation of oil and gas lease and holding "[i]t is axiomatic that equity abhors a forfeiture."); *Batex Ohio Co. v. LaBrisa Land & Cattle Co.*, 352 S.W.2d 769 (Tex. Civ. App.-San Antonio 1961, writ dism'd w.o.j.) ("[t]he implied obligation to

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26 *McCullough Oil, Inc. v. Rezak*, 346 S.E.2d 788 (W.Va. 1986) and *Fey v. A.A. Oil Corp.*, 285 P.2d 578 (Mont. 1955).

continue with reasonable diligence the work of exploration for and production of oil and gas from the leased land . . . was a mere covenant and not a limitation or condition subsequent which would authorize a forfeiture of the lease . . . under extraordinary circumstances, in cases where the award of damages is inadequate to afford complete relief, a court of equity might enter an alternative decree requiring the lessee to do those things necessary to fulfill his obligation under the implied covenant, within a reasonable time fixed by the Court, the lease to be forfeited and cancelled in default of such performance."); *Superior Oil Co. v. Devon Corp.*, 604 F.2d 1063, 1069 (8th Cir. 1979) (Under Nebraska law, "[a]n oil and gas lease is a recognized and protected property interest. A cancellation of an oil and gas lease effects a forfeiture of that interest. The law abhors a forfeiture."); *Meaher v. Getty Oil Co.*, 450 So. 2d 443, 447 (Alabama 1984) ("Second, the law disfavors forfeitures and the cancellation of an oil, gas, and mineral lease is nothing less than a forfeiture of a recognized and protected property interest."); *Ionno v. Glen-Gery Corp.*, 443 N.E.2d 504 (Ohio 1983) ("inasmuch as forfeiture [of an oil and gas lease for failure to develop] is an equitable remedy, a strong showing of a violation of a clear right is required before a court will resort to such an extreme measure"). This comports with Alaska law. *Hendrickson v. Freericks*, 620 P.2d 205, 212 (Alaska 1980) ("[F]orfeitures are not favored and never enforced in equity unless the right thereto is so clear as to permit no denial.") (quoting *Shoemaker v. Shaug*, 5 Wash. App. 700, 490 P.2d 439, 441 (1971)); *see Chalovich v. State, Dept. of Natural Res.*, 104 P.3d 125, 133 (Alaska 2004) (DNR regulation requiring actual receipt of mining claim

payment by September 1 unreasonably "exposes miners to risk of forfeiture . . . .").

These principles are directly applicable here. Approval of a new POD will result in no significant damage to the State's interests in the Point Thomson Unit. Termination, however, will plainly result in a forfeiture of the $800 million that the Owners have invested in the unit, and of the substantial work they have done to explore the Unit and to model and understand its reservoirs. There is no basis in equity that all that work and investment should be thrown away, and the State itself denied the benefit of the knowledge base thus accumulated, merely because after approving 21 PODs, the Director disapproved the 22nd.

### D. Relevant Restatement Provisions Establish That There Has Been No Material Breach

Turning to the more general principles that govern the circumstances in which a court can find a "material" breach, it is clear that those principles also preclude a finding of material breach here. The applicable law is given in Sections 237, 241 and 242 of the Restatement (Second) of Contracts (1979). Section 237 relieves a party of its duty to perform only if there is an "uncured material failure" of performance.[27] Thus, even if the Owners breached the PTUA, the State is not relieved of it obligations under the PTUA

[27] The Second Restatement's introduces the concept of cure as a separately-stated element of the test for whether a contract may be terminated. The idea is that if there is a "material" breach of contract (a "failure of performance" as Section 237 says), it only "suspends" (but does not "discharge") the other party's obligation to perform. An opportunity to cure must be given prior to the point in time when the non-breaching party's obligations are "discharged" and the contract may be terminated. *See* RESTATEMENT § 242, comments a, b.

unless there was an "uncured" and "material" failure to perform by the Owners. As discussed above, if there was a breach, it was not material, and the Owners have submitted a reasonable cure.

§ 241 determines the situations in which a failure of performance is "material" so as to allow suspension of the non-breaching party's obligations, but permits the breaching party to cure.

- § 241(a). As previously discussed, assuming that DNR approves a new POD consistent with the PTUA, as it should, rejection of the last POD submitted by the Owners will prove to have had no impact on the State, and therefore cannot have deprived the State of any benefit which it can reasonably have expected.

- § 241(b). Since there should be no loss to the State, there is no need for compensation. In any event, the Owners propose to cure by the submission and implementation of a POD meeting DNR's requirements, consistent with Sections 10 and 21 of the PTUA, and believe that they have already done so.

- § 241(c). Termination of the PTUA will result in forfeiture of over $800 million that the Owners have invested in the Unit over 30 years.

- § 241(d). The Owners have submitted a new development proposal, which cures any prior deficiency by providing for reasonable delineation of the reservoir and which looks forward to putting the Unit into production promptly. To the extent DNR seeks modifications of the plan proposed, consistent with Sections 10 and 21 of the PTUA, the Owners are prepared to accommodate any reasonable request.

- § 241(e). The Owners have acted in good faith. They submitted 21 PODs which the Director approved, submitted the 22nd Plan to DNR in 2005, agreed with DNR on a briefing schedule when the Director disapproved it, negotiated with DNR in good faith and reached agreement with DNR on the Fiscal Contract, submitted a modified 22nd Plan when DNR requested, and would have accommodated DNR's concerns about the changed situation resulting from the non-approval of the Fiscal Contract, had DNR not terminated the PTUA.

For these reasons, the breach is not material.

§ 242 determines when the period to cure has expired. To terminate or cancel a contract for breach, accordingly, the non-breaching party must show not only that the breach was material within the meaning of § 241, but also that the appropriate period for cure has expired under § 242.

- § 242(a). See discussion of § 241 above.

- § 242(b). As indicated in comment c to Section 242, this provision is primarily addressed to sales of goods in a rapidly fluctuating market, where even a short delay can greatly increase the other party's cost of cover. Obviously that situation has no application here. Nor is there any reason to think that the State has been impeded in making "reasonable substitute arrangements" for the disapproved 22nd POD. The obvious "reasonable substitute arrangement" was a new POD, consistent with Sections 10 and 21, but meeting the State's objectives. Such an arrangement could have been negotiated or sought by DNR pursuant to Section 21 as soon as DNR's disapproval of the

22nd Plan was final, and doubtless would have been but for the termination of the PTUA.

• § 242(c). Section 10 of the PTUA, relating to the submission of PODs, contains no provision for "performance without delay," so this provision is not applicable.

For these reasons, the time to cure any breach has not passed.

Applying these tests, it is clear that DNR's rejection of the proposed 22nd POD and Modified POD cannot be a "material" failure of performance under § 241. It is also clear that if it had been a material failure of performance, the time to cure has not yet passed under § 242. Therefore there can be no basis for terminating the PTUA.

## VII. CONCLUSION

For the reasons stated, DNR should either approve the Owners' new development proposal or commence proceedings to alter the rate of prospecting and development under the procedural and substantive provisions of Section 21.

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DATED at Anchorage, Alaska this 19th day of February 2008.

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**CERTIFICATE OF SERVICE**

I hereby certify that on the 19th day of February 2008, I caused a true and correct copy of the foregoing document to be served on:

**VIA HAND-DELIVERY**

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February 21, 2008

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VIA HAND-DELIVERY

Thomas E. Irwin
Commissioner
Department of Natural Resources
550 W. 7th Avenue, Suite 1400
Anchorage, Alaska 99501

Re: Procedures for hearing commencing on March 3, 2008

Dear Commissioner Irwin:

This letter responds to your February 14, 2008 letter regarding procedures for the proceedings on remand.[1]

You state, "If you assert that this hearing should be an Article 21 proceeding, submit a brief citing the relevant legal authorities and explaining your reasoning to my office by February 22." The working interest owners ("Owners") do assert that there must be a Section 21 hearing if DNR rejects, or wishes to modify, the Owners' new development proposal. The reasoning and supporting legal authorities are set forth in our letter to you of February 8, 2008 and in the joint brief filed yesterday.

You further state, "DNR is the decision-maker in this remand hearing, not a party." We disagree. DNR may be the decision-maker in this remand hearing, but it is also a party to the PTUA and the PTU leases with a vested interest in the outcome of these proceedings. In the judicial phases of these proceedings, DNR has been and will be an adversary party. In the administrative phases of these proceedings, DNR is - in substance if not in form - an adversary party. Your ability to act as an independent decision-maker in these proceedings is inherently impaired. We again urge you to adopt basic procedural safeguards to mitigate further impairment of your ability to act as an independent decision-maker in these proceedings.

[1] Your letter was sent by mail, postmarked February 15, 2008, and was not received by any of the Owners before February 19, 2008, the deadline you set for filing briefs, witness lists, and documents. This delay effectively prevented the Owners from taking anything in your letter into consideration in our filings. We request that in the future we be provided timely and adequate notice, which, under the expedited procedures you have set, necessitates delivery by fax, email, or hand delivery.

You further state, "In making its decision . . . DNR will rely on the unit records . . . and will carefully and thoroughly evaluate the evidence and argument you submit on February 19 and at the hearing." Will you rely upon other evidence and arguments in making your decision? In particular, but without limitation, will you receive other evidence and arguments from DNR staff or consultants, whether at the hearing or otherwise? Through our submissions on February 19, the Owners have provided notice of the evidence and arguments on which we intend to rely in these proceedings. The Owners again request notice and an opportunity to be heard on any other evidence or arguments that you may rely upon in making your decision.

Your letter does not respond to the following requests in our letters of February 8, 2008:

1. assurances that you, in your capacity as decision-maker, have not had and will not have undisclosed communications with DNR staff regarding the subject matter of the hearing;

2. an opportunity to take testimony from DNR staff at the hearing regarding specific DNR documents in the record; and

3. an opportunity to review prior to the hearing DNR documents that are not in the record but directly relate to or support specifically identified DNR documents that are in the record.

We believe these procedures are essential to a fair opportunity to be heard, and we request that you timely respond to these requests or give notice that you deny them.

You further state in your letter that you have asked the hearing officer to convene a prehearing conference to address procedural issues and that you have arranged to hold the hearing in the AOGCC's hearing room. Given that the hearing will commence in eleven days, we ask that the prehearing conference be held this coming Tuesday, February 26, 2008. We further request that the prehearing conference be formally recorded. We believe that the AOGCC hearing room will not be adequate to accommodate the many parties and witnesses and thus request that you relocate the hearing to a larger facility.

In your letter of January 28, 2008, you state, "This is a DNR administrative proceeding on the question of remedy. The procedure is described in 11 AAC 02.010 et seq." But the procedures in 11 AAC 02 are procedures on appeal or reconsideration. This is not an appeal or reconsideration. DNR disapproval of the proposed plan of development was affirmed by Judge Gleason. There is no decision to appeal to you, or to ask you to reconsider, in these proceedings on remand. We believe it is improper for DNR to conduct these proceedings without prescribing appropriate procedures. Accordingly, we request that you give notice of the procedures applicable to these remand proceedings.[2]

The Owners request that you timely respond to these requests. In order to provide the Owners with adequate time to prepare for the hearing, we request that the response be provided no later than the prehearing conference requested above.

Absent a specific written waiver, the Owners do not waive (i) the requests made to you in their letter of January 18, 2008, (ii) the requests made in their letters of February 8, 2008, or (iii) the right to request additional procedures in the course of the remand proceedings.

[2] Furthermore, 11 AAC 02.010 et seq. were not adopted until after the effective date of the PTUA, August 1, 1977. Under Judge Gleason's decision, it is doubtful that these regulations apply to these proceedings. Decision on Appeal, at 33 - 36.

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Very Truly Yours,

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On behalf of all Appellants

DJS/mw

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In re Remand Proceedings Pursuant to
December 26, 2007 Order of Superior Court
Regarding Point Thomson Unit Agreement

# Affidavit of Patrick H. Martin, J.D., Ph.D.

## I. Introduction

### A. Identification of Witness

1. I am the Campanile Professor of Mineral Law at Louisiana State University Law Center and Director of the Louisiana Mineral Law Institute; I have been a professor at LSU since 1977.* At LSU and other institutions I have taught, among other subjects, various oil and gas courses and administrative law and procedure.

2. A true and correct copy of my *curriculum vitae* is attached as an Appendix to this report. This identifies the cases in which I have testified as an expert at trial or by deposition.

3. I have been retained by Exxon Mobil Corporation to address the issues discussed in this affidavit. However, the words and views presented in this affidavit are my own.

### B. Areas of Relevant Expertise

1. I have served as an expert witness in oil and gas matters in a number of states and abroad and have worked on oil and gas matters, including unitization issues, in several foreign countries. I have worked with oil and gas leases, mineral interests, royalty interests, division orders and pooling and unitization of such interests since I began my employment as an attorney 34 years ago. I have been recognized as an expert

* Louisiana State University and its Law Center are in no way involved in my participation in this matter; the opinions expressed herein are based on my own experience and expertise and do not represent any view of the University or Law Center.

witness on oil and gas issues in courts and arbitration proceedings. For approximately two years I served as Commissioner of Conservation for the State of Louisiana, a position which made me responsible for most state-related pooling and unitization matters. On several occasions I have served as an attorney for the state of Louisiana, including as an attorney for the Louisiana Department of Natural Resources. In addition, I have had direct involvement in unitization issues for the Prudhoe Bay Field on several occasions since 1984, in particular for issues arising from the Prudhoe Bay Unit Operating Agreement. For a time I was an officer and shareholder of a gas utility company operating in Prudhoe Bay. I have authored a report and directed a project on pooling and unitization for enhanced oil recovery for the Office of Technology Assessment of the United States Congress. For nearly thirty years I have been the Reporter for the Mineral Code Committee of the Louisiana Law Institute, and in that capacity have had a role in Louisiana oil and gas law reform.

2. I have authored or co-authored numerous articles and publications on oil and gas matters, including the matters addressed in this expert report. Among these:

a). I am (with Professor Bruce Kramer) responsible for revising and updating the widely-used treatise on oil and gas law, *Williams & Meyers, Oil and Gas Law* (updated annually);

b). I am the (with Professor Bruce Kramer) co-author of *The Law of Pooling and Unitization* (3d. ed. 1989) (updated annually);

c). I am the co-author (with Professors Maxwell and Kramer) of *Oil and Gas, Cases and Materials* (8th ed. 2007);

d). I am the editor of *Oil and Gas Law for a New Century: Precedent as Prologue* (1998); and

e). I am the co-author of *Economic Regulation: Energy, Transportation and Utilities* (with Pierce and Allison); Michie/Bobbs-Merrill, 1980.

C. **Purpose of Analysis**

I have been asked to provide my opinion concerning issues that have arisen in the captioned proceeding. Specifically, I have been informed that the Department of Natural

Resources (DNR) rejected a plan of development proposed by the Owners of the Point Thomson Unit in 2006. The matter is now before the Commissioner of the Department of Natural Resources to consider the appropriate remedy following that rejection. DNR has advised that it is considering termination of the Unit and has identified no alternative remedies. The Owners have provided a new plan of development to DNR for the PTU as a proposed remedy. I have been asked to respond to the following question: "Based on your professional experience and knowledge of the oil and gas industry and its regulation, and the terms of the Point Thomson Unit Agreement, the Point Thomas leases and similar documents used in the oil and gas industry, and the Alaskan statute and regulations addressed in Judge Gleason's decision remanding this matter to DNR, what are the procedures and remedies that are appropriate in this situation?"

## II. My Understanding of the Essential Facts and DNR's Position

1. The State of Alaska granted leases to Owners beginning in the 1960s. As lessor, the State, through the Commissioner of the Department of Natural Resources, entered into the Point Thomson Unit Agreement (PTUA) with Owners, effective August 1, 1977. Pursuant to the leases, the PTUA, the Point Thomson Unit Operating Agreement (PTUOA), and a series of 21 Plans of Development (POD) approved by DNR, the Owners drilled wells that are capable of producing significant quantities of hydrocarbons from reservoirs subject to the leases. In a decision issued in September 2005 and amended in October 2005, the Director of the Division of Oil and Gas rejected the POD submitted by the operator on behalf of the Owners, held the PTU was in default, and gave the Owners an opportunity to cure the unit default. The basis for the decision evidently was that DNR concluded that development could take place at a faster pace than the lessees believed economic or prudent. On appeal the Commissioner of Natural Resources declared the Unit to be terminated in November 2006 and decertified seven wells that had been certified as capable of producing in paying quantities. The apparent purpose and anticipated effect of so doing was to terminate the leases. The plan of DNR is evidently to lease the same acreage again to third parties who would take over the reservoirs discovered by the Owners along with the wells developed by the lessees at their sole expense. The September 2005 decision stated that it was time to "give new lessees had [sic] a chance to develop the known hydrocarbon resources within the PTU." DNR

apparently contends that it has power to terminate administratively its own leases and the unit agreement unless judicial action is specifically required by statute or regulation. The Commissioner's November 27, 2006 decision states that "it matters not what a Reasonably Prudent Operator would do, the state is entitled to terminate the PTU." [p. 18]. On appeal to the superior court, Judge Gleason affirmed the DNR's rejection of a proposed 22nd POD but reversed and remanded to afford the Owners an opportunity to be heard before the agency as to the appropriate remedy when the DNR has rejected a proposed POD for the Point Thomson Unit.

2. I do not understand that DNR claims that the Operator and Owners were in breach of the leases or the PTUA prior to the submission of the Twenty-second Plan of Development on August 31, 2005. Rather, it appears to me that DNR asserts that the Owners' failure to present a POD acceptable to DNR is a "default" under the PTUA, and that DNR has no duty to specify any criteria that would make or define an acceptable POD.

3. My understanding of the Owners' position is not that DNR must accept any Plan of Development they propose that meets the standard of a reasonably prudent operator but instead that:

a) if the Department rejects a POD, it cannot do so on a basis inconsistent with the PTUA or that requires the Owners to adhere to a plan that violates the reasonably prudent operator standard.

b) the Department must follow the procedures of section 21 of the PTUA if it wishes to modify a POD or require any increase in the rate of prospecting and development (but which may not exceed that which would be undertaken by a reasonably prudent operator);

c) the Department has no authority under the PTUA, the DNR regulations, or any Alaskan statute to terminate the Point Thomson Unit, which has wells certified as capable of producing in paying quantities, without judicial procedures.

## III. Opinion

The leases and unit agreement between the Owners and DNR are contracts and establish property rights and interests. The interests held by Owners and maintained by the PTUA have been acquired through great costs and are of enormous value to the interest owners. DNR cannot unilaterally terminate those interests because it believes it can do better by entering into new contracts with new parties who would benefit from the exploration and development accomplished under the existing leases and unit agreement. By the express provision of the PTUA and under the terms of the leases the performance of the operator and lessees is to be measured by the reasonably prudent operator standard. Unless a lessee or the operator is in material breach of this standard, the unit and the leases cannot be terminated. A lessor must establish such a breach has occurred in order for a court to terminate a unit or lease for breach or default by lessee or operator. In my opinion the PTUA and leases are not subject to a special limitation or condition under which termination occurs automatically. If DNR decides to reject a proposed POD, to fulfill its duty of cooperation for mutual benefit to both parties it must determine what POD a reasonably prudent operator would propose and undertake that would also protect the State's legitimate interests. If DNR believes that the Operator has failed to fulfill its duty to perform as a reasonably prudent operator, it must seek a court adjudication of this contention, and the Owners must be given an opportunity to comply with the court's ascertainment of what development would be undertaken by a reasonably prudent operator. At the very least, cooperation for the mutual benefit of the parties to the leases and unit agreement and to fulfill its duties to serve the best interests of the State, DNR must specify criteria for determining the contents of an acceptable POD. My own review of the Plan of Development proposed under date of February 19, 2008 leads me to the conclusion that it satisfies the standard of a reasonably prudent operator, is consistent with good and diligent oil and gas engineering and production practices, and would be in the best interests of the State. It is also my opinion that termination of the Point Thomson Unit would delay the development of the oil and gas reservoirs within the Point Thomson Unit Area.

## IV. Basis for Opinion; Analysis

### *A. What Unitization is*

1. A fundamental principle of oil and gas law is the rule of capture. It stems from the fact that oil and gas are fugacious minerals; that is, they have the property of being able to move about within a reservoir in which they are found. Followed by every jurisdiction within the United States, the rule of capture is to the effect that a landowner may produce oil or gas from a well located on his land even if the oil or gas was originally in place under the surface of another landowner, so long as the producer does not physically trespass on the other's land. The other landowner's recourse against drainage of the petroleum under his property is the rule of capture itself: he may drill a well and produce the hydrocarbons and thereby prevent their migration to the property of another.

2. The problem with the rule of capture has been that it encourages too rapid development of oil and gas. A landowner or the landowner's lessee must drill to recover the oil and gas beneath the property or they will be recovered by a neighbor and lost forever to the landowner. Overdrilling results from a rush to recover the oil and gas before it is produced by another owner, and overdrilling causes the natural pressure of the reservoir to be depleted too rapidly, thereby leaving oil in the ground that could have been recovered with sounder engineering practices.

3. Recognizing that the rule of capture was resulting in great loss of resources and excessive production of oil, the producing states began enacting legislation to modify it in the mid-1930s. To prevent excessive drilling the states authorized regulatory commissions to promulgate well spacing rules, limiting the number of wells that can be drilled in a given area, such as a 40 or 80 acre block. In general, in each major producing state special spacing rules are established for each different field and exceptions may be granted upon showing of good cause. Well spacing alone would not be enough to overcome the problem of excessive production, for a producer might continue to produce at an excessive rate in such a manner as to deplete prematurely the natural drive of the reservoir. To overcome this, the states establish well allowables; that

is, they set a limit to the amount of oil or gas that can be produced in a month from a field or well.

4. State regulation of well spacing and production can cause significant problems that must be overcome by the producers themselves or by additional regulations. If there can be only one well within a given area and there are several parcels of land with different owners, some determination must be made as to who will be able to drill a well and who will be entitled to receive proceeds from the production from the well. The integration of the various interests within the area for the purpose of creating a drilling unit for development of a well and sharing of the proceeds is known as **pooling.**

5. Pooling then refers to the bringing together of the different interests in a given area so as to integrate the acreage necessary for establishing a drilling unit, and it may be voluntary or compulsory. Virtually all states with production of oil or gas have compulsory pooling statutes which can apply when the parties are unable to reach an agreement for voluntary pooling. Pooling does not result in the reservoir being treated as a single entity. It does reduce the number of competitive properties within a reservoir, but there will still be competitive operations among the units to the extent permitted by law.

6. Often when there is pooling the working interest owners (those bearing the costs of development) will enter into a joint operating agreement that allows one of them to be the operator of the pooled unit. This integration of operations allows the more efficient production of the oil and gas.

7. The most efficient and productive method of producing oil can be achieved only if the entire reservoir can be treated as a single producing mechanism, i.e., when the reservoir may be operated without regard to property lines. This becomes possible when one owner or lessee owns or leases the rights to the entire reservoir or when all the interest holders in the reservoir unite for a cooperative plan of development. When owners of interest do come together for such a purpose for development of most or all of a reservoir this is referred to as **unitization.** It is much the same in principle as pooling, for it is an integration of interests, and as with pooling it may be voluntary or compulsory. But it is much more complex than pooling in attempting to reach agreement

on cost and production sharing, and the statutory schemes for compulsory unitization are more difficult to comply with than for compulsory pooling. Unitization of most or all of a reservoir is very desirable or is required in order for there to be application of enhanced recovery techniques to a reservoir and the maximization of production.

8. Ideally, unitization should take place at the first discovery of a reservoir capable of producing hydrocarbons in commercial quantities, or even during the exploration phase. However, this is often not feasible, for it is only through drilling a number of wells—with information from the first well and subsequent wells going on—that the parameters of the reservoir can be established. Only when the characteristics and the limits of the field are generally known will the parties with an interest in the field be willing and able to unitize. Prior to that time, they would run the risk of agreeing to share production of petroleum from under their lands with parties who had no petroleum under theirs. It is only after drilling that it is possible to make an intelligent assessment of the basis upon which participation in the production from the reservoir should be established.

9. Once it is clear to some of the parties with interest in the reservoir that unitization is desirable, there is the problem of determining who may undertake the unitization. Without express authorization, either in the lease or by separate agreement, the lessee is not able to unitize the interest of the royalty owners to whom it must pay royalty. The lessee may unitize its own interest—that is, agree to share with another the percentage of production that it owns—but without the consent of the royalty owner(s) it may not agree with others to treat the potential production attributable to the royalty interest from the leased acreage on any basis other than the one-eighth (or other fraction) going to the royalty owners. Where the same lessor grants all the leases over a reservoir, such as with the Point Thomson Unit, the lessor has every reason to desire the unitization to achieve the greatest and most efficient recovery possible.

10. Fieldwide or reservoirwide unitization is accomplished generally through two related agreements: the unitization agreement and the unit operating agreement. The unitization agreement is among all the parties, both working interest owners and royalty owners. It is an agreement for development and operation for the recovery of oil and gas within the area made subject to the agreement as a single consolidated unit without

regard to separate ownerships. It provides for the allocation of costs and benefits on a basis as defined in the agreement or in the related operating agreement. The integration of separate and often divergent ownership interests necessarily requires careful negotiation, which may extend over years.

11. The "participation formula" (share of unit production accruing to the separate ownership interests) is the heart of the unitization agreement. As such, it represents the principal point of contention among the parties negotiating the voluntary formation of a reservoirwide unit. The ideal is that each operator's share of production from the unit shall be in proportion to the contribution which it makes to the unit.

12. The "unit operating agreement" is the agreement executed between the working interest owners in a unit that describes the voting mechanisms, the operational details and the cost allocation formula(s) for the implementation of the unit agreement. The operating agreement contains a legal statement of matters concerning the participation formula and adjustments thereof, provisions for enlarging the unit operation, cost allocation, operational procedures, and matters pertaining to titles, easements, and term. Furthermore, the selection of the unit operator is generally specified in this document; the unit operator is usually the largest leaseholder in the unit and is responsible for the general supervision of the unit operation. The purpose of the unit operating agreement can be described as bringing about functional integration, centralization of management, and economies of scale among the parties to the operating agreement for their interests, which have been consolidated through the unit agreement.

*B. The Point Thomson Field Unitization*

1. The leases that are the subject of the PTUA were granted beginning in the 1960s and many are on the Alaska state lease form DL-1. These leases create a form of property right, acquired for valuable consideration from the State by the Owners. The leases establish rights and duties for both lessor and lessees.

2. The Point Thomson Unit Agreement is typical of unit agreements of the period, i.e. 1977 when the parties agreed to its terms. Its purpose is to "conserve natural resources, prevent waste, and secure other benefits obtainable through development and operation of the area subject" to the agreement. The PTUA recognizes the existence of

the rights of the lessees and uses property law terminology to describe the rights and duties of the parties to the Unit Agreement: "19. COVENANTS RUN WITH LAND. The covenants herein shall be construed to be covenants running with the land with respect to the interests of the parties hereto and their successors in interest until this agreement terminates." Thus DNR has recognized that the Owners enjoy property rights under the PTUA and that the PTUA imposes property-related duties upon the covenants of the parties, including DNR. These covenants are both express and implied. They continue until the PTUA terminates. Paragraph 20 of the PTUA provides the only express means by which the PTUA may be terminated. It does not allow the Commissioner to terminate the PTUA unilaterally by his own rejection of a POD.

3. Section 21 of the PTUA does provide authority to the Director "to alter or modify from time to time in his discretion the quantity and rate of production . . . ." However, this discretion is constrained to specifics set forth in the paragraph and the Director must state in the order of alteration or modification the purpose of the alteration or modification and how the public interest is to be served thereby. The paragraph provides that the Director may alter or modify the rate of prospecting or development "when such alteration or modification is in the interest of attaining the conservation objectives stated in this agreement . . . ." Thus, the discretion of the Director is strictly confined to attaining the conservation objectives of the PTUA. The Director is not vested with authority to require additional development simply to enhance the revenue prospects of the State. In fact, the Director and the Commissioner have not sought to modify the rate of prospecting or development at all under section 21 of the PTUA. The PTUA does not contemplate or provide for the termination of the PTUA when the Director or Commissioner does not believe the Operator's POD is adequate. Rather it authorizes "alteration or modification" of the "rate of prospecting, development and production" within the confines of the terms of the PTUA. These terms are binding on DNR.

4. It is rare in unit agreements that the royalty owner has an approval power over the development decisions of a unit operator. I see no reason to read section 21 of the PTUA as contemplating the rejection of a POD as a basis for terminating the PTUA. Moreover, in exercising its approval authority, DNR is acting in the proprietary capacity of the State, not in its police/regulatory role.

5. Equally important, the PTUA provides explicitly the manner in which the authority under Paragraph 21 is to be exercised. There must be notice and hearing on the rate of prospecting and development and the Director's authority "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 and diligent oil and gas engineering and production practices . . . ." This last phrase is derived from and consonant with the Alaska conservation statute's definition of "waste", AS 31.05.170(15)(A). In my opinion the statute and the PTUA are concerned with preventing the inefficient, excessive, or improper use of, or unnecessary dissipation of, reservoir energy; and the locating, spacing, drilling, equipping, operating or producing of any oil or gas well in a manner which results or tends to result in reducing the quantity of oil or gas to be recovered from a pool. It is not a basis for terminating a unit or lease to obtain additional revenues to the state of Alaska. This concept of waste in relation to good engineering practices was a matter addressed in 1996 Opinion Attorney General No. 3, AOGCC/DNR Unitization Jurisdiction A.G. file no: 663-96-0121 (July 3, 1996), pp. 30-31.

6. Paragraph 16 of the PTUA provides: "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." This provision is binding upon all the parties to the Unit Agreement, including DNR. The Operator must comply with this provision in submitting any POD and DNR must apply it in granting or denying approval to the PODs submitted by the Operator. The Commissioner is implicitly required to determine that a proposed POD does not "provide for the most economical and efficient recovery of said substances without waste" and that an alternative POD would "provide for the most economical and efficient recovery of said substances without waste."

7. The Point Thomson Unit Operating Agreement is the product of years of study, experience and negotiation among the working interest owners. They have amended the PTUOA to facilitate cooperation and development in a timely manner and to reduce potential conflicts of interest in unitized development. In particular they have modified the voting protocol for operations and have provided for an alignment of

interests across depths. I believe that it would take years for any new lessees to achieve this level of cooperation.

*C. The State as Proprietor.*

1. Government acts in two capacities with respect to its lessees: it is both proprietor and regulator. As a proprietor or landowner, it has the same interests and concerns as other landowners, with a primary interest in maximizing return. It also has limits on its authority similar to other landowners, i.e., it is bound by its own contracts. The United States Supreme Court has said of a state's contract: "This is a contract, and although a state is a party, it ought to be construed according to those well established principles which regulate contracts generally." *Huidekoper's Lessee v. Douglass*, 3 Cranch 1, 70, 7 U.S. 1, 70, 2 L.Ed. 347, 369 (1805). *See also Merrion v. Jicarilla Apache Tribe*, 455 U.S. 130 (1981), which also distinguishes the dual roles of a governmental entity. Similarly, the Texas Supreme Court has held: "[W]hen the state becomes a party to a contract with a citizen, the same law applies to it as under like conditions governs the contracts of individuals." *Anderson v. Robison*, 111 Tex. 402, 406-07, 229 S.W. 459, 460 (1921). The modern oil and gas lease granted by a government body is a form of property interest; *Union Oil Co. v. Morton*, 512 F.2d 743, 747 (9th Cir.1975): the "lease does convey a property interest enforceable against the Government . . . ."

2. A notable aspect of this proprietary role is that government is the biggest landowner in any state. No private landowners can equal the magnitude of governmental holdings. This means that government has strong bargaining power. State lessors can include in their leases terms that are much more favorable to the state than one can even dream of with private owners, who often must accept the lessee's terms or have no lease at all. States have so much land that they can hold public auctions for their leases that bring top dollar in bonus, rental and royalty amounts. They can include multiple royalty provisions that allow them to insist on the highest method of royalty calculation. The states' resources are such that they can have full time staffs to monitor royalty collection and audit payments. These qualities flow simply from government's size and extent of holdings, not from the status of sovereign. Because of this bargaining power, the role of

lessor and lessee is such that state leases may be read against the government, rather than against the lessee, as the court quoted in the next paragraph states.

3. An Alaskan federal court has applied the foregoing principles in treating a contract between a government body acting in a proprietary capacity as lessor as bound by ordinary rules of contract and oil and gas law. The court in *Standard Oil Co. of Cal. v. Hickel*, 317 F.Supp. 1192, 1197 (D.C.Alaska 1970), said:

> The Government's rights and obligations as lessor of public lands are no different from those of any other lessor. . . . The rules of construction applicable to Government contracts are the same rules applied to contracts between private parties. . . . The rule that omissions and ambiguities in a contract are construed most strongly against the party who prepared the instrument, Restatement of Contracts, § 236(d), is not vitiated by the mere fact that the federal government drafted the instrument. . . . Any confusion caused by the failure to expressly provide for the situation in which a lease previously committed in toto to a unit agreement is partially eliminated by contraction must be charged to the party who drew the lease.

Similarly, a federal court sitting in California ruled along the same lines:

> "the government's role is taken to be no different from that of any private lessor or proprietor, for while the Kettleman Hills lands involved are public mineral lands, and as such until their disposition are under the supervision and control of Congress, the government as to such lands acts in a proprietary capacity, and treats with them in the same way as does the private landowner. Regardless of the type of lease Congress might authorize, a lease executed in accordance with what it has authorized becomes a private, contractual matter and is to be interpreted according to the general rules of law respecting contracts between individuals."

*United States v. General Petroleum Corp.*, 73 F.Supp. 225, 234 (S.D.Cal.1946), aff'd, *Continental Oil Co. v. United States*, 184 F.2d 802 (9th Cir. 1950).

4. The Ninth Circuit Court of Appeals has distinguished between the proprietary and the regulatory roles of government. *Union Oil Co. v. Morton*, 512 F.2d 743, 747 (9th Cir.1975). Because of the property nature of the oil and gas leases at issue there, the court ruled that the Department of the Interior did not have the power to cancel or terminate the leases. The Court declared:

> without congressional authorization, the Secretary or the executive branch in general has no intrinsic powers of condemnation. . . . Congress' clear

concern to distinguish police power regulation from invasion of property rights in these leases convinces us that Congress did not confer powers of condemnation upon the Secretary by implication.

5. Judge Gleason, responding to the State's assertion 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, ruled that the power to terminate the Unit fell within the agency's broad statutory powers. (Decision on Appeal pp. 30-31). However, I believe this fails to account for Court's analysis of implied governmental authority in *Union Oil v. Morton*. Her decision relies in part on *Boesche v. Udall*, 373 U.S. 472, 478 (1963), *White v. State, Dept. of Natural Resources*, 14 P.3d 956 (Alaska 2000)(*White II*) and *Danco v. State*, 924 P.2d 432 (Alaska 1996). *Boesche* did not recognize any implied authority of the Secretary of the Interior to cancel a valid lease. Rather, the question addressed was whether the Secretary had the authority to cancel in an administrative proceeding a lease that had been granted in violation of the Mineral Leasing Act, even though there had been no wrongdoing on the part of the lessee. The Court ruled that the "general powers of management" gave him the authority to cancel a lease *invalid at its inception*. Because the lease had never been valid the Secretary's "cancellation" was no more than an exercise of a "power to correct administrative errors . . ." 373 U.S. 485. The later case of *Union Oil v. Morton* made clear that the Supreme Court in *Boesche* had not recognized any inherent authority of the Secretary to cancel valid leases. Similarly, the Alaska cases of *White v. State* and *Danco v. State* stand for nothing more that the general principle of administrative law that one must exhaust an *available* administrative remedy, expressly provided for in existing regulations. They do not recognize an implied substantive authority to terminate an otherwise valid unit or lease.

6. Under 11 AAC 83.374 (d) the Commissioner may seek to terminate a unit agreement only by judicial proceedings with respect to a unit in which there is a well capable of producing in paying quantities. The regulations in my opinion make clear that the Department recognizes there is no inherent authority of the Commissioner to terminate a unit or a lease, whether one looks to the authority of DNR in 1977 or 2008. The DNR approach of decertifying the relevant wells administratively, contrary to prior

DNR practice, seems to me an effort to evade the DNR's own regulations. See Gleason, Decision on Appeal, pp. 14-15, 20].

7. The Alaskan regulation cited above parallels the treatment of the same issue under the Mineral Leasing Act of 1920. That statute vests the Secretary with authority to cancel a lease administratively when there has been a failure upon the part of the lessee to comply with the provisions of the lease. However, the Secretary's express authority is limited to the cancellation of leases covering lands that do not contain a well capable of producing oil or gas in paying quantities, or leases not committed to an approved unit agreement that contains a well capable of producing unitized substances in paying quantities. To cancel such leases, a judicial proceeding must be commenced in federal district court. *See* Randy L. Parcel "Extension, Suspension, Termination, and Reinstatement of Leases," *Rocky Mtn. Min. L. Fdn. Law of Federal Oil and Gas Leases*, ch. 14 (2007).

***D. The reasonably prudent operator standard***

1. The prudent operator or reasonably prudent operator standard is a term used in the oil and gas industry, in the courts, and in arbitration and administrative proceedings as a measure of a lessee's or operator's conduct or performance under a lease, a unit agreement or a joint operating agreement. It is most often used as the test for determining whether the lessee or other party has breached his implied covenants or express provisions of the contract. The lessee is held to that performance of the covenants that would be made by an ordinary, prudent operator under the same or similar circumstances. It is also used to determine if a lessee has continued production in paying quantities for purposes of the habendum clause of a lease. *Clifton v. Koontz*, 160 Tex. 82, 325 S.W.2d 684 (1959). In oil and gas matters, the prudent operator standard is the contract equivalent of the reasonable man standard applied in tort cases. The prudent operator standard is defined as follows:

> The prudent operator is a reasonable man engaged in oil and gas operations. He is a hypothetical oil operator who does what he ought to do not what he ought not to do with respect to operations on the leasehold. Since the standard of conduct is objective, a defendant cannot justify his act or omission on personal grounds or by reference to his peculiar

> circumstances. It is no excuse that defendant failed to drill the offset well a prudent operator would have drilled because defendant is short of cash, over-committed on drilling programs, has no need for more production, or prefers to spend his money on other things. In short, the question is not what was meet and proper for this defendant to do, given his peculiar circumstances, but what a hypothetical operator acting reasonably would have done, given circumstances generally obtained in the locality.
>
> Pat Martin & Bruce Kramer, *Williams & Meyers Oil and Gas Law* § 806.3 (2007)

2. In any contract in which one party has promised a performance rather than an identified achievement, it is virtually inescapable that one must test that performance by some standard, such as good faith, or "good faith business judgment", prudent operator, best efforts or fiduciary. Attorneys, doctors, and teachers, among others, normally do not promise particular results or achievements but instead that they will use reasonable efforts in the performance of their services. Even if a patient does not recover from an illness, the physician who has used reasonable efforts and skill in treatment of the patient has not breached her contract.

3. The oil and gas lease is a special type of contract, though it is by no means unique in the feature I shall identify. This feature is that while the interests of the lessor and lessee often coincide, they will diverge when the degree of effort by the lessee is at issue. The lessor virtually always holds an interest that bears no costs of operation. Hence the lessor often will expect or demand expenditures by the lessee that bear no relation to the costs that must be incurred by the lessee. For example, if the lease provides for a royalty of 12.5%, and a well on the lease will produce $1,000,000, the lessor will receive $125,000 even if the well would cost $10,000,000 to drill. The lessor enjoys the royalty even while the lessee loses an enormous amount of money and the expenditure is wasteful. This feature explains the ubiquity of the prudent operator standard in oil and gas cases. It is to avoid the interests of one party, the non-cost bearing party, from being the sole measure of the performance of the other under the contract.

4. Commentators, including judges, have long called attention to the divergence of interest between lessor and lessee in discussing the origins and application of the prudent operator standard. For example, Samuel H. Glassmire in his 1935 treatise on the law of oil and gas leases and royalties stated that under most of the covenants of a

lease the relationship between lessee and lessor is reciprocal. But under other provisions their interests diverge and the correlative rights come into conflict. He continues that "the moment an implied covenant imposes the burden of apparently unnecessary drilling by the lessee to obtain that product, without imposing any corresponding obligation on the lessor to contribute pro rata to that excess drilling expense, the interests immediately diverge; the lessee relies on the 'reasonable diligence' clause to protect his rights in an economic development of the lease, while the lessor or royalty owner is concerned solely with obtaining his immediate profit, regardless of the conditions and circumstances controlling the lessee in his management of the property." Samuel H. Glassmire, Law of Oil and Gas Leases and Royalties, §59, pp. 208-09 (1935). Glassmire called this divergence of interests or conflict "the bane of the petroleum industry."

5. Glassmire's identification of this feature of oil and gas relationships has been more recently echoed by Judge Richard Posner, the jurist and legal philosopher most closely identified with "Law and Economics" analysis of law. In a case involving an implied covenant to protect against drainage, Posner stated the following:

> [A] conflict of interest is built into any royalty arrangement, or any other arrangement in which one party to a contract receives a percentage of gross revenues. The [lessors] were entitled to one-sixth of all oil produced under the lease, and this was the equivalent of a 16.67 percent royalty on the gross revenues (minus selling costs) from the sale of all the oil. It was a matter of indifference to them, but intense interest to [the lessee], how much the oil cost to produce. Suppose the oil had a value of 100, and cost 90 to produce. Production would then be profitable from the standpoint of the property as a whole and of course from the [lessors'] standpoint. But [lessee] would lose money because it would bear the entire cost and that cost (90) would exceed its share of the revenues (83.33). A similar conflict is created by royalty arrangements between publishers and authors and by contingent-fee contracts. It is not, however, a conflict that has prompted the courts to impose a fiduciary duty on the cost-bearing party to such contracts, . . .

*Finley v. Marathon Oil Co.*, 75 F.3d 1225, 1230 (7th Cir. 1996), reprinted in Maxwell, Martin & Kramer, *Cases and Materials on Oil and Gas Law*, p. 432 (2007).

6. Judge Posner explained how the prudent operator standard came to be applied in oil and gas matters: "Both the general duty of prudent operation and the subsumed duty to avoid drainage illustrate the office of the common law of property and

contracts in interpolating into a contract or conveyance provisions that the parties would almost certainly have agreed to had the need for them been foreseen." [75 F.3d at 1228].

7. In the instant matter, the unit agreement in section 10 itself provides expressly for the standard of the "reasonably prudent operator". Under section 18 of the PTUA, the terms, conditions and provisions of all leases and other contracts related to exploration, development and operation of the subject lands are expressly modified and amended to conform to this standard.

8. In prior litigation between plaintiffs – the State of Alaska, the Commissioner of Natural Resources and the Director of the Division of Lands – and defendants who included Exxon and the other major parties to the PTUA over the same state lease form that pertains to the PTUA, the DL-1, the court held that an oil and gas lease, including the Alaska DL-1, "is merely a contract between parties and is to be tested by the same rules as any other contract." *In re ANS Royalty Litigation*, (Memorandum Opinion, March 13, 1991, Case No. 1JU-77-847 Civil), p. 39. The DL-1, the court held, "contains an implied covenant of good faith and fair dealing that neither party will injure the right of the other to receive the benefits of the agreement." *Id.* Citing the classic case of *Brewster v. Lanyon Zinc*, then Superior Court Judge Carpeneti ruled that the prudent operator standard is "an established doctrine in the common law of oil and gas" and is "appropriately applied as a rule of decision unless inconsistent with the federal or state constitutions, or the Alaska statutes." *Id.* P. 42. The court went on to rule that the state cannot impose a more stringent standard on the lessees operating pursuant to the lease. In light of Judge Carpeneti's precedent, I believe that Judge Gleason's opinion to the effect that "DNR did not err when it declined to review the modified POD under a reasonably prudent operator standard" (Decision on Appeal, p.23) is incorrect and is contrary to the virtually universally recognized standard of conduct in the oil and gas industry. I believe that this standard was applicable in Alaska in 1977 when the PTUA was signed.

9. It is also well-recognized in the oil and gas industry that a lessee (or unit operator) has not only a duty to act as a prudent operator but also a right to act as a prudent operator. Thus where lessees/operators have delayed production from or shut in wells to obtain better results for the mutual benefit of lessor and lessee their actions have

been upheld. *See Pack v. Santa Fe Minerals*, 1994 OK 23, 869 P.2d 323; *McDowell v. PG & E Resources Co.*, 658 So.2d 779 (La. App. 1995) writ denied, 661 So.2d 1382 (both reprinted in Maxwell, Martin & Kramer, *Cases and Materials on Oil and Gas Law*, (2007)).

10. The foundation of the law of implied covenants and the prudent operator standard is in the contract principle of cooperation, where contracting parties are expected to work for their mutual benefit in carrying out the object of the contract. This principle is explored in the Oil and Gas Treatise for which I am now co-author and editor in the section headed: "Origin and basis of implied covenants: Principle of cooperation." Pat Martin & Bruce Kramer, *Williams & Meyers Oil and Gas Law* §802.1 (2007). The Treatise explains that the principle of cooperation requires that parties to a contract cooperate in order to carry out the purposes of the agreement. It is based upon both the reasonable expectations of the parties when they enter into an agreement and ethical concepts of conduct. The requirement of cooperation is fully applicable to the oil and gas lease, and it operates to raise both constructive conditions and implied promises. A familiar example of the constructive condition of cooperation is found in those cases excusing the lessee from performing express or implied duties while the lessor wrongfully bars him from entry on the premises or engages him in litigation over the validity of the lease. The principle of cooperation is necessary in oil and gas leases because of the many uncertainties about what may arise in the course of performance of the lease. As the Treatise discusses:

> The nature of the leasing transaction indicates the propriety of broad application of the cooperation principle. In most instances, lessor and lessee cannot state specifically how future operations on the land are to be conducted. Too many unknown factors will affect the lessee's conduct: geology, reservoir mechanics, conservation regulations, economic conditions — all these and others will bear on the lessee's operations. Neither party wants to bind himself to express, specific contract terms at a time when the relevant facts are unknown. In contrast to other fields of business, the oil industry's basic procurement contract the oil and gas lease is not designed to stabilize expectations in every detail, as, for example, the life insurance contract attempts to do. The parties to an oil and gas lease leave open a number of important matters, because both are better served if events, rather than dim foresight, shape future conduct. In such a case, reliance on cooperation to achieve the fundamental objectives

> of the agreement is more than justified; it is unavoidable. And because this is the situation of the parties to an oil and gas lease, the implication of promises therein does not require a court to choose between conflicting goals — the goal of stability in the written word and the goal of achieving equity even at the expense of the writing. Since the conduct of operations has not been prescribed by a writing, stability depends upon judicial application of the principle of cooperation not only in stereotyped litigation governed by *stare decisis* but in novel disputes as well.

*Id.*

11. A second aspect of the prudent operator standard is that neither the lessor nor lessee can have unfettered discretion to determine whether the terms of the contract are being fulfilled. Turning again to the century old but still relevant opinion of Justice Van Devanter in *Brewster v. Lanyon Zinc*, the principle of mutual benefit means that neither the lessor nor the lessee can be the sole judge of reasonable development:

> The object of the operations being to obtain a benefit or profit for both lessor and lessee, it seems obvious, in the absence of some stipulation to that effect, that *neither is made the arbiter of the extent to which or the diligence with which the operations shall proceed, and that both are bound by the standard of what is reasonable.* This is the rule in respect of all other contracts where the time, mode, or quality of performance is not specified, and no reason is perceived why it should not be equally applicable to oil and gas leases.

*Brewster v. Lanyon Zinc Co.*, 140 F. 801, 814 (8th Cir. 1905)(emphasis added).

12. The idea that the lessor cannot determine on its own that the lessee is not in compliance with the lease is merely a particular application of a fundamental aspect of due process and fairness in any legal controversy: "*aliquis non debet esse Judex in propria causa*" — no man ought to be a judge of his own cause. This was the ruling of Lord Coke in *Dr. Bonham's Case*, 8 Co. Rep. 107a, 114a C.P. 1610, 77 Eng. Rep. 638 (C.P. 1610). The United States Supreme Court has repeatedly invoked this principle as a requirement of due process under the United States Constitution. In *Arnett v. Kennedy*, 416 U.S. 134, 197 (1974) the court stated:

> In considering appellee's claim to have an impartial hearing examiner, we might start with a first principle: '(N)o man shall be a judge in his own cause.' Bonham's Case, 8 Co. 114a, 118a, 77 Eng.Rep. 646, 652 (1610). .

> . . Our decisions have stressed, in situations analogous to the one faced here, that the right to an impartial decision-maker is required by due process. The Court has held that those with a substantial pecuniary interest in legal proceedings should not adjudicate these disputes. *Tumey v. Ohio*, 273 U.S. 510, 47 S.Ct. 437, 71 L.Ed. 749 (1927); *Ward v. Village of Monroeville*, 409 U.S. 57, 93 S.Ct. 80, 34 L.Ed.2d 267 (1972). The Court has observed that disqualification because of interest has been extended with equal force to administrative adjudications. *Gibson v. Berryhill*, 411 U.S. 564, 579, 93 S.Ct. 1689, 1698, 36 L.Ed.2d 488 (1973).

In my opinion the inherent validity of this principle, connected as it is to the prudent operator standard, is a reason why a lessor such as the State of Alaska cannot be the sole judge of a lessee's performance nor unilaterally terminate a unit and leases to which it has agreed.

13. I do not understand the Owners' position to be that DNR must accept any proposed POD that is reasonable and prudent. There may be a number of development operations or PODs that would satisfy the reasonably prudent operator standard. Rejection of one POD by DNR does not preclude there being an alternative POD that can be proposed that would be reasonable and prudent and would also satisfy the other criteria of the PTUA. Certainly it follows then that DNR's rejection of one proposed POD does not establish that the Owners' proposal was not reasonable and prudent or that it was a breach or default under the Point Thomson Unit Agreement or the leases.

## V. Remedies

### A. Generally, Lease Termination for Breach Requires a Judicial Determination, with Burden on Lessor

1. It is the custom of the oil and gas industry and a requirement generally recognized by law that a lessor must give notice to a lessee of a failure of the lessee to fulfill the duty to develop as a reasonably prudent operator and allow the lessee the opportunity to undertake the necessary development. This is written into many leases. Moreover, many courts will grant only conditional termination of an oil and gas lease, giving a lessee an opportunity to cure any deficiencies in developing as a prudent operator. These points are discussed in the oil and gas treatise for which I am now co-author and revision editor.

We note that "there is a substantial body of law requiring notice and demand as a prerequisite to forfeiture . . . ." Pat Martin & Bruce Kramer, *Williams & Meyers Oil and Gas Law* § 682 (2007). Also in §682 we comment that in those states in which notice of breach of covenant and demand for performance, with reasonable time to cure the breach, are prerequisites of a lessor's action to forfeit the lease: "The reason for requiring that notice and demand precede a suit for cancellation of the lease for breach of covenant is easy enough to discover. Whether the action be considered as one for extraordinary relief in equity or as one to enforce a right of entry for breach of a condition subsequent, forfeiture is the relief sought and accordingly the action is cognizable in equity. Since equity dislikes forfeiture and since one seeking equity must do equity, notice, demand and an opportunity to cure the breach are required."

2. Because some states seem not to have the requirement, and because in others the nature of the requirement is unclear, it is common to include in oil and gas leases a notice and demand clause or judicial ascertainment clauses. Such clauses will usually provide in effect that the lessee will not be viewed as being in default under any obligation imposed under the lease until after his failure to comply with such obligation within a specified period of time after the lessor has given him notice of alleged default and demand for performance of his obligation or after judicial ascertainment of default.

3. I believe that industry custom and practice and judicial standards generally followed throughout the United States require notice of a claimed breach of a lease duty by a lessee and a meaningful opportunity to correct the breach be given to the lessee. This belief is reflected in statutory law in Louisiana that I participated in drafting and which I refer to here as indicative of a generally accepted understanding of the operation of the reasonably prudent operator standard. Because of uncertainties in the jurisprudence arising from a revision of an article in the Louisiana Civil Code, I initiated a revision of Article 136 of the Louisiana Mineral Code to make explicit the requirement for an opportunity to cure any defect in performance prior to judicial termination of an oil and gas lease. This was done in my function as Reporter of the Mineral Code Committee of the Louisiana Law Institute. The language I proposed, which was then adopted by the Louisiana legislature, is the following:

> If a mineral lessor seeks relief from his lessee arising from drainage of the property leased or from any other claim that the lessee has failed to develop and operate the property leased as a prudent operator, he must give his lessee written notice of the asserted breach to perform and allow a reasonable time for performance by the lessee as a prerequisite to a judicial demand for damages or dissolution of the lease.
>
> LA R.S. 31:136, as amended by Acts 1995, No. 1116, § 1.

4. The United States Supreme Court in an implied covenant case involving a question of prudent operation and development, ruled in favor of only a conditional cancellation of a lease, recognizing that equity required giving the lessee an opportunity to perform:

> The District Court decreed a cancellation as to all except a strip 400 feet wide along the southern boundary of the S.E. 1/4 of the S.W. 1/4 of section 16, containing about 8 acres. The dissenting judge in the Court of Appeals thought that a decree should be entered canceling the lease as to the 320-acre tract (the E. 1/2 of the section) unless within a reasonable time an exploratory well should be drilled therein to the Mississippi lime, and that the 40 acres embraced in the S.E. 1/4 of the S.W. 1/4 of section 16 should remain under the lease. We are of opinion that such a decree would recognize and protect the equities of both parties.
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> *Sauder v. Mid-Continent Petroleum Corp.*, 292 U.S. 272, 282 (1934).

5. Typical of the cases that provide for conditional cancellation for breach of the implied covenant of reasonable development is *Roberson Enterprises, Inc. v. Miller Land & Lumber Co.*, 287 Ark. 422, 700 S.W.2d 57, 87 O.&G.R. 239 (1985), which observed that:

> "Cancellation of an oil and gas lease is an appropriate remedy when breach of the implied covenant of reasonable development is shown. When this equitable remedy is sought on the basis that the remedy at law is inadequate, however, the remedy of conditional cancellation is preferred" (citing H. Williams and C. Meyers, *Oil and Gas Law*, § 834, pp. 247-248 (1984))
>
> . . .
>
> "A good reason for ordering conditional rather than absolute cancellation upon finding a breach of the covenant is that the question of reasonableness of development is a difficult one, generally approached *ad hoc*. (citing H. Williams and C. Meyers, *Oil and Gas Law*, § 832.2 (1984)).

6. Similarly, *Humble Oil & Refining Co. v. Romero*, 194 F.2d 383 (5th Cir. 1952) is instructive on the judicial approach to conditional cancellation. The case takes an extreme position on the development obligation yet limits the remedy. The lease covered 876 acres on which three wells had been drilled at a cost of $500,000. One well was a producer and two were dry holes. About eight months after the third well was abandoned, plaintiff demanded additional drilling. This was refused and within a year to eighteen months thereafter (the opinion does not specify), the suit for cancellation was filed. The plaintiff relied on the testimony of two witnesses, a geologist who testified of probable production from another well and an operator who testified he would drill the land if he could get a lease. The district judge found that a preponderance of evidence did not show that another well would be profitable but held that the lease should be cancelled (except for twenty acres around the producing well) upon the offer of the prospective operator-witness to drill. The decree required the lessee to drill within sixty days or lose the lease. The Court of Appeals for the Fifth Circuit upheld the substance of the ruling, but modified the decree to make cancellation dependent on the witness's furnishing "satisfactory assurances" that he would drill if the lease were cancelled and he were the operator.

7. Applying the foregoing principles and standards, it is my opinion that it would be inappropriate to terminate the PTU and the Point Thomson leases without DNR providing notice and demand of the specific activities and operations necessary for the Owners to maintain the PTU and leases. Upon the failure of the Owners to comply, the DNR could then seek a court determination that Owners have breached their duties under the PTUA and the leases, and that the DNR's criteria for a program of development meets the requirements of the PTU and the conservation statutes and best serves the public interest.

**B. Alternative Plan or Conditional decree**

1. The approach most consistent with the application of the reasonably prudent operator standard and the nearly universal judicial treatment of like cases in questions of exploration and development would be to suspend consideration of

termination while giving Owners the opportunity to develop the leases and unit under their proposed Plan of Development.

2. The Department would evaluate the proposed POD using the best available engineering and geological data and employ the reasonably prudent operator standard to see if the proposed POD measures up to that standard. The Department would then monitor implementation of the POD to insure compliance by the Owners. The PTU Owners have said they support regular communication with DNR, on a quarterly or more frequent basis, in an effort to answer questions and resolve disagreements at an early stage.

3. Should the Department decide to reject the proposed POD, I believe that the duty of cooperation, fundamental fairness and due process would require DNR to make specific findings in its decision as to the facts, the provisions of the PTUA, the DNR regulations and the statutory authority upon which it relies. DNR should explain what breach of duty by the Operator and Owners would justify termination and why it concludes that the proposed POD does not meet the requirements of the prudent operator standard and why and how new (and unidentifiable) lessees could better develop the Point Thomson Unit Area resources and better serve the public interest than the present proposed POD. Such findings and explanation would be necessary to show that the decision of DNR was based on substantial evidence and that the exercise of its authority was not arbitrary and capricious.

4. From my examination of the history of the Point Thomson Unit and the decisions of the DNR involved in the present proceeding, I see nothing that would justify the drastic remedy of termination of the PTU and the Point Thomson leases. There were approvals of twenty-one prior PODs that were arrived at in a cooperative manner by DNR and the Owners. When the twenty-second POD was proposed it was rejected as not being in the public interest. But I do not believe that the proposed twenty-second POD nor the amended proposal for the twenty-second POD contained anything that could be characterized as a material breach of any duty of the Owners under the PTUA that would justify termination.

## VI. Conclusion

1. Based on my familiarity with oil and gas leasing and development and with Alaska North Slope operating conditions, there is no reason to believe that terminating the Point Thomson Unit and the underlying leases that constitute the PTU would lead to "economical and efficient recovery" of the oil and gas resources of the Point Thomson Unit Area. Rather, even if new leases could be granted promptly despite the likelihood of on-going litigation over the DNR's termination, the new leases would have less likelihood of successful development than the present leases under the current lessees. That is, it would likely take years for new leases to be granted for such a large area and for the new lessees to put together a new field wide unit for the Point Thomson Unit Area. New lessees would have to duplicate exploration and development activities already accomplished by the present Owners, and this would be wasteful and potentially damaging. Indeed, based on my experience with units and with Alaskan unit matters, I suspect it would be difficult for any group of new lessees to be able to put together a new Point Thomson Unit and to come together on a united Plan of Development for a new PTU. New lessees would almost undoubtedly lack the experience, expertise and resources of the present Owners. New leases and new lessees thus are likely to impede instead of facilitate the economical and efficient recovery of the Point Thomson oil and gas. The Alaska North Slope is a hostile environment and few operators in the world have the resources to undertake the responsible development of the Point Thomson resources in a manner that serves the public interest.

2. I am impressed with the Owners' proposed POD that they submitted with their brief in this matter under date of February 19, 2008. It is a very substantial commitment of resources to the development of the PTU. It shifts from a standard-based commitment to a specific work commitment by the Owners. Unlike the experience of the Prudhoe Bay Unit for many years, the Owners here are now aligned in their interests in the different reservoirs underlying the PTU Area. Their voting procedures under the revised PTUOA should more easily facilitate implementation of the proposed operations. As I have indicated, I think it would be very difficult with new leases and new lessees to reach this level of cooperation and commitment for some years into the future. In particular, I do not think DNR could undertake a new round of leasing the Point Thomson

area and expect new lessees to come up with any better plan of development. If DNR is to fulfill its obligations to protect and promote the public interest, it would be necessary to obtain advance commitments from potential lessees to specific programs of development and to do so without being able to give them access to the geological and engineering data upon which a program of development would have to be based. In my opinion, the State is likely to achieve far less development by pursuing termination of the Point Thomson Unit and leases than by approving the proposed POD. The exceptional rise in oil prices between 2005 and 2008 persuades me that the proposed POD is feasible, prudent, and in the public interest.