State of Alaska
FY2004 Governor's Operating Budget

Department of Natural Resources
Oil & Gas Development
Component Budget Summary

Component: Oil & Gas Development

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Component Mission

The mission of the Division of Oil and Gas is to administer oil and gas lands in a manner that assures both responsible oil and gas exploration and development and maximum revenues to the state (Differs from Ch.124, SLA 2002).

Component Services Provided

Make prospective lands available for oil and gas exploration, development, and production on a predictable basis.

Administer conventional oil and gas leases, shallow natural gas leases, and exploration licenses, as well as exploration incentive programs.

Maximize the economic and physical recovery of hydrocarbon resources through unitized or cooperative operations.

Ensure that full value is received from the extraction and sale of state resources.

Develop marketing strategies and negotiate agreements for the sale of royalty oil and gas to provide in-state benefits.

Ensure that bonus, rental, license fees, net profit, and royalty payments are correct and received when due.

Ensure that shared federal bonus, rent, and royalties are properly received and allocated.

Ensure that leasehold and unit-related operations are conducted in a timely and environmentally sound manner.

Provide technical and policy support for the Alaska congressional delegation, the Governor's office, the Legislature, and the Commissioner of DNR.

Provide oil and gas related information to the public and the press through our website or personal contact.

Advocate responsible petroleum development throughout the state.

Component Goals and Strategies

Convey rights to explore for, develop, and produce oil and gas by conducting four areawide oil and gas lease sales and issuing multiple oil and gas exploration licenses and hundreds of shallow natural gas leases.

Manage the state’s interest in oil and gas lands by monitoring operations on 1400+ leases and in 35+ units, mandating additional activities when advisable, and accounting for oil and gas rental and royalty payments.

Collect and verify oil and gas revenues of $0.6 to $1.3 billion through timely and accurate accounting and auditing.

Negotiate new royalty settlement agreements and amend existing royalty settlement agreements when economically advantageous to the state.

Market royalty oil and gas to maximize state revenues and stimulate economic development.

Initiate and administer programs that encourage responsible exploration and development.

These goals support a commitment to maintain and enhance competition, diversity, and balance in the exploration, development, and production of Alaskan resources, sustain or increase oil and gas production, and the revenues derived from that production, and ensure that the State's natural resources are developed in an environmentally and socially responsible manner.

Key Component Issues for FY2003 – 2004

The Division of Oil & Gas manages the state's oil and gas resources with a staff of 59, consisting of highly specialized technical experts schooled as geologists, geophysicists, engineers, attorneys, economists, accountants, and natural resource specialists, who work as a team but are assigned to six sections: administration, resource evaluation, leasing, commercial, royalty accounting, and lease, permit and unit administration. Together, they brought in more than $850 million in FY02. During that same period, and in the four months since, they handled an explosion of activity. They:

- leased or licensed exploration on millions of acres,
- implemented the new shallow natural gas leasing program,
- negotiated agreements for the formation or expansion of eight units and four areas of production within units,
- augmented royalty and net profit share revenues by auditing lessees and negotiating or amending royalty settlement agreements,
- concluded proceedings for redetermination of the methodologies used by BP and ConocoPhillips in valuing North Slope royalty oil,
- worked with the producers, the governor's policy council, and the legislature on gasline issues,
- offered royalty gas for sale,
- processed over 900 applications for the assignment of interests in oil and gas leases and verified the financial responsibility of each assignee, and
- participated in the EIS process for the Colville River Unit satellite development and the Point Thomson development projects.

The division's existing budget level will allow continuation of these types of activities; however, incremental funding is needed to:

- reduce the time for issuance of a lease from as much as a year down to four months, and thus accelerate the collection of ~$9 million in bonus bids and lease rentals, as well as accelerate oil and gas exploration, development, and production on state lands;
- improve and expand the oil and gas royalty tracking system so that the division can continuously monitor crude and gas values and field, processing, and transportation costs, and thus audit royalty payers quickly and timely and reopen and renegotiate royalty settlement agreements to rapidly enhance state revenues;
- promote and facilitate an increased role for independent oil and gas companies willing to develop new regions of the state; and
- minimize or eliminate vacancies and keep the division fully and competently staffed to rapidly lease acreage, promote or compel early exploration, development, and production, and maximize revenues to the state.

Additionally, incremental funding requested by other state agencies is needed to accomplish division goals:

- $1.5 million is being requested by the Department of Law for FY04 and to supplement FY03 for arbitration on the methodology governing calculation of Exxon's North Slope royalty obligations to the state.

Major activities occurring in or planned for FY03-FY04 are discussed below by section. In the upcoming fiscal year, the division expects to see a decrease in exploration activity by BP and ConocoPhillips but an increase in activity by independents, both large and small. As the majors deal with merger-related expenses, additional acquisition, and other worldwide opportunities, the independents will become increasingly important to the state. Many believe this is a natural evolution similar to one that occurred in the onshore and shallow marine portions of the Gulf of Mexico. While the frontier exploration efforts of the majors has diminished, they have been active in the development of satellite fields near existing infrastructure and are proceeding with the initial permitting stages for the development of Point Thomson.

Leasing

The North Slope, Beaufort Sea, North Slope Foothills, and Cook Inlet areawide lease sales are increasing the number of leases sold annually, especially the Foothills sales. In four areawide lease sales during 2002, the division leased 94 tracts covering 353,000 acres. New companies are participating in the leasing program, and companies that have not participated for a number of years are returning.

As a result of this increased areawide leasing activity, along with the addition of shallow gas leasing, the number of leases being issued and administered has risen dramatically (see Figure 1).

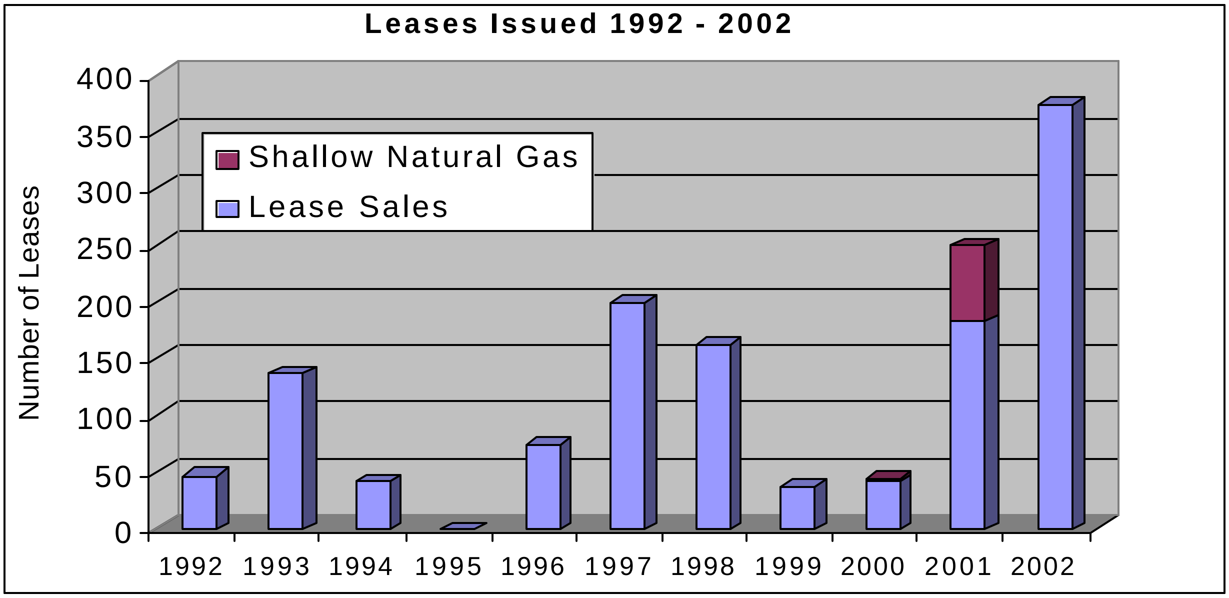

Figure 1

Interest in exploration licensing also continues to be high. The division issued two exploration licenses, one in the Copper River basin and one in the Nenana basin, and has proposals for two licenses in the Susitna Valley, west of Willow and Talkeetna. Exploration licensing has presented the division with previously unscheduled work requirements, most notably title work. The four licenses have added nearly 2 million acres to the division's title workload. Additionally, the licensing program must be supported by geological investigations and resource assessments by the division and all of these exploration licenses require best interest findings.

Likewise, the shallow gas leasing program, which resulted in over 300 applications, has required title work on over a million acres, while exploration licensing required title work on one-half million acres and areawide leasing 1.73 million acres. Figure 2 shows the increase in title work as a result of areawide leasing and the exploration licensing and shallow gas leasing programs.

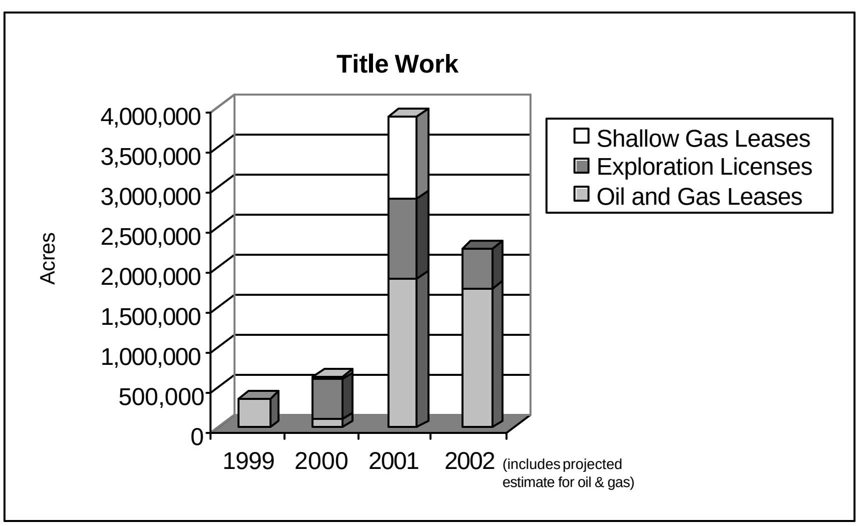

Figure 2

The success of the exploration licensing and shallow gas leasing programs combined with four annual areawide sales has resulted in a significant increase in title work. This increased workload has, in turn, meant significant delays in issuing oil and gas leases (see Figure 3). This delay carries a fiscal cost. The state collects twenty percent of bonus bids during a sale; the remaining amount, along with the first year's rental, is due when the lease is awarded. The state is delaying millions of dollars in revenue because of the backlog in title work. For example, leases for Beaufort Sea Areawide and North Slope Areawide sales held in October 2001 were not issued until August 2002. As shown in Figure 4, over $8.7 million in bonus and rental payments to the state were deferred because of this long delay. Additional staff is needed to complete the title work in a timely fashion.

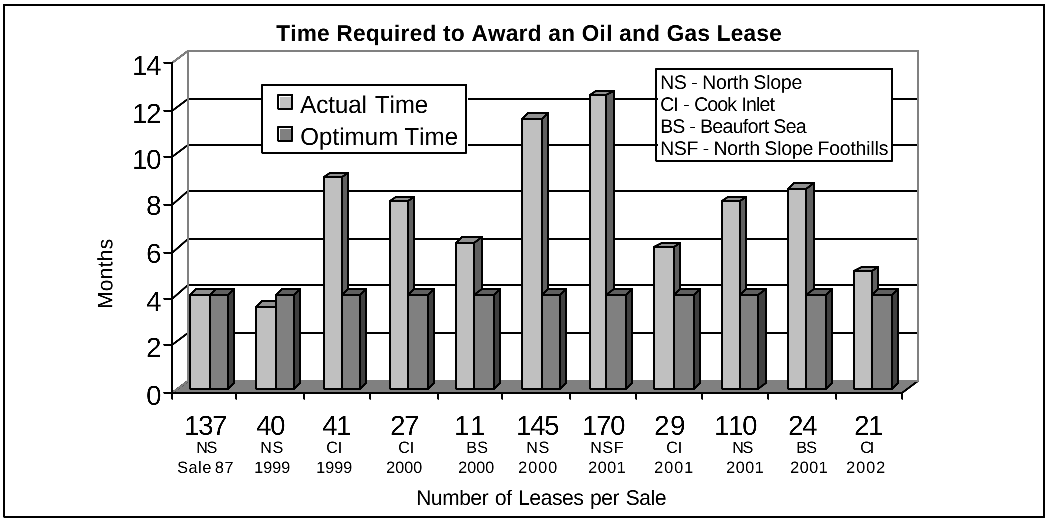

Figure 3

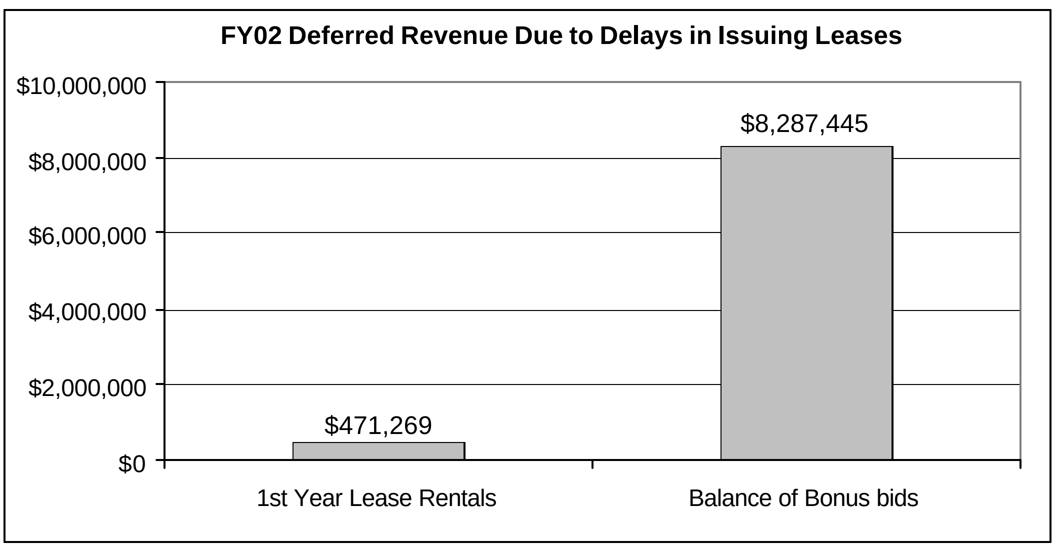

Figure 4

Part of this division's budget request is for an increment to provide funding for new positions to assist in the lease issuance process, thereby alleviating the backlog and reducing the delay in collecting revenue.

Also with regard to leasing, the division continues to review all mitigation measures for competitive lease sales, exploration licensing, and shallow gas leasing, modifying these measures as new concerns arise and the oil and gas industry evolves. Additionally, the division must defend its leasing decisions against lawsuits by environmental groups. Although DNR was successful in defending appeals of the best interest findings for Cook Inlet and Beaufort Sea Areawide Sale 85A, the division anticipates that environmental groups will continue to challenge DNR actions involving oil and gas activities. A recent example is the September 2002 request for reconsideration of the division's best interest finding for the Nenana Exploration License. Moreover, the division has recently seen increased scrutiny by environmental litigants on its permitting actions.

Concerns over the beluga whale will continue to be an issue in Cook Inlet. The department is under court order to withhold leasing of 126 tracts until the court is satisfied that safeguards are in place to protect the belugas. The department has stated that it would not offer these tracts until subsistence hunters and the National Marine Fisheries Service (NMFS) have agreed on a co-management plan; such a plan is now in effect. The division will need to supplement the beluga whale discussion in its 1999 Cook Inlet Areawide best interest finding before these tracts can be offered in a lease sale.

Finally, the division renewed a contract with IndigoPool.com to place lease sale information on its website in order to reach a broader international market. Through IndigoPool's contacts and proactive marketing, information about the state's leasing and licensing programs is reaching a much wider audience. If funding is renewed, the division will continue using IndigoPool, and also will be able to take advantage of the low advertising rates IndigoPool' clientele is given by major industry publications, which will increase worldwide exposure. The division's outreach programs, including the use of IndigoPool, and it's promotional booth at two large oil and gas trade conventions (AAPG and SEG) are at least partially responsible for the increase in number of new bidders at recent state sales. These companies include large independents such as EnCana, Burlington Resources, and Armstrong Resources, as well as smaller well-financed companies. Finally, the division intends to add its presence at the North American Prospect Expo (NAPE) in Houston, Texas during January 2003.

Lease Administration and Units

Oil and gas units and participating areas (PAs) are the backbone of oil and gas production in Alaska. The division's ability to manage the state's units is critical to the state's economic future. These complex negotiated unit and PA agreements provide the framework for maximizing production with minimum environmental impact while protecting the rights of all parties. In order to offset the decline in production from the main reservoir at Prudhoe Bay, an increasing percent of Alaska's oil production will need to come from new and smaller reservoirs, each requiring the formation of a new PA, and in some cases new units. The good news is that these new units and PAs are the result of recent exploration and development activities that in turn has lead to a significant amount of new production. For example, in and since FY02, the division negotiated agreements for the formation of the South Ninilchik, Deep Creek, Cosmopolitan, Sakonowyak River, and Ninilchik Units, for the expansion of the Kuparuk River and Colville Units, and for the formation of the Aurora, Polaris, Borealis, McArthur River Hemlock, and Northstar Participating Areas. The division also oversaw the startup of production at Alpine, Meltwater, Borealis, and Northstar. Additionally, the division is currently evaluating applications for the formation of the Big Delta and Kasilof Units and the Redoubt Participating Area.

The division currently oversees 36 active units and 55 active participating areas. Over 170 unit actions were adjudicated last year. Figures 5, 6, and 7 illustrate the significant long-term increase in units and PAs and the new production associated with them. Managing the increased workload associated with the increase is one of the major challenges facing the division.

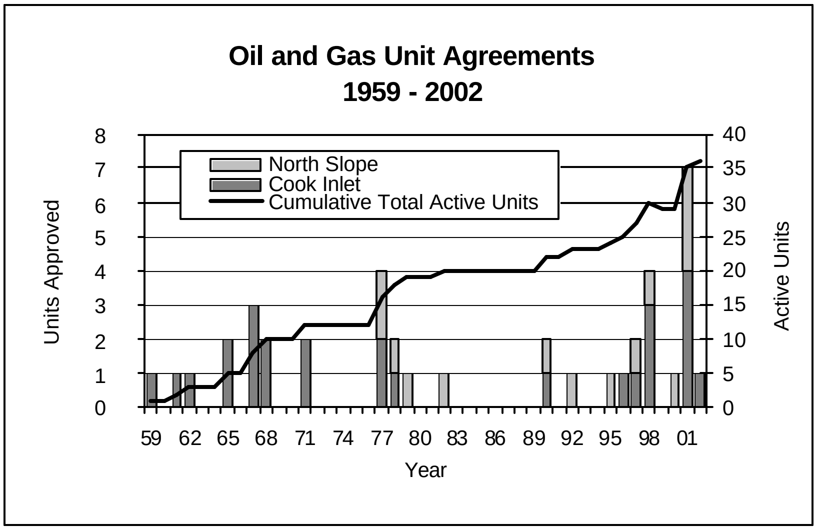

Figure 5

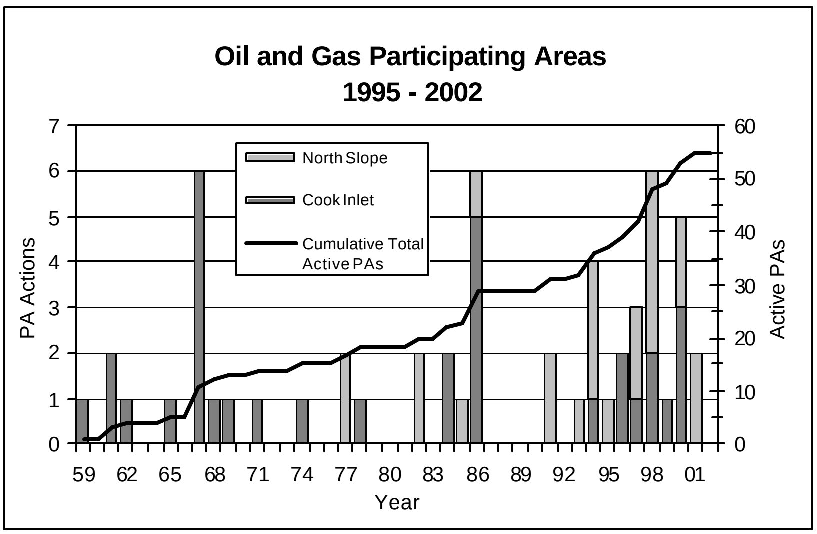

Figure 6

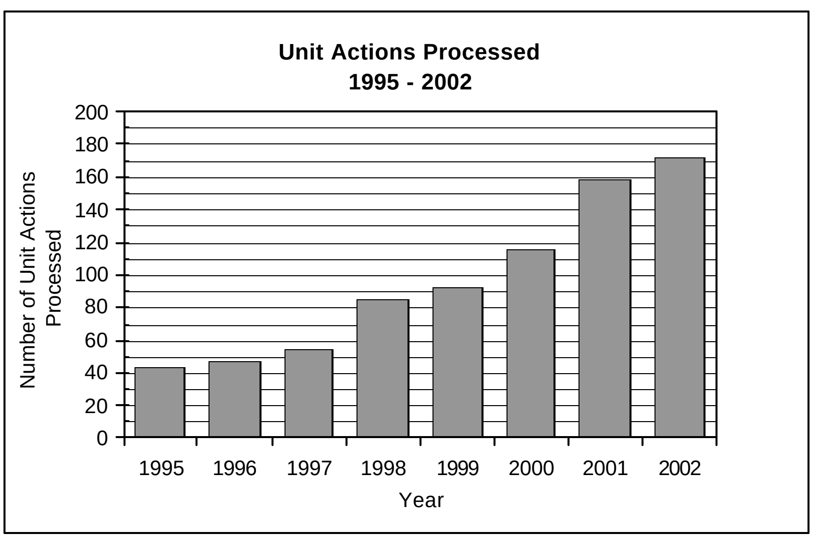

Figure 7

Oil and gas production from satellite pools and new field start-ups is becoming an increasingly important part of North Slope output. Currently over 25 percent of ANS output is from new pools, new participating areas, and expansion areas of older participating areas that began production since 1995. (See Figure 8.)

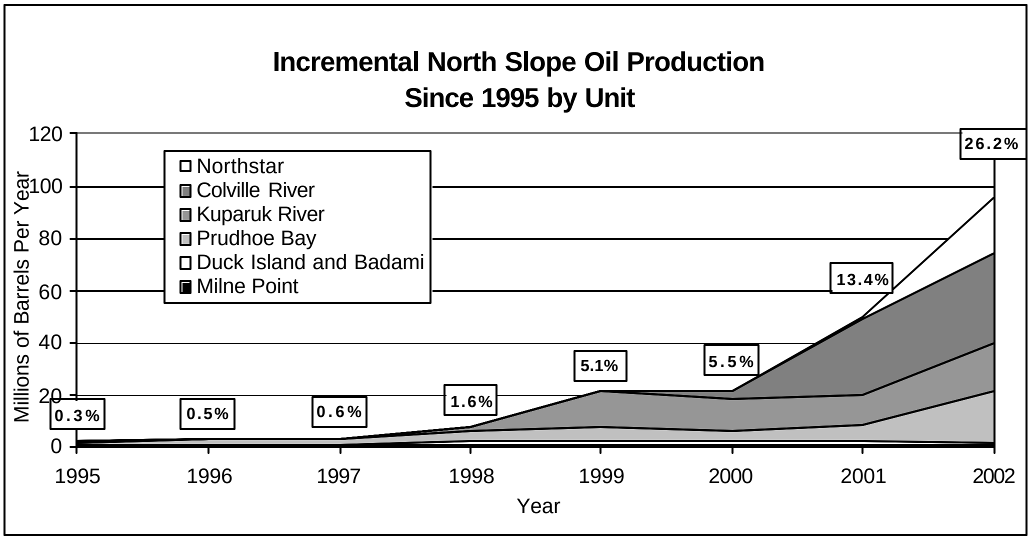

Figure 8

Additionally, relatively high oil and gas prices and the potential for a North Slope gasline are leading to much greater activity in the division and in the field. Phillips and BP are both projecting little or no overall production decline. BP has publicly stated that they have lowered operating costs at the PBU from $3.00 per barrel to $1.50 per barrel, which should make many more projects economic within that unit. Moreover, the equalization of the interests in the Prudhoe Bay leases has spurred an increase in the activity for satellite developments and gas-related projects in the unit. As a result of a number of successful "satellite" wells, the number of unit actions has increased. Although they involve fewer barrels than the major reservoir at Prudhoe Bay, these actions are extremely complex. Much of the new activity occurs at the edges of existing units or at the conjunction of two (or more) units and involves commingling of different production streams through common facilities and facility sharing agreements.

Exploration and development activity will also require more time from the division's permitting group. More projects will have to be reviewed, permitted, and monitored for stipulation compliance. The ongoing push towards North Slope gas commercialization and heavy (viscous) oil development at Prudhoe Bay, Kuparuk River, and Milne Point will increase the permitting and inspection workload due to new developments, pads, pipelines, and infrastructure on the North Slope.

High oil and gas prices and declining gas reserves are causing an increase in exploration and development activity in Cook Inlet. Smaller companies and new companies are showing an interest in drilling exploration wells and operating existing facilities. Smaller and new companies tend to have less experience or resources compared to larger companies. This can slow the permitting process and increase the risk of default under the terms of the oil and gas leases. Staff are spending larger amounts of time educating and guiding these companies through the permitting process, as well as on oversight, monitoring activities in the field, and formulating performance bonds to lower risk to the state.

In addition, the shallow gas lease and the exploration license programs are providing an incentive to explore for oil and gas in areas where a significant percent of the surface is owned by private parties. Consequently, more staff time is required to educate the public. Moreover, the relationship between surface and subsurface owners involves complex legal issues that have not yet been fully resolved in Alaska. The uncertainty is resulting in appeals and hearings over the issue of damages and compensation to the surface owner. Staff is spending larger amounts of time on these issues.

Issuance of shallow gas leases may result in new short term drilling activity because the primary term of the lease is just three years. To keep any lease beyond that period requires ongoing drilling, drilling a well capable of commercial production, or unitization. The state should expect drilling programs and applications to unitize to be proposed very soon after the leases are issued.

The first coal bed methane unit (the Pioneer Unit) has had several wells drilled to date. The division hopes to see more progress this year as a new operator, Evergreen, has assumed control in the unit and proposes to drill and test two or three pilot areas this year. The division is prepared to issue additional shallow gas leases in the Cook Inlet area but is waiting for a resolution of several appeals. Existing Cook Inlet markets and infrastructure improve the economics for shallow gas exploration and production in that area.

The division is actively participating in the National Petroleum Reserve, Alaska (NPRA), Colville River, and Point Thomson EIS preparations. Offshore development projects such as Redoubt in Cook Inlet and McCovey in the Beaufort Sea continue to be a permitting challenge. As instructed by the legislature in 2001, DO&G is drafting regulations that would outline public notice procedures for DO&G permits not covered by the ACMP.

Finally, the division processed over 900 applications for assignment of leasehold interests, many of them occasioned by the realignment of the interests of BP, Phillips, Exxon, and Forest Oil at Prudhoe Bay. In addition, the division is just starting to process assignments for the alignment of interests at Point Thomson. A third wave will be forthcoming as a result of the Chevron-Texaco merger and the recently announced global alignment at Prudhoe Bay.

Resource Evaluation

During FY02, lessees completed seventeen significant exploration and delineation wells in Alaska. Ten of these are located on state lands, four are located on federal lands within the NPRA, two are on Native lands, and one is on private land. Although the results of all these wells have not yet been disclosed, it is clear that the state's recoverable hydrocarbon reserve inventory continues to increase as four of these wells were completed or suspended as successful gas wells and three were completed or suspended as successful oil wells. Particularly significant were the continued successful delineation program by Forest Oil at the Redoubt Unit in Cook Inlet and Marathon Oil Company's gas discovery at the Ninilchik Unit. When brought on-stream, these fields will increase present Cook Inlet oil production rates by about 25 percent and add approximately 90 billion cubic feet to the Cook Inlet's natural gas reserves. The results of the wells drilled on the NPRA and Native lands during FY02 have not been disclosed.

Extensive effort continued to be dedicated to review of activities and actions proposed by operators of the Point Thomson and Northstar units, the latter involving, for the first time, shared unit management responsibilities with the federal Minerals Management Service (MMS). The resource evaluation section, the Alaska Oil and Gas Conservation Commission, and the MMS collaborated on development of a full-field reservoir simulation model whereby the agencies can monitor and verify Northstar production to better assure accurate resource allocation among the stakeholders. This should serve as a model for future joint state-federal unit management of the proposed McCovey and Cosmopolitan projects.

The resurgence of interest in and possible commercialization of North Slope gas reserves has had a significant impact on the resource evaluation section. The successful areawide lease sales in the North Slope Foothills area have introduced several new players to the area, each attempting to acquire large lease positions and each bringing new exploration and engineering concepts to the Alaska scene. The resource evaluation section continues to evaluate the natural gas potential of the area in conjunction with the Division of Geological and Geophysical Surveys by supporting and participating in geological field programs in the region. The section is also compiling a summary of the results of conventional and unconventional natural gas resource assessments of Alaska basins that might be accessible from a trans-Alaska gas pipeline.

Since the state receives half of the revenues produced by NPRA oil and gas activities, the division remains hopeful that cooperative federal-state management agreements will be implemented as development of those reserves proceeds. The possible impact of ANWR remains an unknown. Throughout much of FY02 the division dedicated significant time and resources to promoting the opening of ANWR for responsible oil and gas exploration and development. Although interest has waned in recent months, division experts were involved in the issue at many levels: locally, statewide, nationally, and internationally. This included briefing key federal officials and providing information to media outlets.

The Department's denial of a discovery royalty certification for the Sambuca well remains controversial. British Petroleum, Exxon, and ConcoPhillips have appealed the Department's denial of discovery royalty certification to the superior court. Reversal of the denial, though unexpected, would result in the loss of approximately $23 million in royalty revenue.

Commercial

The division's petroleum investments manager, petroleum market analyst, commercial analysts, and auditors work with other members of the division in maximizing royalties payable to the state. During FY01 and FY02, they initiated proceedings for redetermination of the methodologies used by BP and Exxon in valuing North Slope royalty oil; re-engaged Phillips in a reopener proceeding that had been stayed following the BP-ARCO merger; offered both royalty oil and royalty gas for sale; worked with the producers, the governor's policy council, and the legislature on gasline issues; and resolved a number of outstanding royalty and net profit share issues with the producers, as more specifically described below.

In the early 1990s, the major North Slope oil producers and the state entered royalty settlement agreements that tied each producer's royalty obligation to a market basket of seven crudes. Subsequently, the settlements with BP and ARCO (now Phillips) were amended to require royalty payments based on ANS spot prices, except where the market basket of seven crudes and ANS spot differed by more than $0.50. In late FY01, the division compared the amounts being paid under these formulae to market value as measured by ANS sales contracts and actual receipts and found the formulae wanting. Consequently, the division "reopened" the royalty settlement agreements with BP, Exxon, and Phillips to renegotiate a valuation methodology that better reflects the market value of ANS. As of the date of this writing, the division has completed negotiations with BP and Phillips. Negotiations with Exxon are stalled. If negotiations with Exxon fail, then the division will proceed to arbitration in 2003. (See Figure 9.)

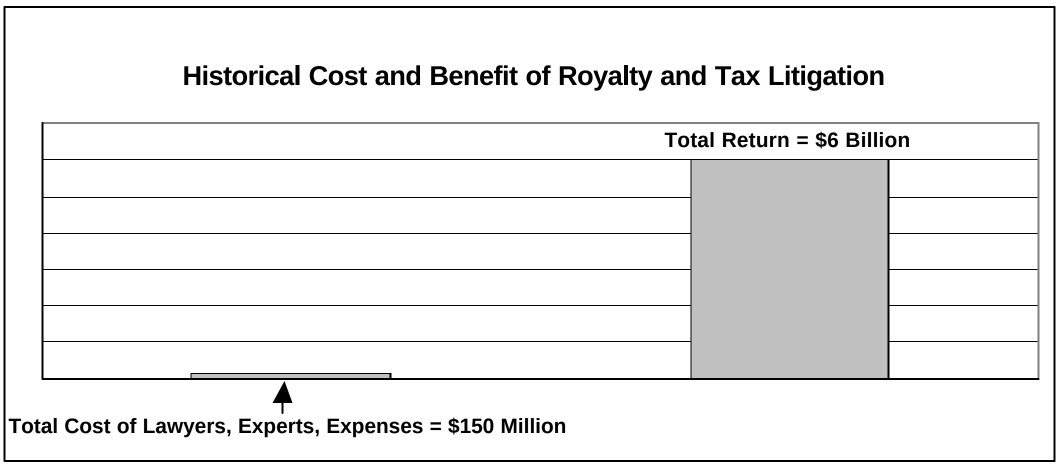

Figure 9

The conclusion of the BP and Phillips reopeners this year resulted in payment of an additional $11 million by BP and Phillips in retroactive adjustments. Additionally, the position of the State in the future will be improved by new prospective methods incorporated in the royalty settlement agreements. The chart above illustrates how the State has benefited dramatically from pro-active management of its royalty and severance tax revenues. This last year has seen a similar cost benefit ratio comparing the outlays for staffing in the division, the Department of Law, and the cost of outside experts.

The division continues to supply royalty in-kind (RIK) oil to the Alaska refining industry. Currently, about 41 percent of ANS royalty oil is sold by the division in-kind. The expiration of two major ANS RIK oil contracts in 2003 suggests that another offering in calendar year 2003 may be appropriate.

The commercial section also devoted many hours to advance the ANS gas pipeline project. Staff has been developing in-house expertise in the marketing and valuation of gas and gas liquids in the United States and Canada, transportation economics, and rate-making. They have served both the governor's policy council and the joint legislative committee on gas pipelines. In early 2002 they negotiated a contract to sell 350 million cubic feet of ANS royalty gas.

The division, working together with the Department of Revenue, will continue to bring oil and gas royalty and net profit share audits more current. Our goal is to see all royalty reports and net profit share payment reports audited within three years of filing. The revenue auditors in the commercial section have completed several audits this year that closed out long-standing issues between the State and the lessees. The backlog of royalty audits has decreased and the audit cycle covers more current years. In the last nine years, 120 royalty and net profit share audits have been issued and

101 closed. These audits yielded an additional $87.9 million in royalty revenue to the State. Collections have averaged almost $10 million per year with just four DNR auditors and support from 1.6 positions in DOR. When the commercial section was reorganized in October 2000, the median exposure to the State for open audits was ten years; today the exposure has been reduced to five years. Progress made by the commercial section's revenue staff is illustrated in the chart below. (See Figure 10.)

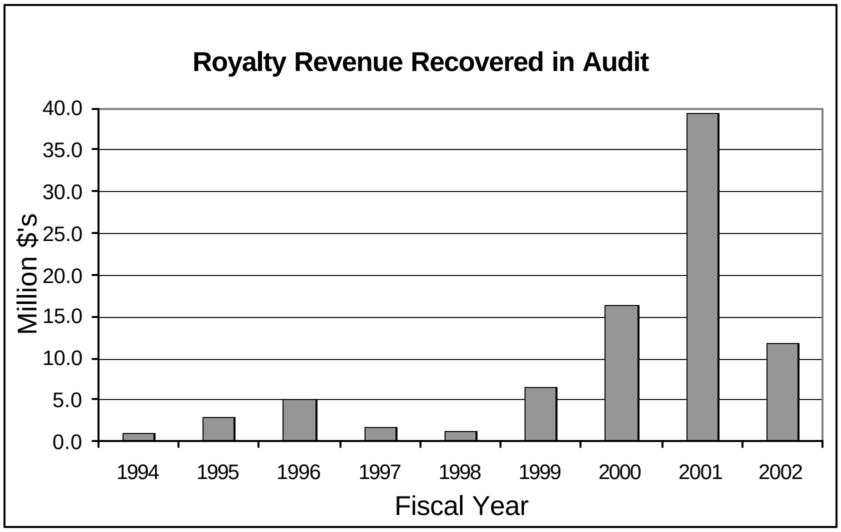

Figure 10

The remainder of the commercial section's time is devoted to working with the units and resource evaluation sections in developing commercial terms for lease sales and for the formation and expansion of units and participating areas.

Royalty Accounting

During previous fiscal years, oil and gas royalty reporting was standardized through design and implementation of standard report formats and content requirements. The standardized reporting was automated using National Standards for Electronic Data Interchange (EDI). The EDI interface is a crucial component of the division's oil and gas royalty accounting system (OGRA). Currently all lessees are reporting using these standardized reports and deliver reports electronically rather than by the endless stream of paper of the past. The benefits are that all lessees now report for all required fields on time and that these reports are loaded to an electronic database upon receipt. In contrast, historically, reports were incomplete, not filed, or filed late, and data loading was weeks behind in many cases. All of these past deficiencies have been eliminated. Other benefits include real-time report availability, more detailed reporting, improved data quality, and immediate reconciliation of reported amounts due with actual payments received. During FY02, a major effort was completed to load three years of revisions for one company due to a change in marine costs and a reopener of the ANS settlement agreement.

In September 2002, the division completed both an internal and an external review of OGRA. These reviews determined that the state could dramatically increase the value of OGRA by redesigned the system. The rewrite would allow the state to gain much greater efficiency out of the system by eliminating duplication with other state systems and, even more significantly, maximize the ability to use of the data for audit and commercial analyses. DNR has determined it will be both cheaper and more efficient to contract out the rewrite and is requesting CIP funds to accomplish it.

Miscellaneous

Litigation will remain a significant component of the division's workload, draining resources needed to accomplish the division's technical mission; unfortunately, this has become the norm rather than the exception.

The legislature's approval of higher pay for exempt division employees has had a very positive affect in retaining and attracting key specialists. However, pay for the division's non-exempt employees (particularly those in the natural resource officer and manager series) remains low, making it difficult for the division to recruit and retain these employees, especially during resurgences of industry and with the prospect of a gas pipeline. Low pay relative to industry, combined with the imminent retirement of many employees within the next five years, is creating a crisis for this division which relies on experienced, technical expertise in its missions to issue leases and permits quickly; maintain reliable competitive leasing, exploration license, and shallow gas programs; and maximize financial return to the state. DNR is in the process of reviewing and rewriting the class specifications for the current natural resource officer and manager series in an effort to specifically recognize the importance of experience and technical expertise. Training and cross-training of staff continues as a priority to minimize this potential problem.

Major Component Accomplishments in 2002

1) In FY02, petroleum revenue collected by the Departments of Natural Resources and Revenue accounted for approximately 81 percent of general fund unrestricted revenue. Total royalty, settlement, rental, federal share, and bonus revenue collected by DNR was $858.6 million. Distribution was as follows: $593.8 million General Fund, $260.2 million Permanent Fund, $.3 million Constitutional Budget Reserve Fund, and $4.3 million School Fund. Revenue decreased 25.1 percent from FY01 to FY02, largely due to the declining price of oil.

2) Resolved a sizeable audit dispute with BP and closed out several long-standing audit claims with other lessees. Among these were: 1994-1999 BP ANS marine transportation audit; 1992-1995 Amerada Hess ANS valuation audit; 1988-1997 Marathon Cook Inlet LNG valuation and transportation audit; and 1987-1992 Texaco Cook Inlet valuation audit. Total revenues generated by settlement of these audits equaled $48 million.

3) Renegotiated royalty settlement agreements with BP and Phillips. Under the renegotiated agreements BP and Phillips paid an incremental $11 million for 2000-2001 and will calculate royalties based on higher crude values in 2002 and future years.

4) Implemented electronic reporting of oil and gas royalty reports for all lessees.

5) Provided commercial, technical, and policy support to the governor’s gas pipeline policy council and the legislature’s gas pipeline committee.

6) Successfully negotiated two large, long-term royalty gas sale contracts for ANS gas produced for an ANS gas pipeline. The contracts are awaiting approval by the Alaska Royalty Oil and Gas Development Board and the legislature.

7) Managed 36 active units and 55 participating areas (PAs) within those units. Management of the units and PAs included negotiation of new unit agreements; negotiation of expansions and contractions to units and PAs; tract allocation and equity determinations; negotiation and monitoring of facility-sharing and production commingling agreements for the new PAs; review of plans of exploration, development, and operation for units and PAs; DNR representation before various state and federal agencies; and response to inquiries from the legislature, oil and gas industry, and public. Unit and PA activity levels have increased due to the development of satellite pools.

8) Conducted geological reviews of industry proposals to establish or modify units, participating areas, and plans of exploration, production, or operations for the following units, fields, and pools: Alpine, Anchor Point, Aurora, Badami, Borealis, Cannery Loop, Colville River, Cosmopolitan, Deep Creek, Kasilof, Kuparuk, McCovey, Meltwater, Midnight Sun, Milne Point, Niakuk, Ninilchik, North Middle Ground Shoal, Trading Bay, Northstar, Polaris, Pt. Thomson, Pretty Creek, Prudhoe Bay, Redoubt, Sakonowyak River, South Ninilchik, Slugger, and West Sak.

9) Negotiated and approved the Northstar Participating Area. Production commenced on October 31, 2001. Development drilling continues.

10) Continued “partnering” with the federal Minerals Management Service in management and oversight of jointly-owned lands in the Northstar, McCovey, and Cosmopolitan Units. The division also “partnered” with the federal Bureau of Land Management on issues regarding management of several jointly-owned fields in the Cook Inlet/Kenai region and continued its attempt to implement a similar procedure in the event that NPRA and state

lands are combined in units in the future. In similar fashion, the division worked in close partnership with the Arctic Slope Regional Corporation to ensure continued development of the Alpine field.

11) Participated in interdisciplinary meetings of state resource agencies (DGC, DNR, DEC, and F&G) addressing issues such as oil spill clean-up in broken ice and the critical issues of early tundra travel and the abbreviated winter drilling seasons.

12) Participated in geological field programs investigating the hydrocarbon potential of the NPRA and North Slope Foothills in support of both proposed lease sales and the North Slope gas pipeline supply studies.

13) Issued 325 oil and gas leases. Issued the Nenana Basin exploration license upon completion of the Nenana Basin best interest finding.

14) Sold 1,119,360 acres in the largest single lease sale ever. Four lease sales held in 2001 resulted in over 1.4 million acres being leased and the state receiving $21 million in bonus bids. In 2002, four lease sales were held, which resulted in 353,000 acres leased and $5.9 million received in bonus bids.

15) Processed over 900 oil and gas lease assignments.

16) Worked extensively with effected landowners who own property overlying state oil and gas leases proposed for exploration and/or development.

17) Worked with the legislature to amend AS 38.05.177 (shallow natural gas leasing). The amended statue increased the total amount of acreage that may be held by lessees, replaced the depth limitation of 3,000 feet with the requirement that some portion of the field be within 3,000 feet of the surface, and raised the application and rental fees. The amended statute is more in keeping with the commercial nature of the program, and it increases state revenue to pay for the program costs.

18) Provided technical support to the legislature on their review of oil and gas incentive programs. The deadline for completion of activity qualifying for exploration incentive credits under Title 41 was extended by legislative amendment until July 1, 2007. The specific intent of this particular EIC program is to encourage the acquisition of data on unleased state lands or non-state lands in remote areas of the state, and to provide a means for the state to obtain data from non-state lands.

19) Improved the division’s capabilities to manage and interpret 3-D was seismic data. Last year, 1,465 square miles of 3D seismic shot on the North Slope, about 3½ times the amount shot the previous year. The division is aggressively acquiring the data shot on state lands.

20) Expanded the content of the division’s website. The website has proved to be a very successful means of distributing information to industry and the public.

Statutory and Regulatory Authority

AS 38.05.130
AS.38.05.131
AS.38.05.134
AS 38.05.135
AS 31.05.035
AS 38.05.020
AS 38.05.030
AS 38.05.035
AS 38.05.137
AS 38.05.145
AS.38.05.177
AS 38.05.180

AS 38.05.181
AS 38.05.182
AS 38.05.183
AS 38.06
AS 41.06
AS 41.09
AS 44.19
AS 46.40
6 AAC 50
11 AAC 02
11 AAC 82
11 AAC 83
11 AAC 89.090
11 AAC 96.210 - 96.240

Oil & Gas Development

Component Financial Summary

All dollars in thousands

	FY2002 Actuals	FY2003 Authorized	FY2004 Governor
Non-Formula Program:			
Component Expenditures:			
71000 Personal Services	4,528.9	5,065.6	5,545.7
72000 Travel	80.9	139.4	149.7
73000 Contractual	494.9	322.7	485.7
74000 Supplies	171.0	133.9	148.9
75000 Equipment	99.9	41.6	56.6
76000 Land/Buildings	0.0	0.0	0.0
77000 Grants, Claims	0.0	0.0	0.0
78000 Miscellaneous	0.0	0.0	0.0
Expenditure Totals	**5,375.6**	**5,703.2**	**6,386.6**
Funding Sources:			
1002 Federal Receipts	0.0	141.7	142.5
1004 General Fund Receipts	3,740.5	3,633.7	3,960.1
1005 General Fund/Program Receipts	49.6	51.8	51.9
1007 Inter-Agency Receipts	114.0	0.0	0.0
1055 Inter-agency/Oil & Hazardous Waste	0.7	20.0	20.0
1061 Capital Improvement Project Receipts	15.4	15.7	15.7
1105 Alaska Permanent Fund Corporation Receipts	1,455.4	1,840.3	1,856.4
1153 State Land Disposal Income Fund	0.0	0.0	340.0
Funding Totals	**5,375.6**	**5,703.2**	**6,386.6**

Oil & Gas Development

Proposed Changes in Levels of Service for FY2004

Due to competitive areawide leasing, the addition of the exploration license program, and the unexpected popularity of the shallow gas-leasing program, it currently takes the division up to a year to conduct title reviews and issue leases. Additionally, shallow gas leases are currently being issued in areas where there are numerous surface owners. This could lead to potential conflicts between surface owners and industry, which can be mitigated, in part, through public education and the division taking a more visible role in conducting on-site inspections. With additional staff requested in the **Increase Revenues from Oil & Gas Bonus Bids and Lease Rentals,** the division's goal is to be able to issue leases 3-4 months following a lease sale or receipt of application, and to be more proactive in conducting inspections of surface activities on the Kenai Peninsula and in the Mat-Su Valley.

1) The Shallow Natural Gas leasing program was originally intended to encourage exploration in rural areas where fuel costs are currently subsidized. However, interest in the program has extended to the commercial market. In any case, the program, if successful, could reduce mine operating costs in Alaska dramatically. This program will bring added costs and resource commitments to the division since it will involve communities not previously involved with oil and gas activity. No incremental funds are requested, other than the staffing increase discussed in the Increase Revenues from Oil & Gas Bonus Bids and Lease Rentals.
2) At a cost of $250.0, the division's increased inventory of state-of-the-art 3D seismic data and enhanced capability to utilize those data should further improve the division's ability to monitor exploration and development activities throughout the state.
3) Statute and regulations dictate the activities and actions of the unitization section. Given the current level of funding and the prospect of further delays in the processing of unit and participating area applications, the division is struggling with increased workload demands. Review and analysis of the complex issues involved in satellite developments could suffer as the industry demands expedited approval for these projects. Already important development applications and approval requests for North Slope projects are taking more time to complete. Full staffing and a reduced vacancy factor of 2% will allow more timely handling of these matters.
4) The division is seeing an increase in workload in response to various industry mergers. Lease administration will have to process lease assignments, units management activities will increase as new producers initiate new exploration and development programs, and permitting will have to respond to new construction proposals. Again, full staffing and a reduced vacancy factor will allow rapid handling of these matters by the division.
5) The division and Exxon have reopened an existing royalty settlement agreement and are engaged in proceeding, which will result in as revision of the methodology used to calculate Exxon's royalty obligation to the State. These proceedings are scheduled for FY03-FY04 and entail the extensive use of experts, voluminous document review, and negotiations and arbitration. A budget of $1.5 million is being sought by the Department of Law for these proceedings; funding this request is expected to result in an increase in state revenues of more than $10 millions.
6) Oil and gas data and general information are being made available to the public and other agencies on the division's website. Fewer printed publications will be available over the counter. Cost-savings will be used to increase the speed and scope of the division's work.
7) The division continues to manage costs by eliminating display ads for lease sales; reducing the amount of travel to the North Slope for public hearings; conduct in hearings via teleconference; relying only on the division's website to disseminate information; eliminating the printing of excess copies of the Five-Year Oil and Gas Leasing Program; and decreasing the volume of mail-outs.

Summary of Component Budget Changes

From FY2003 Authorized to FY2004 Governor

All dollars in thousands

	General Funds	Federal Funds	Other Funds	Total Funds
FY2003 Authorized	**3,685.5**	**141.7**	**1,876.0**	**5,703.2**

	General Funds	Federal Funds	Other Funds	Total Funds
Adjustments which will continue current level of service:				
-Annualize FY2003 COLA Increase for General Government and Supervisory Bargaining Units	0.0	0.8	11.1	11.9
-$75 per Month Health Insurance Increase for Non-covered Staff	11.8	0.0	5.0	16.8
Proposed budget increases:				
-Full Funding for Oil & Gas Workload and Staff	314.7	0.0	0.0	314.7
-Increase Revenues from Oil & Gas Bonus Bids and Lease Rentals	0.0	0.0	340.0	340.0
FY2004 Governor	**4,012.0**	**142.5**	**2,232.1**	**6,386.6**

Oil & Gas Development

Personal Services Information

Authorized Positions	FY2003 Authorized	FY2004 Governor	Personal Services Costs	
Full-time	59	61	Annual Salaries	4,359,495
Part-time	0	0	Premium Pay	0
Nonpermanent	3	3	Annual Benefits	1,299,640
			Less 2.00% Vacancy Factor	(113,435)
			Lump Sum Premium Pay	0
Totals	**62**	**64**	**Total Personal Services**	**5,545,700**

Position Classification Summary

Job Class Title	Anchorage	Fairbanks	Juneau	Others	Total
Accountant III	4	0	0	0	4
Accountant V	1	0	0	0	1
Accounting Clerk II	1	0	0	0	1
Accounting Tech I	2	0	0	0	2
Accounting Tech II	1	0	0	0	1
Administrative Clerk II	2	0	0	0	2
Administrative Clerk III	1	0	0	0	1
Administrative Manager II	1	0	0	0	1
Analyst/Programmer III	1	0	0	0	1
Analyst/Programmer IV	3	0	0	0	3
Cartographer II	1	0	0	0	1
Cartographer IV	1	0	0	0	1
Chief Petroleum Geologist	1	0	0	0	1
Commercial Analyst	3	0	0	0	3
Division Director	1	0	0	0	1
Geologist II	1	0	0	0	1
Geologist III	1	0	0	0	1
Land Surveyor I	1	0	0	0	1
Natural Resource Spec I	2	0	0	0	2
Natural Resource Spec II	2	0	0	0	2
Natural Resource Spec III	5	0	0	0	5
Natural Resource Spec IV	2	0	0	0	2
Natural Resource Spec V	1	0	0	0	1
Natural Resource Tech I	1	0	0	0	1
Natural Resource Tech II	1	0	0	0	1
Natural Resource Tech III	1	0	0	0	1
Operations Res Anl I	1	0	0	0	1
Petroleum Geologist I	4	0	0	0	4
Petroleum Geologist II	2	0	0	0	2
Petroleum Investments Manager	1	0	0	0	1
Petroleum Land Manager	3	0	0	0	3
Petroleum Manager	1	0	0	0	1
Petroleum Market Analyst	1	0	0	0	1
Petroleum Reservoir Engineer	2	0	0	0	2
Revenue Auditor IV	3	0	0	0	3
Revenue Auditor V	1	0	0	0	1
Student Intern I	3	0	0	0	3
Totals	**64**	**0**	**0**	**0**	**64**