State of Alaska
FY2005 Governor's Operating Budget

Department of Natural Resources
Oil & Gas Development
Component Budget Summary

Contents

Component: Oil & Gas Development

Contribution to Department's Mission

The Division of Oil and Gas manages oil and gas lands in a manner that assures both responsible oil and gas exploration and development and maximum revenues to the state.

Core Services

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 oil and gas 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 exploration, 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 publicly available existing and new oil and gas related information to technical users, the general public and the press through technical publications, informational pamphlets, the website or personal contact.

Advocate responsible oil and gas development throughout the state.

End Results	Strategies to Achieve Results
(1) Encourage Exploration and Development. Target: 5,000,000 acres or more under lease; 2,000,000 acres or more under exploration license. Measure: Increase the amount of state acreage leased or licensed. Target: Ten (10). Measure: Number of new exploration wells drilled per year Target: Two new companies per year. Measure: Increased number of oil and gas companies actively exploring or developing in Alaska. **(2) Maximize benefits of development and production to the state.**	**(1) Hold regularly scheduled lease sales** Target: Four (4) sales held on schedule in accordance with the Five-Year Program. Measure: Four (4) to five (5) yearly areawide lease sales held on schedule. **(2) Promptly issue leases and licenses without compromising legal integrity of the lease or license.** Target: Average time of six months to issue a lease. Measure: Award new oil and gas leases five to six months after a lease sale or a shallow gas application is filed. Target: 18 months average time to issue a license. Measure: Issue approved exploration licenses within two

End Results	Strategies to Achieve Results
Target: Zero decrease in statewide oil and gas production. Measure: Rate of production. **(3) Maximize non-tax revenue from state oil and gas production.** Target: $816 million. Measure: Amount of non-tax revenue received for total state production of oil and gas.	years of initial application. **(3) Actively market and evaluate Alaska's oil and gas potential.** Target: Bring in two new companies per year. Measure: Increased number of oil and gas companies actively exploring in Alaska. **(4) Evaluate new areas for oil and gas exploration and development.** Target: Evaluated 100 percent of proposed sale/exploration license areas. Measure: Evaluate all potential lease sale/exploration license areas prior to issuance of lease or license. **(5) Efficiently adjudicate exploration permits while ensuring that adequate environmental protection is provided.** Target: 100 percent of permits issued within the timelines set by the Alaska Coastal Management Program. Measure: Adjudicate completed permit applications within the timeline set out by the ACMP. **(6) Efficiently adjudicate development permits while ensuring that adequate environmental protection is provided.** Target: 100 percent of permits issued within the timelines set by the Alaska Coastal Management Program. Measure: Adjudicate completed permit applications within the timeline set out by the ACMP. **(7) Promptly adjudicate completed lease assignments.** Target: 100 percent of lease assignments adjudicated within 15 working days. Measure: Adjudicate lease assignments within fifteen working days. **(8) Keep up with the increasing numbers of unit-related applications and promote conservation of the oil and gas resource as well as prevent economic and physical waste.** Target: Fifteen (15) unit/participating area decisions issued. Measure: Negotiate and issue unit decisions in a timely manner. **(9) Negotiate unit agreements that accelerate exploration and development and maximize the economic benefit to the state.**

End Results	Strategies to Achieve Results
	Target: Five. Measure: Negotiate new unit agreements. **(10) Ensure that oil and gas operations are conducted in accordance with permit terms.** Target: 85 inspection days. Measure: 100% compliance with permit terms. **(11) Ensure that the state receives the best negotiated value in the sale of its royalty-in-kind (RIK) oil and gas.** Target: Receive $ 0.30 per barrel more from RIK as opposed to RIV. Measure: Receive more benefits from RIK than RIV. **(12) Conduct effective and timely audits.** Target: 75 percent of audits completed within four years. Measure: Reduce time to complete royalty and net profit share audits to four years of the audit year. **(13) Ensure that the state receives full value for oil and gas royalty-in-value (reopeners).** Target: 100 percent. Measure: Number of reopeners that increase value. Target: 100 percent of decisions analyzed by commercial staff. Measure: For all royalties, ensure that transportation and other allowable deductions are just and reasonable.

Major Activities to Advance Strategies

- Public outreach-Mat-Su, Bristol Bay, Alaska Peninsula, southern Kenai Peninsula, and the Sleetmute area
- Oil and gas advocacy-independents, new entrants and new areas in the state
- Resource evaluation - evaluate frontier and existing basins
- Ensure full value for the state's oil and gas resources
- Evaluate requests for royalty in kind sales
- Timely and accurate oil and gas royalty accounting
- Timely processing of lease assignments
- Evaluate requests for unitization of oil and gas leases
- Active inspection and permit compliance work
- Timely permitting
- Respond to requests for exploration licensing - Susitna Valley and Nenana basin
- Propose new lease sales and license areas-Bristol Bay, Alaska Peninsula
- Hold regular competitive, areawide lease sales

FY2005 Resources Allocated to Achieve Results

FY2005 Component Budget: $8,002,300

Personnel:	
Full time	76
Part time	0
Total	76

Performance Measure Detail

(1) Result: Encourage Exploration and Development.

Target: 5,000,000 acres or more under lease; 2,000,000 acres or more under exploration license.
Measure: Increase the amount of state acreage leased or licensed.

Target: Ten (10).
Measure: Number of new exploration wells drilled per year

Target: Two new companies per year.
Measure: Increased number of oil and gas companies actively exploring or developing in Alaska.

(2) Result: Maximize benefits of development and production to the state.

Target: Zero decrease in statewide oil and gas production.
Measure: Rate of production.

(3) Result: Maximize non-tax revenue from state oil and gas production.

Target: $816 million.
Measure: Amount of non-tax revenue received for total state production of oil and gas.

(1) Strategy: Hold regularly scheduled lease sales

Target: Four (4) sales held on schedule in accordance with the Five-Year Program.
Measure: Four (4) to five (5) yearly areawide lease sales held on schedule.

(2) Strategy: Promptly issue leases and licenses without compromising legal integrity of the lease or license.

Target: Average time of six months to issue a lease.
Measure: Award new oil and gas leases five to six months after a lease sale or a shallow gas application is filed.

Target: 18 months average time to issue a license.
Measure: Issue approved exploration licenses within two years of initial application.

(3) Strategy: Actively market and evaluate Alaska's oil and gas potential.

Target: Bring in two new companies per year.
Measure: Increased number of oil and gas companies actively exploring in Alaska.

(4) Strategy: Evaluate new areas for oil and gas exploration and development.

Target: Evaluated 100 percent of proposed sale/exploration license areas.
Measure: Evaluate all potential lease sale/exploration license areas prior to issuance of lease or license.

(5) Strategy: Efficiently adjudicate exploration permits while ensuring that adequate environmental protection is provided.

Target: 100 percent of permits issued within the timelines set by the Alaska Coastal Management Program.
Measure: Adjudicate completed permit applications within the timeline set out by the ACMP.

(6) Strategy: Efficiently adjudicate development permits while ensuring that adequate environmental protection is provided.

Target: 100 percent of permits issued within the timelines set by the Alaska Coastal Management Program.
Measure: Adjudicate completed permit applications within the timeline set out by the ACMP.

(7) Strategy: Promptly adjudicate completed lease assignments.

Target: 100 percent of lease assignments adjudicated within 15 working days.
Measure: Adjudicate lease assignments within fifteen working days.

(8) Strategy: Keep up with the increasing numbers of unit-related applications and promote conservation of the oil and gas resource as well as prevent economic and physical waste.

Target: Fifteen (15) unit/participating area decisions issued.
Measure: Negotiate and issue unit decisions in a timely manner.

(9) Strategy: Negotiate unit agreements that accelerate exploration and development and maximize the economic benefit to the state.

Target: Five.
Measure: Negotiate new unit agreements.

(10) Strategy: Ensure that oil and gas operations are conducted in accordance with permit terms.

Target: 85 inspection days.
Measure: 100% compliance with permit terms.

(11) Strategy: Ensure that the state receives the best negotiated value in the sale of its royalty-in-kind (RIK) oil and gas.

Target: Receive $ 0.30 per barrel more from RIK as opposed to RIV.
Measure: Receive more benefits from RIK than RIV.

(12) Strategy: Conduct effective and timely audits.

Target: 75 percent of audits completed within four years.
Measure: Reduce time to complete royalty and net profit share audits to four years of the audit year.

(13) Strategy: Ensure that the state receives full value for oil and gas royalty-in-value (reopeners).

Target: 100 percent.
Measure: Number of reopeners that increase value.

Target: 100 percent of decisions analyzed by commercial staff.
Measure: For all royalties, ensure that transportation and other allowable deductions are just and reasonable.

Key Component Challenges

The Division of Oil & Gas manages the state's oil and gas resources with a staff of 61, consisting of highly specialized technical experts schooled as geologists, geophysicists, engineers, computer sciences, attorneys, economists, accountants, and natural resource specialists, who work in asset teams but administratively are assigned to six sections: administration; resource evaluation; leasing/lease administration; commercial; royalty accounting; and permitting/units. Together, they brought in more than $1.24 billion in FY03. During that same period, and in the four months since, they handled an ever-increasing level of activity.

They:

- leased or licensed 1.7 million acres,
- increased public outreach as a result of shallow natural gas leasing in populated areas,
- negotiated agreements for the formation or expansion of eight units and twelve participating areas within units,
- augmented royalty and net profit share revenues by auditing lessees and negotiating or amending royalty settlement agreements,
- negotiated a short term RIK oil contract and continued negotiations on a long term RIK oil contract,
- continued proceedings for redetermination of the methodologies used by ExxonMobil in valuing North Slope royalty oil,
- worked with the producers, the governor's office, and the legislature on gasline issues,
- processed over 1443 applications for the assignment of interests in oil and gas leases and verified the financial responsibility of each assignee,
- worked with the Governor's office, Arctic Slope Regional Corporation and North Slope lessees on drafting portions of a national energy bill,
- participated in the EIS process for the Colville River Unit satellite development, National Petroleum Reserve, Alaska (NPRA) and the Point Thomson development projects,
- participated in negotiations with the North Slope gas producers on application procedures and requirements under the Stranded Gas Act
- participated with Law and DOR in drafting a draft model gas contract for an applicant as required under the Stranded Gas Act
- began negotiations to resolve coal bed methane exploration and development conflicts; Mat-Su public process

- participated in the North Slope Borough proposed Title 19 rewrite
- participated in creation of the Office of Project management and Permitting
- initiated activities for a proposed Bristol Bay exploration license and an Alaska Peninsula lease sale
- initiated discussions along with Law and DOR with the TAPS owners on a proposed new tariff structure.

The division's existing budget and staffing level will not allow continuation of all of these types of activities and at the same time allow the division to continue the division's day to day business; incremental funding is requested in this budget to strengthen all of the division's asset teams. Specifically we need to:

- add commercial and audit expertise to evaluate new oil and gas pipeline tariff proposals, North Slope gas fiscal systems and North Slope facility sharing models and to improve audit capabilities
- prepare for additional RIK oil and gas sales
- better evaluate Cook Inlet long term gas supply and deliverability
- improve and expand the oil and gas royalty accounting 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;
- 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;
- fully evaluate the resource potential of the Alaska Peninsula for a proposed oil and gas lease sale;
- increase the number of permitters/inspectors to oversee coalbed methane operations in populated areas: and
- improve the quality and quantity of information on the division's web site in order to attract new companies to Alaska and facilitate resource development in the state
- increase the division participation in geological field work on the North Slope foothills and Bristol Bay in support of DGGS field programs that promote exploration in these areas

Additionally, sustained funding requested by the Department of Law to maintain the Oil, Gas and Mining section is needed to accomplish several important division goals.

Major activities occurring in or planned for FY04-FY05 are discussed below by section. In the upcoming fiscal year, the division expects to see a decrease in North Slope exploration activity by traditional explorers BP and ConocoPhillips and an increase in activity by independents, both large and small, and other new entrants to Alaska. As the major oil companies deal with merger-related issues, 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, the Colville River Delta and NPRA. On the horizon is Liberty in the Beaufort Sea, a new viscous oil drill site at Milne Point, a new viscous oil drill site at Prudhoe Bay and continued activity associated with West Sak development in Kuparuk.

Cook Inlet exploration activity has already increased and a higher than normal level of activity is expected to continue for several years to come as the search for new gas reserves continues by both traditional explorers and new entrants. A new point of focus in the Mat-Su area and other interior basins of the state is coal bed methane.

Leasing and Lease Administration

With the demand for additional areawide lease sales, exploration licenses, and new shallow gas applications comes an increase in title work and lease administration as well as environmental, and socioeconomic review in the form of best interest findings, development of mitigation measures, and compliance with the Alaska Coastal Management Program.

- With regard to leasing and licensing, 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. Each exploration license requires a best interest finding. In some cases, an Alaska Coastal Management Program (ACMP) consistency determination is required (ensuring the license provisions are consistent with the state's ACMP and local management plans).

- In addition, shallow gas leasing and the exploration license programs are occurring in areas where private parties own a significant percent of the surface. 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 lengthy discussions, workshops, and meetings between staff, oil and gas lessees, and landowners in these areas. Shallow gas leasing in the Mat-Su Valley has especially brought the surface vs. subsurface estate relationship issue to the forefront with the public. Consequently more staff time is required to educate the public. The split estate may lead to appeals and hearings over the issue of damages and compensation to the surface owner.

- Increased title work: Exploration licensing has presented the division with previously unscheduled work requirements, most notably title work. Each license proposal requires title work on approximately 500,000 acres. Shallow gas leasing, which has become a controversial program, especially in the heavily populated areas such as the Mat-Su Valley and on the Southern Kenai Peninsula, has also increased the division's title workload. Title work in these areas is both complicated and time-consuming because of multiple subsurface estate ownership issues. Keeping up with this increased title workload has been difficult for the division's two-person Title Unit. The Division of Mining, Land, and Water has also had to balance of preparation title reports for oil and gas with other state projects. The division anticipates title work demands to increase as a result of successful lease sales in FY04 and the proposed Bristol Bay exploration license.

- Increased demand for administration of oil and gas leases: The North Slope, Beaufort Sea, North Slope Foothills, and Cook Inlet areawide lease sales, along with the shallow natural gas program, continually increase the number of leases the division manages. 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 in the past few years (see Figures 1 and 2). Keeping up with the rising number of oil and gas leases that must be administered by the division is a constant challenge.

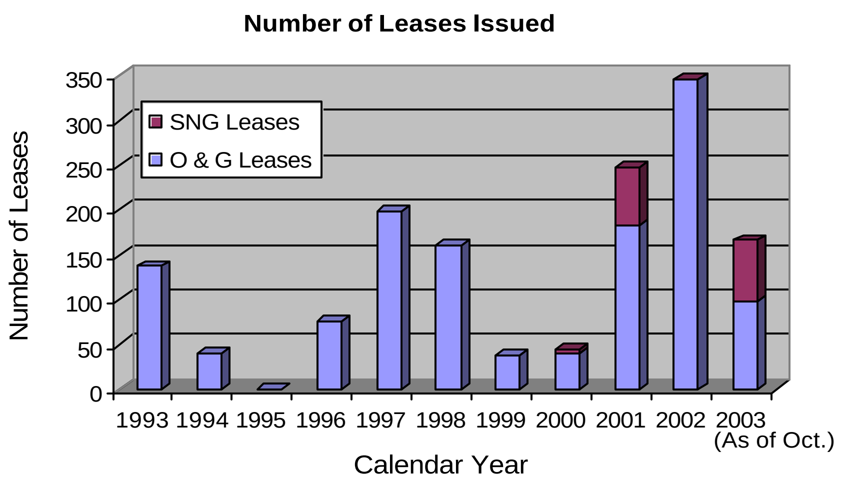

Figure 1

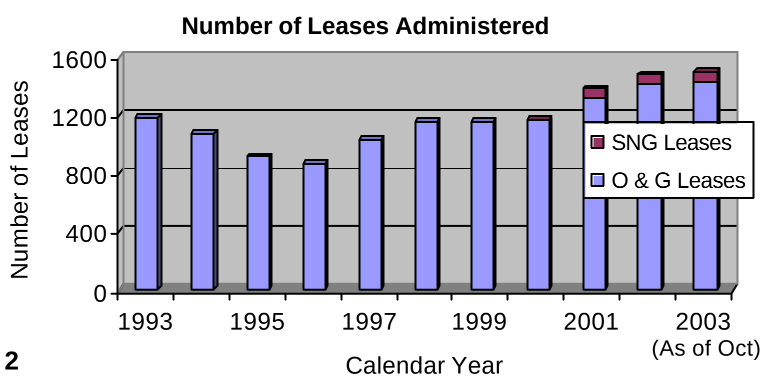

Figure 2

The division must continue to find and use innovative methods of outreach to attract new companies to Alaska. The division is using IndigoPool.com to place lease sale and exploration licensing information on its website in order to reach a broader international market. The division's outreach programs include a promotional booth at two large oil and gas trade shows, American Assoc. of Petroleum Geologists (AAPG) and North American Prospect Expo (NAPE). This year, the outreach will be particularly focused on the Bristol Bay/Alaska Peninsula lease sale.

Permitting and Units

- Units: Oil and gas units and participating areas (PAs) are the backbone of oil and gas production in Alaska. The division's continued 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 reservoirs at Prudhoe Bay and Kuparuk, 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 led to a significant amount of new production. For example, in and since FY03, the division negotiated agreements for the formation of the Kasilof unit in Cook Inlet and the Oooguruk unit on the North Slope for the expansion of the Kuparuk River and Colville Units, and for the formation of the Polaris, Borealis, McArthur River Hemlock, Redoubt, Susan Dion, Falls Creek, Grassim Olsolkoff and Northstar Participating Areas and expansion of the Kuparuk, Hemlock, Alpine, Grayling Gas, and Schrader Bluff PAs. The division also oversaw the startup of production at Kuparuk 3 S pad, Borealis, Orion, Polaris, Falls Creek and Northstar. Additionally, the division is currently evaluating applications for the formation of the Nikolaevsk Unit, the Orion, Sag Delta, Cairn and Redoubt Gas Participating Area, contraction and expansion of the West Sak PA, and expansion of the Pioneer and Nicolai Creek units.

- As of October 2003, the division currently oversees 33 active units and 60 active participating areas. One hundred sixteen (116) unit actions were adjudicated last calendar year. Figures 3, 4, and 5 illustrate the significant long-term increase in units and participating areas and the new production associated with them. Managing the increased workload associated with the increase in unit activity is one of the major challenges facing the division. Negotiations are longer and require a more proactive effort from the division as new companies with little or no experience in Alaska become involved in unitization matters.

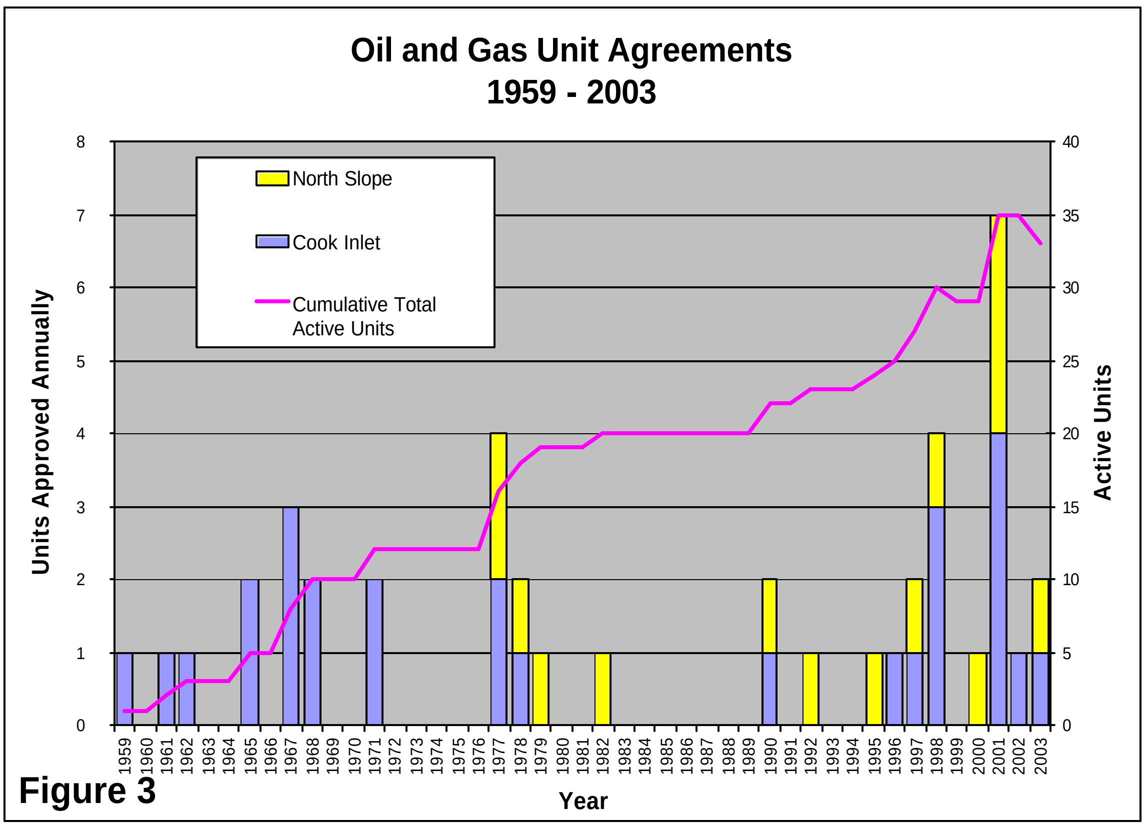

Figure 3

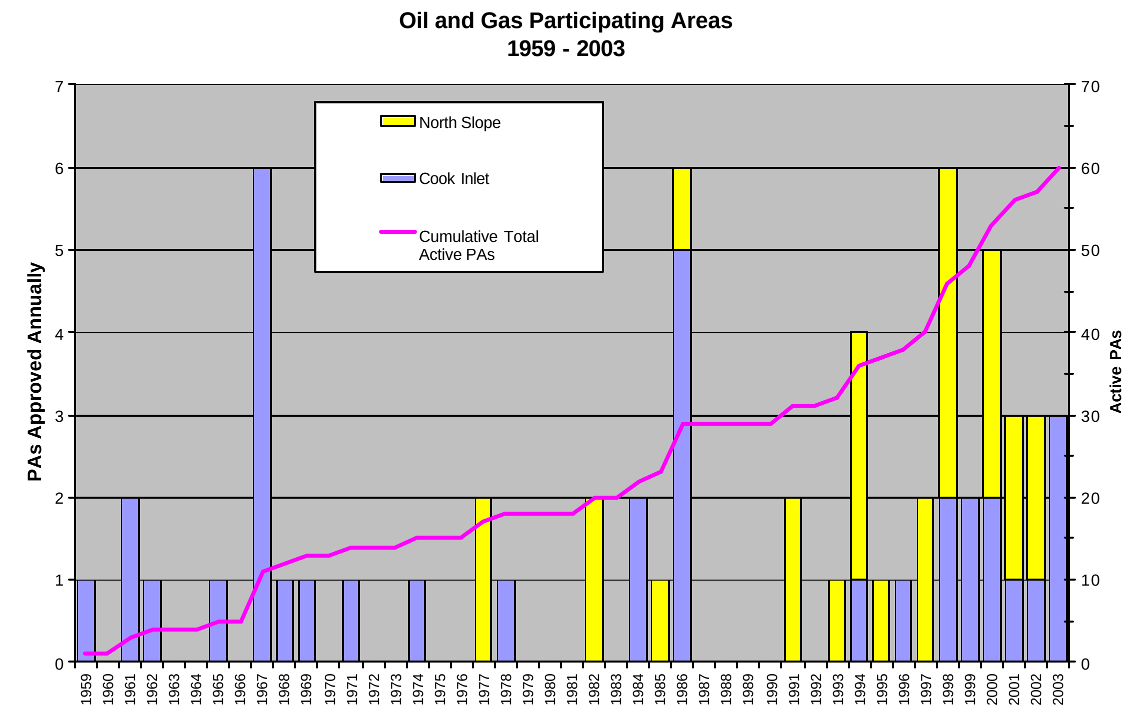

Figure 4

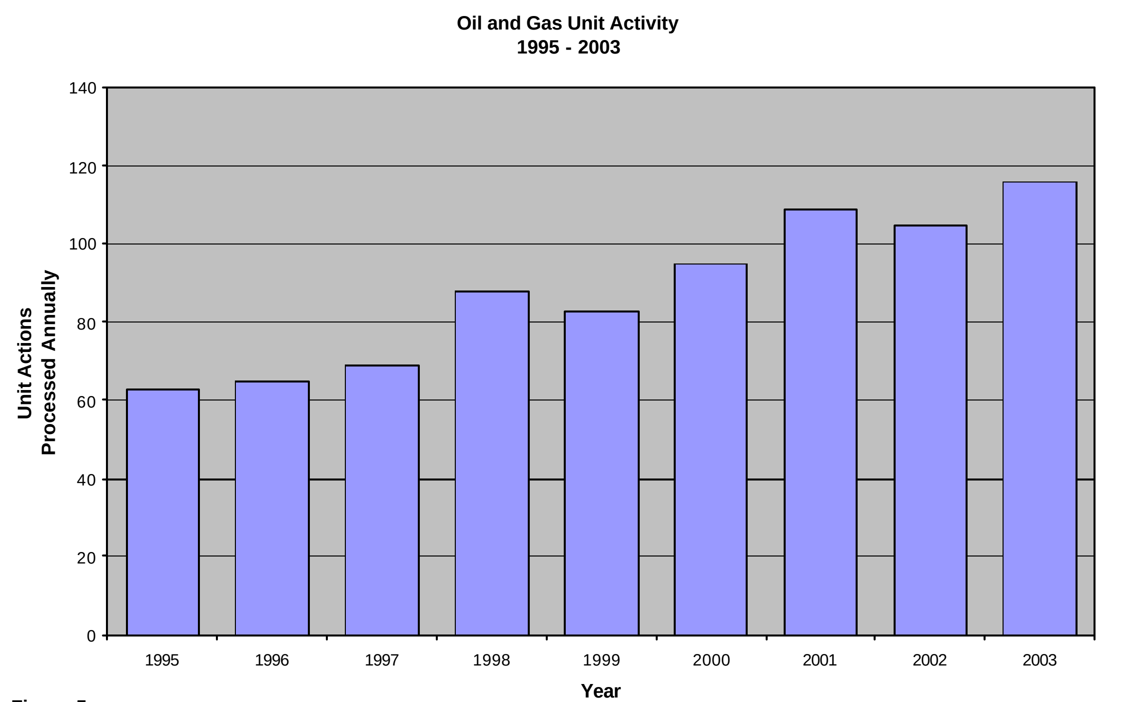

Figure 5

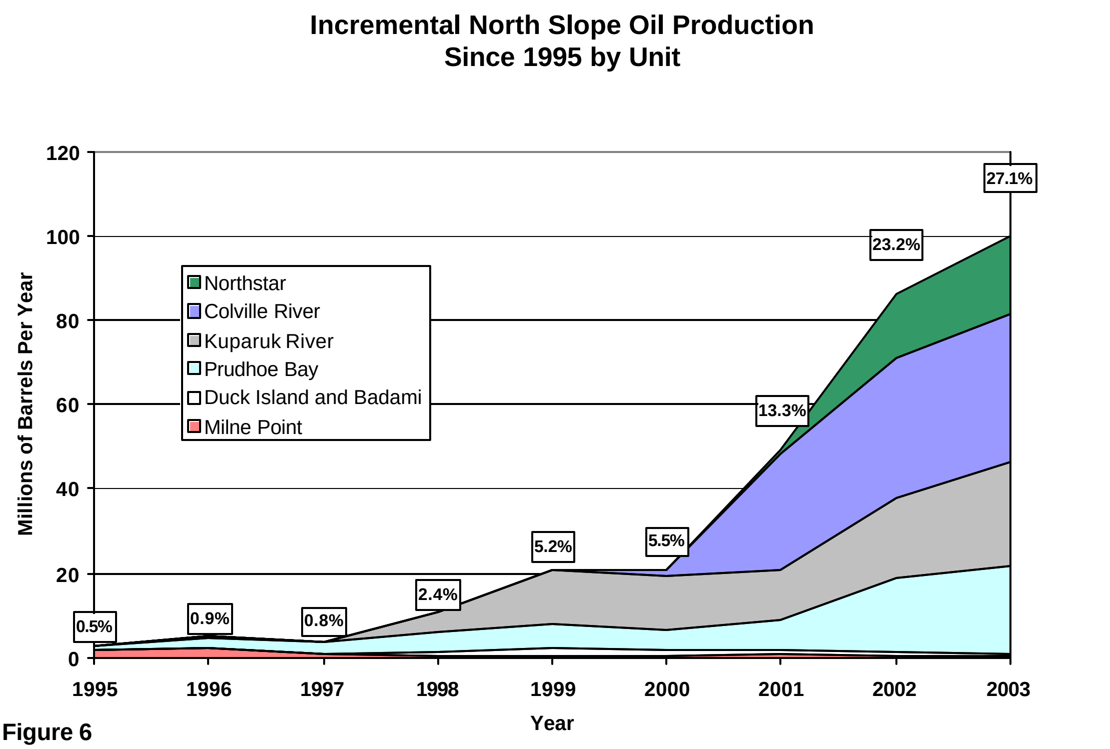

Figure 6

- Oil and gas production from satellite pools and new field start-ups is becoming an increasingly important part of North Slope output. In 2002, over 25 percent of ANS output was from new pools, new participating areas, and expansion areas of older participating areas that began production since 1995. (See Figure 6.)

- 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. ConocoPhillips and BP are both projecting little or no overall North Slope oil 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, such as, Polaris, Borealis, and Orion economic within that unit.

- Moreover, the equalization of the interests in the Prudhoe Bay and Kuparuk Units has spurred an increase in the activity for satellite developments and gas-related projects in the units. As a result of a number of successful "satellite" wells, the number of unit actions has increased. Although they involve fewer barrels than flow from the major reservoirs at Prudhoe Bay and Kuparuk, many of 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 owned by different parties or having different royalty terms through common facilities using facility sharing agreements.

- Issuance of shallow gas leases may result in a burst of new 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 division expects drilling programs and unit applications very soon after the leases are issued.

- Permitting: 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. As remote fields become developed, greater distances and more complex logistics are involved associated with traveling to locations for inspections. Staff is actively participating in industry and government sponsored programs to extend the winter tundra travel season and evaluate novel options for operating in the summer season.

- High oil and gas prices, declining gas reserves, and gas deliverability 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 and monitoring activities in the field, and formulating performance bonds to lower risk to the state.

- The increase in leasing and licensing for oil and gas in previously non traditional oil and gas areas such as Bristol Bay, Copper River, Nenana and the upper and lower Susitna Valley translates into more involved and time consuming permitting activities involving the applicants, state and local agencies and the public.

- The first coal bed methane unit (the Pioneer Unit) has had several wells drilled to date. A new operator, Evergreen, has assumed control in the unit and is operating two shallow gas pilot projects to help determine if there are economic quantities of coal bed methane in the Mat-Su area. Evergreen has proposed construction of two more pilot projects and to drill seven additional core holes. Existing Cook Inlet gas markets and infrastructure improve the economics for shallow gas exploration and production in the area. The division has undertaken a public process to involve citizens, recreational users, local government and landowners in the area, in the evaluation of land use and development options, should development occur.

- The division is actively participating in the NPRA, Colville River, and Point Thomson EIS preparations. Offshore development projects similar to Redoubt in Cook Inlet and McCovey in the Beaufort Sea continue to be a permitting challenge, although Armstrong Oil and Gas and Pioneer were successful last winter in permitting and implementing a three-well exploration program in the Beaufort Sea north of the Kuparuk River Unit. In addition, Armstrong has successfully permitted four additional offshore wells for the coming winter exploration season. As instructed by the legislature, DO&G is drafting regulations that would outline public notice procedures for DO&G permits not covered by the ACMP.

- Finally the division was very involved in the rewrite of the coastal zone management regulations, participated in the North Slope Borough proposed Title 19 rewrite and assisted in creation of the Office of Project Management and Permitting. The division is preparing to process assignments for the alignment of ownership interests at Point Thomson. Figure 7 shows the steady increase in the number of assignments over the past several years.

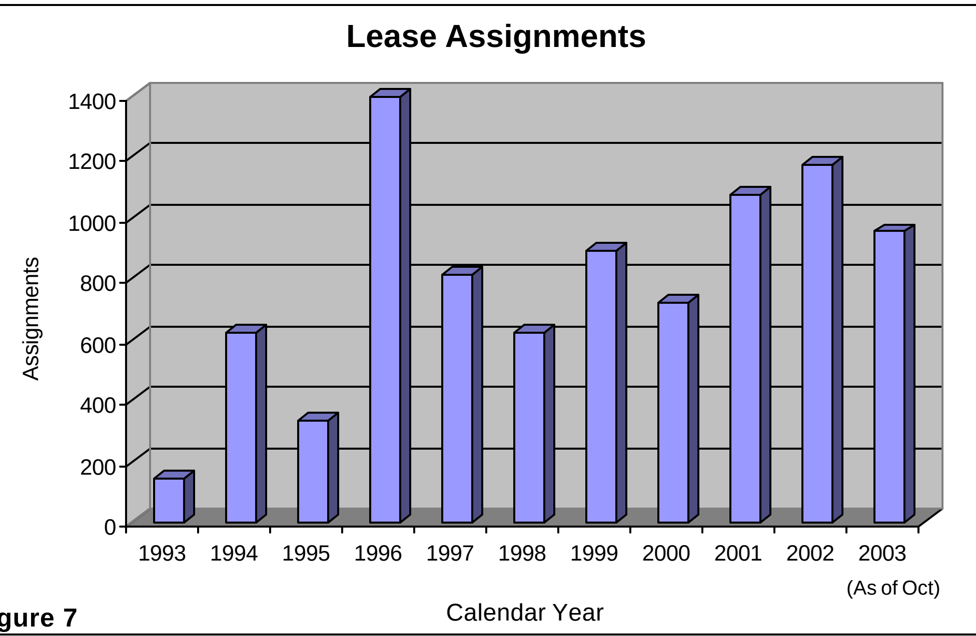

Figure 7

Resource Evaluation

- Alaska Peninsula competitive oil and gas lease sale: A significant challenge throughout the next two years will be completion of a petroleum resource assessment of the recently proposed Alaska Peninsula areawide oil and gas lease sale targeted for late 2005. Once an area of interest to industry, the area has remained unexplored for nearly twenty years. Consequently much of the geological and geophysical data needed to evaluate the area are buried in various industry and government archives and difficult to identify and recover. The division, in conjunction with the Division of Geological and Geophysical Surveys' energy program and with the help of the Bristol Bay Native Corporation and possibly with the support of the U.S. Department of Energy, will undertake several geological field programs in the area beginning in summer 2004.

- Much of the geophysical data acquired for subsurface mapping in the area preceded state regulations requiring submittal of the data as a permit stipulation. Consequently, much of those data, unless available through the Bristol Bay Native Corporation, will need to be purchased from the operators. Identifying the operators, determining current ownership and confidentiality of the data, and establishing the costs is taking some time and diverting technical staff from other important projects.

- Uninterpreted subsurface information from most wells drilled in the area is available for the division's use, but must be analyzed to be useful for the resource assessment. If the assessment is to be accomplished in a timely professional manner an additional petroleum geologist should be added the staff to serve as project coordinator/manager.

- With only two years to prepare for the lease sale and to promote industry interest, the division has undertaken a concerted outreach program to increase industry awareness of the opportunity. This, too, has added unanticipated burdens to the database management and cartographic staff's workload as we try to acquire and prepare informational packages containing geological, geophysical and other information for distribution at conventions and through the division's website.

- While the incremental workload imposed on our cartographic staff by the added lease sale might appear to be a short-term phenomena, we've found that as our programs expand, as our informational databases grow and as the demand for the division's products increases we face a longer term problem - we haven't the cartographic and technical staff needed to compile and distribute through the web and other means the oil and gas information necessary to support the state's initiative to encourage development of our petroleum resources by the smaller explorers and developers that might be interested in establishing a position in Alaska. This was recently brought to light by our inability to adequately meet the need to prepare maps and other graphics useful for addressing questions arising from the development of coal bed methane in the Mat-Su Valley. An additional permanent cartographer supported by faster higher capacity software and hardware will be required to fulfill such needs.

- South-central gas supply: The U.S. Department of Energy has initiated the first phase of a proposed three-phase program to quantify the potential natural gas supply for south-central Alaska. Several division personnel will be required to provide part-time support for this program.

- The primary terms of many leases are approaching expiry and, in an effort to extend their leaseholds, lessees are more frequently submitting proposals to unitize leaseholds, to expand units and to establish participating areas. This workload has been exacerbated by mergers and acquisitions and, on the North Slope, by British Petroleum's recent sale of three large leasehold blocks. Each of these proposals must be carefully evaluated in order to protect the state's interest by securing appropriate commitments from the lessee. British Petroleum also relinquished a large number of North Slope leases, tracts that must be reevaluated for inclusion in future areawide sales.

- In the division's effort to ensure that the state and other stakeholders receive equitable shares of production we will fill an existing petroleum reservoir engineer position to evaluate lessee and operator tract allocation proposals and field development. This is a substantial responsibility and requires extensive software and computer support as producing reservoirs must be interactively modeled to ascertain past and predicted movement of oil, gas, and water in the reservoirs throughout a field's productive life. Each reservoir simulation (full field model) is derived from an integrated geological, geophysical, and engineering database and may contain millions of three-dimensional cells. Preliminary tract allocations are an integral part of every initial unit approval process and, in most cases, subsequent tract reallocations are required as the field matures and the reservoir properties are better understood. Only in this manner can accurate and equitable production and revenue allocations be made to the stakeholders. A final tract reallocation will soon be due for the Alpine field and the Northstar field is under frequent periodic review by a joint state and federal team. Although the field is not yet in production, the division must also dedicate considerable effort to monitoring the Point Thomson Unit as the owners evaluate the commerciality of various production scenarios there.

- 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. A petroleum geologist serves as liaison between the Division of Geological and Geophysical Surveys and interested industry participants for the purpose of coordinating fieldwork and subsequent analytical studies.

- During the last two years, the division has acquired thousands of miles and square miles respectively of digital 2-D and 3-D seismic data. Transfer of a petroleum geophysicist interpreter from another division section, will allow the resource evaluation section to divide the responsibility into north and south Alaska, thereby providing improved support

- The addition of a petroleum reservoir engineer, a petroleum geophysicist, two additional petroleum geologists and a cartographer to the section staff will have a huge impact on the resource evaluation section and the division as a whole. If these professional specialists are to accomplish their tasks they must utilize massive databases compiled from numerous sources. They haven’t the time to accomplish their primary tasks and to compile, format and fully manage the supporting databases. Consequently, two Natural Resource Technicians with specific geoscientific, engineering and cartographic skills should be added to the section staff to support the geoscientists, engineer and cartographers. It must be recognized that the section’s professional staff cannot function adequately unless supported by qualified technicians.

<u>Commercial</u>

- Valuing North Slope royalty oil: The division’s petroleum market analyst, petroleum investments manager, commercial analysts, and auditors work with other members of the division in maximizing royalties payable to the state. During FY01, they initiated proceedings for redetermination of the methodologies used by ExxonMobil, BP, and ConocoPhillips in valuing North Slope royalty oil. The disputes with BP and ConocoPhillips were resolved in FY02 and the companies paid the state $11 million as part of these settlements. The ExxonMobil proceedings are ongoing and may culminate in a hearing before an arbitration panel in third quarter FY04. Commercial section staff may also initiate a separate negotiation track to resolve the dispute in lieu of a full-blown arbitration. The division offered royalty oil for sale and worked with the producers, the governor’s cabinet, 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.

- Royalty reopeners: 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 ConocoPhillips) 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, ExxonMobil, and ConocoPhillips to renegotiate a valuation methodology that better reflects the market value of ANS. The division has completed negotiations with BP and ConocoPhillips in FY02. Lack of progress in negotiations with ExxonMobil through FY03 has compelled the division to proceed to arbitration. This arbitration process may conclude in early FY05. The division’s resolve in this matter combined with the in-house legal talent and outside experts hired by the Department of Law to adjudicate the reopener arbitration has contributed to a greater sense of cooperation from ExxonMobil. As a result negotiations for a settlement of the dispute will begin again soon.

- The conclusion of the BP and ConocoPhillips reopeners in FY03 resulted in payment of an additional $11 million by BP and ConocoPhillips 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 eventual successful completion of these reopeners illustrate how the state has benefited dramatically from pro-active management of its royalty revenues.

- Royalty-in-kind sales: The division continues to supply royalty in-kind (RIK) oil to the Alaska refining industry. In FY03, the division sold 38 percent of ANS royalty oil in-kind. The expiration of two major ANS RIK oil contracts in 2003 has created a new opportunity to advance the state's RIK policy. The commercial section is currently negotiating a royalty oil contract with the successor-owner of the Williams Alaska North Pole refinery. Successful conclusion of the negotiations and subsequent approval of the legislature in FY04 will yield a RIK oil contract unlike any other.

- The commercial section devotes many hours to advance the ANS gas pipeline project. Staff has developed 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 supported both the governor's gas cabinet and contributed to the Stranded Gas Working Group to formulate the state's position in developing a form stranded gas contract.

- The division in FY04 assumed the authority to conduct its own royalty and NPSL audit. This transition will be achieved through an RSA between the Department of Natural Resources and the Department of Revenue. 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 will complete all of its outstanding audits this fiscal year. The commercial section is working to streamline the collection of Cook Inlet oil royalties so that audit staff can be more productively employed on North Slope audits. In the last ten years, 120 royalty and net profit share audits have been issued and 109 closed. These audits yielded an additional $102.7 million in royalty revenue to the state. Collections have averaged almost $10 million per year. 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 8.)

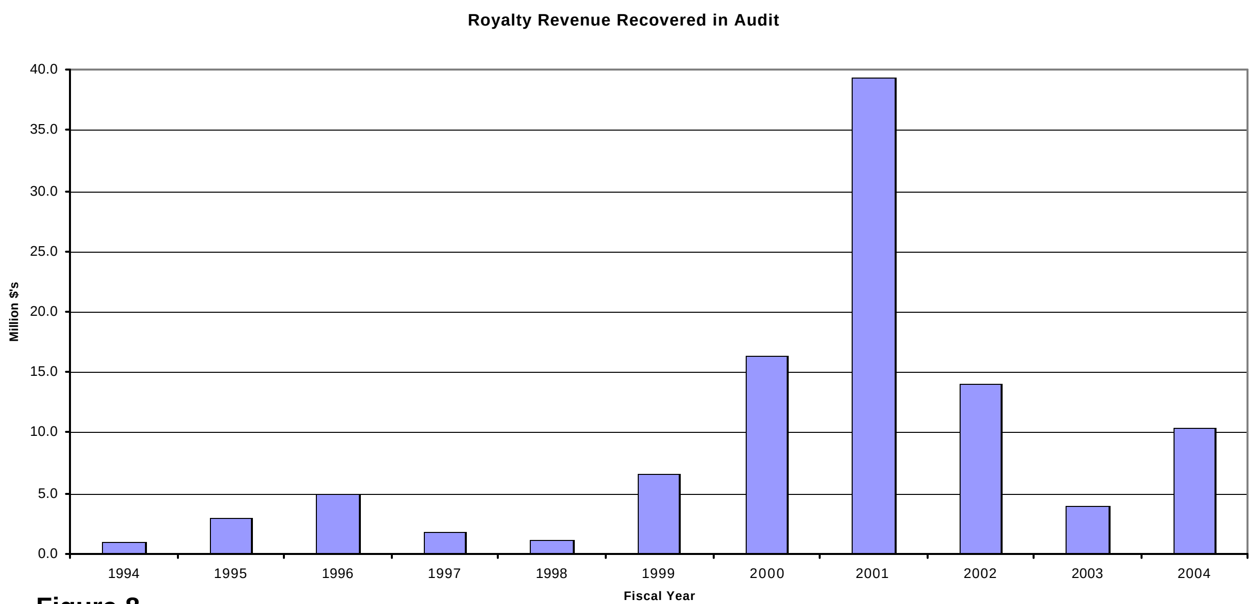

Figure 8

- The commercial section works with the units and resource evaluation sections in developing commercial terms for lease sales and creating appropriate incentives to encourage the formation and expansion of units and participating areas.

<u>Royalty Accounting</u>

- Continue to accurately invoice royalty payments to the state. During FY03, the Royalty Accounting Section accurately invoiced $438.5 million to the state royalty-in-kind purchaser and processed and analyzed an additional $727.9 million in royalty-in-value, net-profit share lease, and federal payments.

- Redesigning and implementing the new oil and gas royalty accounting system (OGRA): In September 2002, the division completed both an internal and an external review of the OGRA. These reviews determined that the state could dramatically increase the value of OGRA by redesigning the system. The redesign of the system will 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. During FY03, the division obtained CIP funds for this project and in FY04 will contract out this 18-month project. These funds will be used to complete the design and actual programming of OGRA, however, additional funds are being requested in FY05 for project completion.

Miscellaneous

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

- The division must continue to defend its leasing decisions against lawsuits by environmental groups.
- Moreover, the division has recently seen increased scrutiny by environmental litigants on its permitting actions.

Significant Changes in Results to be Delivered in FY2005

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 many months 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 lessees, which can be mitigated, in part, through public education. The division is taking a more visible role by increasing the number of on-site inspections. With additional staff requested in the increment, the division’s goal is to be able to issue leases 3-4 months following a lease sale or receipt of an application, to be more proactive in conducting inspections of surface activities on the Kenai Peninsula and in the Mat-Su Valley, and actively conduct a public outreach program.

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. This program brings added costs and resource commitments to the division since it involves communities not previously involved with oil and gas activity and the potential for conflicts with land owners and recreational users.
2) **Royalty valuation reopeners**, audit of leases not covered by royalty settlements, pipeline tariff evaluation, analysis of North Slope gas fiscal systems, long term Cook Inlet gas supply and deliverability forecasts and **RIK oil and gas sales** will require additional time of technical and commercial staff and well as support staff.
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 low vacancy factor will allow more timely handling of these matters.
4) New **exploration and lease sale activity in the Bristol Bay and Alaska Peninsula areas** will require additional time and travel from members of the division’s asset teams.
5) The division and ExxonMobil have **reopened an existing royalty settlement agreement** and are engaged in arbitration proceedings, which will result in a revision of the methodology used to calculate ExxonMobil’s royalty obligation to the state. These proceedings are scheduled for FY04-FY05 and entail the extensive use of experts, voluminous document review, and negotiations and arbitration.
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.
7) Professional and support staff will participate in more royalty and net profit share audits, evaluate Cook Inlet oil and gas royalty reduction requests and rulings, analyze Cook Inlet gas valuation proposals and options for storage of Cook Inlet gas, and work with lessees to commercialize viscous oil on the North Slope.

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; conducting 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. However, as has been the case in the Mat-Su valley, this decrease in public notice activity results in at least some of the public complaining of inadequate notice.

Major Component Accomplishments in 2003

1) In FY03, petroleum revenue collected by the Departments of Natural Resources and Revenue accounted for approximately 84 percent of general fund unrestricted revenue. Total royalty, settlement, rental, federal share, and bonus revenue collected by DNR was $1.24 billion. Distribution was as follows: $839.3 million General Fund, $393.8 million Permanent Fund, $1.4 million Constitutional Budget Reserve Fund, and $6.2 million School Fund. Revenue increased 44.5 percent from FY02 to FY03, largely due to the increase price of oil.

2) Resolved a major audit dispute with Unocal on the question of royalty gas valuation for gas supplies for the for the Agrium fertilizer plant in Nikiski. The Division also closed a smaller audit of royalty gas values in the Beluga River Unit.

3) Litigated a multi-million dollar royalty settlement agreement reopener arbitration with ExxonMobil.

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

5) Negotiated a long term ANS royalty oil sales contract. The contract is awaiting approval by the Alaska Royalty Oil and Gas Development Board and the legislature.

6) Managed 33 active units and 60 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.

7) Conducted geological reviews of virtually all unit and participating area management functions accomplished by the Division’s unit administration section and listed above. Many of these functions required determination or verification of tract allocations for equitable revenue distribution to the state and other stakeholders.

8) In conjunction with the U.S. Minerals Management Service and the Alaska Oil and Gas Conservation Commission, conducted a full field model reservoir simulation of the state-federal co-managed Northstar unit to establish the initial tract allocation.

9) 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 and with the CIRI at Deep Creek.

10) 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 North Slope tundra travel and the abbreviated winter drilling seasons.

11) Partially funded and participated in geological field programs investigating the hydrocarbon potential of the NPRA and North Slope Foothills in support of lease sales and the North Slope gas pipeline supply studies. Planning

for similar fieldwork has been undertaken to support the Alaska Peninsula/Bristol Basin sale resource assessment.

12) Two lease sales held, resulting in 79,629 acres being leased and the state receiving $726,525 in bonus bids.

13) Issued 97 oil and gas leases.

14) Issued 68 shallow natural gas leases.

15) Issued two exploration licenses

16) Processed 1288 oil and gas lease assignments.

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

18) Worked with the Legislature to amend AS 38.05.140(c) increasing the amount of onshore chargeable acreage an oil and gas lessee may hold from 500,000 acres to 750,000 acres, of which not more than 500,000 acres may be located north of the Umiat baseline. By increasing the maximum onshore acreage to 750,000 but limiting the 250,000-acre increase to south of the Umiat baseline, companies will be able to lease and explore acreage in some of Alaska's frontier basins while still maintaining their interests on the North Slope. Increasing the onshore acreage limitation from 500,000 to 750,000 acres should have a positive revenue impact to the state from additional bonus bids, rentals, and eventually, production royalties.

19) Worked with the Legislature to transfer from Department of Revenue back to Department of Natural Resources the authority to conduct audits of revenues from royalty and net profit shares from state oil and gas leases and costs associated with exploration incentive credits granted under AS 38 and AS 41. This transfer of audit responsibilities will bring greater government efficiency with respect to royalty and net profit share issues.

20) Provided technical support to the Legislature and Administration regarding new oil and gas incentive programs and amending those already in statute. This included commercial, economic, and engineering analysis of proposed legislation.

21) Improved the division's capabilities to manage and interpret 3-D seismic data and purchased approximately 8,000 line miles of 2-D seismic data and 1,800 square miles of 3-D seismic data as the division continues to aggressively collect seismic data and, when needed, convert from paper to digital form the data shot on state lands.

22) Continued expansion of the content of the Division's website in order to support oil and gas programs. A major addition to content during the past year is the suite of unit maps with supporting lease information. Major web-interfaced informational data packages now being undertaken include Alaska Peninsula/Bristol Basin, Mat-Su Valley, and Kenai Peninsula "atlases" to support conventional and shallow natural gas leasing programs in those areas.

23) The website has proven to be a successful means of distributing notices, decisions, and general oil and gas information to industry and the public and the demand for additional public information continues to grow.

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

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Oil & Gas Development
Component Financial Summary

All dollars shown in thousands

	FY2003 Actuals	FY2004 Authorized	FY2005 Governor
Non-Formula Program:			
Component Expenditures:			
71000 Personal Services	5,067.0	5,582.7	6,794.9
72000 Travel	103.3	149.7	176.0
73000 Contractual	317.7	635.7	719.6
74000 Supplies	158.8	148.9	208.2
75000 Equipment	14.4	56.6	103.6
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	**5,661.2**	**6,573.6**	**8,002.3**
Funding Sources:			
1002 Federal Receipts	0.0	143.4	146.6
1004 General Fund Receipts	3,592.3	3,983.7	5,117.2
1005 General Fund/Program Receipts	51.8	52.4	52.4
1055 Inter-agency/Oil & Hazardous Waste	1.4	20.0	0.0
1061 Capital Improvement Project Receipts	175.4	15.7	15.7
1105 Alaska Permanent Fund Corporation Receipts	1,840.3	1,866.6	2,172.9
1108 Statutory Designated Program Receipts	0.0	150.0	150.0
1153 State Land Disposal Income Fund	0.0	341.8	347.5
Funding Totals	**5,661.2**	**6,573.6**	**8,002.3**

Estimated Revenue Collections

Description	Master Revenue Account	FY2003 Actuals	FY2004 Authorized	FY2005 Governor
Unrestricted Revenues				
General Fund Program Receipts	51060	216.3	281.7	281.7
Unrestricted Fund	68515	1,240,434.5	1,204,112.2	1,005,075.9
Unrestricted Total		**1,240,650.8**	**1,204,393.9**	**1,005,357.6**
Restricted Revenues				
Federal Receipts	51010	0.0	143.4	146.6
General Fund Program Receipts	51060	51.8	52.4	52.4
Statutory Designated Program Receipts	51063	0.0	150.0	150.0
Capital Improvement Project Receipts	51200	175.4	15.7	15.7
Interagency Recs./Oil & Hazardous Waste	51395	1.4	20.0	0.0
State Land Disposal Income Fund	51434	0.0	341.8	347.5

Estimated Revenue Collections

Description	Master Revenue Account	FY2003 Actuals	FY2004 Authorized	FY2005 Governor
Restricted Total		**228.6**	**723.3**	**712.2**
Total Estimated Revenues		**1,240,879.4**	**1,205,117.2**	**1,006,069.8**

Summary of Component Budget Changes
From FY2004 Authorized to FY2005 Governor

All dollars shown in thousands

	General Funds	Federal Funds	Other Funds	Total Funds
FY2004 Authorized	**4,036.1**	**143.4**	**2,394.1**	**6,573.6**
Adjustments which will continue current level of service:				
-Changes to Retirement and Other Personal Services Rates	0.0	3.2	75.1	78.3
-Transfer Revenue Auditor Functions from Department of Revenue	0.0	0.0	237.1	237.1
Proposed budget decreases:				
-Eliminate IA/Oil & Haz Receipt Authorization for Contingency Planning	0.0	0.0	-20.2	-20.2
Proposed budget increases:				
-Advancing the State's Oil and Gas Initiatives	1,133.5	0.0	0.0	1,133.5
FY2005 Governor	**5,169.6**	**146.6**	**2,686.1**	**8,002.3**

Oil & Gas Development
Personal Services Information

Authorized Positions	FY2004 Authorized	FY2005 Governor	Personal Services Costs	
Full-time	61	76	Annual Salaries	5,230,424
Part-time	0	0	Premium Pay	65,411
Nonpermanent	3	3	Annual Benefits	1,928,299
			Less 5.94% Vacancy Factor	(429,234)
			Lump Sum Premium Pay	0
Totals	**64**	**79**	**Total Personal Services**	**6,794,900**

Position Classification Summary

Job Class Title	Anchorage	Fairbanks	Juneau	Others	Total
Accountant III	4	0	0	0	4
Accountant IV	1	0	0	0	1
Accounting Tech I	2	0	0	0	2
Accounting Tech II	3	0	0	0	3
Administrative Assistant	1	0	0	0	1
Administrative Clerk III	4	0	0	0	4
Administrative Manager II	1	0	0	0	1
Analyst/Programmer IV	4	0	0	0	4
Cartographer II	3	0	0	0	3
Cartographer IV	1	0	0	0	1
Chief Petroleum Geologist	1	0	0	0	1
Commercial Analyst	4	0	0	0	4
Deputy Director	1	0	0	0	1
Division Director	1	0	0	0	1
Economist I	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 Mgr I	1	0	0	0	1
Natural Resource Spec I	2	0	0	0	2
Natural Resource Spec II	4	0	0	0	4
Natural Resource Spec III	3	0	0	0	3
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	5	0	0	0	5
Natural Resource Tech III	1	0	0	0	1
Operations Res Anl I	1	0	0	0	1
Petroleum Geologist I	5	0	0	0	5
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	2	0	0	0	2
Revenue Auditor V	3	0	0	0	3
Student Intern I	3	0	0	0	3
Totals	**79**	**0**	**0**	**0**	**79**