State of Alaska
FY2007 Governor's Operating Budget

Department of Natural Resources
Oil & Gas Development
Component Budget Summary

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

A. Encourage Exploration and Development:
- Make prospective lands available for oil and gas exploration, development, and production on a predictable basis.
- 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.
- Provide technical and policy support for the Alaska Congressional Delegation, the Governor's office, the Legislature, and the Commissioner of DNR.
- Adjudicate exploration permits effectively and maintain a proactive inspection program.

B. Maximize Benefits of Development and Production to the State:
- Administer conventional oil and 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 exploration, leasehold, and unit-related operations are conducted in a timely and environmentally sound manner.
- Advocate responsible oil and gas development throughout the State.
- Analyze and negotiate royalty reduction requests.

C. Maximize Non-tax Revenue from State Oil and Gas Production:
- 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 and revenue enhancements.
- Ensure that bonus, rental, license fees, net profit, and royalty payments are correct, allocated to the proper revenue fund and received when due.
- Ensure that shared federal bonus, rent, and royalty are properly received and allocated to the proper revenue fund.
- Conduct North Slope gas pipeline and gas treatment plant contract, LLC and project scope analysis and negotiations.

End Results	Strategies to Achieve Results
A: Encourage Exploration and Development. Target #1: Maintain 3,600,000 acres or more under lease during FY. Measure #1: Amount of state acreage under lease Target #2: Maintain 1,500,000 acres or more under exploration license during FY. Measure #2: Amount of state acreage under license. Target #3: Ten new exploration wells in FY. Measure #3: Number of new exploration wells drilled per year	**A1: Hold regularly scheduled lease sales** Target #1: Five sales held on schedule in accordance with the Five-Year Program. Measure #1: Number of sales held on schedule. **A2: Promptly issue leases and licenses without compromising legal integrity of the lease or license.** Target #1: All leases awarded within nine months of lease sale Measure #1: Average time to award a lease.

	Target #2: All licenses awarded within 18 months. Measure #2: Number of licenses awarded within 18 months. **A3: Actively market and evaluate Alaska's oil and gas potential.** Target #1: Two new companies actively exploring in Alaska per FY. Measure #1: Number of new oil and gas companies actively exploring or developing in Alaska. **A4: Evaluate new areas for oil and gas exploration and development prior to a final best interest finding** Target #1: Evaluate 100 percent of proposed sale/exploration license areas. Measure #1: Percent of potential lease sale/exploration licenses evaluated. **A5: Efficiently adjudicate exploration permits.** Target #1: 100 percent of exploration permits issued within the timelines set by the Alaska Coastal Management Program during FY. Measure #1: Percent of exploration permits issued within the timeline.
End Results	**Strategies to Achieve Results**
B: Maximize benefits of development and production to the state. Target #1: Five percent maximum decrease in statewide oil and gas production from previous fiscal year. Measure #1: Percentage change in rate of production.	**B1: Efficiently adjudicate development permits** Target #1: 100 percent of development permits issued within the timelines set by the Alaska Coastal Management Program during FY. Measure #1: Percent of development permits issued within the timeline. **B2: Promptly adjudicate completed lease assignments.** Target #1: 100 percent of lease assignments adjudicated within 15 working days. Measure #1: Percentage of lease assignments adjudicated within fifteen working days. **B3: Keep up with the increasing numbers of unit-related decisions (plans of exploration/development/PAs).** Target #1: 90 percent of unit/participating area decisions issued within 90 days. Measure #1: Percentage of unit/participating area decisions negotiated and issued within 90 days. **B4: Negotiate new unit agreements that accelerate exploration and development and maximize the economic benefit to the state.**

End Results	Strategies to Achieve Results
	<u>Target #1:</u> Negotiate two new unit agreements per FY. <u>Measure #1:</u> Number of new unit agreements **B5: Perform inspections of oil and gas operations.** <u>Target #1:</u> 100 percent of seismic, exploratory, and production operations inspected each year. <u>Measure #1:</u> Percent of seismic, exploratory, production operations inspected each year.

End Results	Strategies to Achieve Results
C: Maximize non-tax revenue from state oil and gas production. <u>Target #1:</u> $ 1.2 billion <u>Measure #1:</u> Amount of non-tax revenue received for total state production of oil and gas.	**C1: Ensure that the state receives the best negotiated value in the sale of its royalty-in-kind (RIK) oil and gas.** <u>Target #1:</u> Receive $ .30 per barrel more from RIK as opposed to royalty-in-value (RIV). <u>Measure #1:</u> Difference between RIK than RIV. **C2: Conduct timely audits.** <u>Target #1:</u> Complete four royalty audits each FY. <u>Measure #1:</u> Number of royalty audits completed during FY. **C3: Ensure that the state receives full value for oil and gas royalty-in-value (reopeners).** <u>Target #1:</u> 100 percent of reopeners increase value. <u>Measure #1:</u> Percent of reopeners that increase value.

Major Activities to Advance Strategies

- Public outreach - MatSu, North Slope, Alaska Peninsula, Healy, Nenana, and Sleetmute; conventions, conferences, symposiums
- Oil and gas advocacy-independents, new entrants and new areas in the state
- Evaluate frontier and producing basins; pursue gas hydrates, shallow biogenic gas, and tight gas sands
- 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 - Healy and Holitna areas
- Hold regular competitive, areawide lease sales
- Encourage leasing of federal onshore and offshore lands in manner most beneficial to the state
- Processing royalty relief applications

FY2007 Resources Allocated to Achieve Results

FY2007 Component Budget: $12,389,800

Personnel:	
Full time	95
Part time	0
Total	95

Performance Measure Detail

A: Result - Encourage Exploration and Development.

Target #1: Maintain 3,600,000 acres or more under lease during FY.
Measure #1: Amount of state acreage under lease

Acres under lease

Year	YTD Total
2003	4.6 million
2004	4.6 million
2005	4.0 million
2006	4,100,000 1st qtr FY06

Analysis of results and challenges: First quarter FY06: 4.1 million acres under lease. FY05: 4.0 million acres under lease.

In 2004, the legislature eliminated the Shallow Natural Gas Program. During FY 05, many of the existing shallow natural gas leases were relinquished resulting in less acreage under lease than anticipated. In addition, a number of conventional leases were relinquished as a result of the BP/ARCO merger. These relinquishments were unanticipated and beyond the control of DNR, however, relinquished acreage may be reoffered for lease. Without additional resources acreage under lease will drop.

Target #2: Maintain 1,500,000 acres or more under exploration license during FY.
Measure #2: Amount of state acreage under license.

Year	YTD Total
2003	1.6 million
2004	1.6 million
2005	1.7 million
2006	1.3 million 1st qtr FY06

Analysis of results and challenges: First quarter FY06: 1.3 million acres under license. Decrease in acreage due to expiration of the Copper River basin license. Ten percent of the Copper River basin license is being converted to leases.

FY05: 1.7 million acres under license. In FY05, DO&G completed the title work, best interest finding and public process for the Bristol Bay Exploration License. The license was awarded to the applicant, however, the applicant failed to execute the license. Applicants have chosen not to execute two of the last four exploration licenses awarded by DO&G, a circumstance beyond DNR's control, resulting in lower licensed acreage than anticipated. Proposed exploration licenses for Healy and Holitna are in progress. Without additional resources acreage under lease will drop.

Target #3: Ten new exploration wells in FY.

Measure #3: Number of new exploration wells drilled per year

Analysis of results and challenges: First quarter FY06: Three conventional exploration wells have been permitted during first quarter FY06. In addition, two shallow shale gas wells and one shallow stratigraphic test were permitted. Only the shallow stratigraphic test well is listed as completed. Five of the Cook Inlet wells are classified as gas discoveries.

100 percent compliance in FY05 (15 wells drilled).
Eight were completed in North Alaska during FY05: 5 on state Beaufort Sea tidewater leases (1 a possible oil discovery, no information yet on the others); 1 on a state North Slope onshore lease; and 2 on federal NPR-A leases. At least 7 were completed in the Cook Inlet basin (all onshore): 4 on state leases; 1 on a MHT lease; and 2 on CIRI leases. Five of the Cook Inlet wells are classified as gas discoveries.

100 percent compliance in FY04.

A1: Strategy - Hold regularly scheduled lease sales

Target #1: Five sales held on schedule in accordance with the Five-Year Program.
Measure #1: Number of sales held on schedule.

Analysis of results and challenges: 100 percent in compliance.
Without additional resources we will have the loss of one lease sale per year.

A2: Strategy - Promptly issue leases and licenses without compromising legal integrity of the lease or license.

Target #1: All leases awarded within nine months of lease sale
Measure #1: Average time to award a lease.

Analysis of results and challenges: First quarter FY 06: North Slope Foothills – expect to award within 6 months. Cook Inlet expect to award within 9 months.

FY 05: North Slope Foothills sale – 6 weeks to award. Cook Inlet sale –10 months to award. Beaufort Sea sale – 6 months to award. North Slope sale – 8 months to award.

Target #2: All licenses awarded within 18 months.
Measure #2: Number of licenses awarded within 18 months.

Analysis of results and challenges: First quarter FY06: Two licenses are in process and within timelines. Without additional resources there could be up to 1 year delay in awarding licenses.

FY 05: Awarded Bristol Bay Exploration License 14 months after receiving application.

A3: Strategy - Actively market and evaluate Alaska's oil and gas potential.

Target #1: Two new companies actively exploring in Alaska per FY.
Measure #1: Number of new oil and gas companies actively exploring or developing in Alaska.

Analysis of results and challenges: First quarter FY06: One new company (ENI) is involved in Alaska. With additional resources we will be able to evaluate oil & gas potential along gasline corridor and perform follow-up lease sale planning and avoid delays in releasing public oil and gas information. We will also pursue facility sharing agreements and continue outreach to companies not currently active in Alaska.

FY05: Three new companies are involved in Alaska:
Alaska Energy Alliance, Rutter & Wilbanks Corp, and
Storm Cat Energy Corp acquired leases in the recent Cook Inlet lease sale.

FY04: Four new companies are involved in Alaska.
Kerr-McGee has partnered with Armstrong Alaska Inc. in their Beaufort Sea exploration and Pioneer Natural Resources Alaska Inc. acquired leases in the Beaufort Sea, North Slope, and Matsu areas. Fortuna acquired leases in the Beaufort Sea, and Pioneer Oil and Gas acquired leases in Cook Inlet.

A4: Strategy - Evaluate new areas for oil and gas exploration and development prior to a final best interest finding

Target #1: Evaluate 100 percent of proposed sale/exploration license areas.
Measure #1: Percent of potential lease sale/exploration licenses evaluated.

Analysis of results and challenges: First quarter FY06: Significant subsurface geological information pertaining to evaluation of the Alaska Peninsula lease sale has been released. Other lease sale areas are under continual review. Additional resources will be necessary to evaluate unexplored areas nominated for exploration licensing since such areas are outside of area wide lease sale areas that are subject to on-going assessment by division staff.

FY05: Evaluated hydrocarbon potential on unleased tracts prior to all scheduled lease sales. Initial Alaska Peninsula geological field program completed.

FY04: Evaluated hydrocarbon potential on unleased tracts prior to all scheduled lease sales.

A5: Strategy - Efficiently adjudicate exploration permits.

Target #1: 100 percent of exploration permits issued within the timelines set by the Alaska Coastal Management Program during FY.
Measure #1: Percent of exploration permits issued within the timeline.

Percent of exploration permits issued on time

Year	YTD Total
2003	90 %
2004	90 %
2005	100 %
2006	100 %

Analysis of results and challenges: First quarter FY06: 100 percent issued on time.
With increased resources to fund a NRS IV and a NRS III the division's ability to adjudicate new and increasing statewide gas-related exploration activities, including Alaska Peninsula permits, gasline permitting, gas hydrates and gas-only exploration licenses and leases will be increased.

FY05: 100 percent issued on time.

B: Result - Maximize benefits of development and production to the state.

Target #1: Five percent maximum decrease in statewide oil and gas production from previous fiscal year.
Measure #1: Percentage change in rate of production.

Analysis of results and challenges: First quarter FY06: There is a volume increase between first quarter FY05 and first quarter FY06 of 2 percent. This was due to the fact of an unanticipated maintenance in the Prudhoe Bay Unit for August and September 2004 that had a significant impact on FY05 production.

FY05: Two percent drop in oil production rate; slight decline in Cook Inlet gas production.

FY04: One percent drop in oil production rate: slight decline in Cook Inlet gas production.

B1: Strategy - Efficiently adjudicate development permits

Target #1: 100 percent of development permits issued within the timelines set by the Alaska Coastal Management Program during FY.
Measure #1: Percent of development permits issued within the timeline.

Percent of permits issued on time

Year	YTD Total
2003	0
2004	0
2005	100%
2006	100%

Analysis of results and challenges: First quarter FY06: 100 percent issued on time.
Current resources are maximized with current workload. With additional resources to fund a NRS IV and a NRS III the division's will be able to adjudicate new and increasing ability to adjudicate new statewide gas-related development activities, including gasline permitting, gas hydrates and gas-only exploration licenses.
FY05: 100 percent issued on time.
The Division is actively participating in the permitting for the Oooguruk and Nikaitchuk North Slope offshore development proposals. Offshore development projects continue to be a permitting challenge due to increased environmental and oil spill response issues.

B2: Strategy - Promptly adjudicate completed lease assignments.

Target #1: 100 percent of lease assignments adjudicated within 15 working days.
Measure #1: Percentage of lease assignments adjudicated within fifteen working days.

% of lease assignments within 15 days

Year	Aver # days	YTD Total
2004	15.5	54.9%
2005	28.6	22.1%
2006	13.7	74.2% 1st qtr FY06

Analysis of results and challenges: First quarter FY06: 74.2 percent issued within 15 days; overall average time to issue is 13.7 days.

FY05: 22.1 percent issued within 15 days; overall average time to issue is 28.6 days FY05 performance was impacted by the gasline negotiations. Internal alignments were made to meet the target in the first quarter of FY06.

B3: Strategy - Keep up with the increasing numbers of unit-related decisions (plans of exploration/development/PAs).

Target #1: 90 percent of unit/participating area decisions issued within 90 days.
Measure #1: Percentage of unit/participating area decisions negotiated and issued within 90 days.

% of unit decisions within 90 days

Year	YTD Total
2004	100%
2005	100%
2006	100% 1 qtr FY06

Analysis of results and challenges: 100 percent compliance in first quarter FY06. 100 percent compliance in FY05. Without additional resources a 25% drop in approved activities.

Oil and gas units and participating areas (PAs) are the operating and commercial framework for most 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.

100 percent compliance in FY04.

B4: Strategy - Negotiate new unit agreements that accelerate exploration and development and maximize the economic benefit to the state.

Target #1: Negotiate two new unit agreements per FY.
Measure #1: Number of new unit agreements

Analysis of results and challenges: Four new unit agreements under negotiation in first quarter FY06. Without additional resources a delay of 6 months in negotiating new units.

One new unit agreements in FY05.

Three new unit agreements in FY04.

B5: Strategy - Perform inspections of oil and gas operations.

Target #1: 100 percent of seismic, exploratory, and production operations inspected each year.
Measure #1: Percent of seismic, exploratory, production operations inspected each year.

Analysis of results and challenges: First quarter FY06: Four inspection field trips were conducted during the Quarter; facilities inspected include 100% of new developments, trenching and maintenance activities; 100% of winter exploration wells; and 100% winter seismic work.

Inspections are on schedule during the first (summer) quarter, but are expected to decrease in the second quarter, due to staffing challenges in Oil & Gas Permitting, which both adjudicates and inspects all oil and gas related activity. Ongoing exploration activities and incremental changes to existing development increase, each year, the total number of sites requiring on-site inspection for compliance with lease and permit conditions.

Additional resources the NRS-IV and NRS-III will allow full implementation of increasing statewide gas-related inspection activities, including gasline permitting, Alaska Peninsula activities, gas hydrates and gas-only exploration licenses.

85 percent complete in FY05. Operations not inspected by June 30, 2005 include those planned for summer construction or inspection, and seismic operations planned for next winter.

85 percent complete in FY04.

C: Result - Maximize non-tax revenue from state oil and gas production.

Target #1: $ 1.2 billion
Measure #1: Amount of non-tax revenue received for total state production of oil and gas.

Amount of non-tax revenues

Year	YTD Total
2004	$1.42 billion
2005	$1.91billion
2006	$568.1 million 1st qtr FY06

Analysis of results and challenges: First quarter of FY06 non-tax oil and gas revenue was $568.1 million. $1.9 billion for FY05. Without additional resources analysis of pipeline tariff rates and quality bank fees will be postponed.

This amount includes income from bonus bids, rental payments, and royalties (regular payments as well as money from reopeners and audits) from oil and gas throughout the state. See "details" for more information.

The FY04 average ANS spot price was estimated to be $31.13 a barrel with an estimated ANS production volume of 0.980 million barrels per day of oil. The FY05 price was estimated to be an average of $41.75 a barrel with an estimated production volume of 0.920 million barrels per day of oil.

C1: Strategy - Ensure that the state receives the best negotiated value in the sale of its royalty-in-kind (RIK) oil and gas.

Target #1: Receive $ .30 per barrel more from RIK as opposed to royalty-in-value (RIV).
Measure #1: Difference between RIK than RIV.

Analysis of results and challenges: First quarter FY06: 100 percent compliance.
Without additional resources there will be a delay in RIK analyses and billing.

100 percent compliance in FY05.
100 percent compliance in FY04.

C2: Strategy - Conduct timely audits.

Target #1: Complete four royalty audits each FY.
Measure #1: Number of royalty audits completed during FY.

Analysis of results and challenges: Four royalty audits are in progress during first quarter FY06. With two additional auditors two new audits can be performed with cost recoveries up to $5M.

The Audit Section is responsible for auditing, analyzing or verifying virtually all of the oil and gas royalties collected by the State of Alaska, which at $1.9 billion in FY 2005 are the state's largest single component of revenue (excluding federal and investment revenues). The section's auditors are responsible for verifying oil and gas royalties either directly through audits or through review and negotiations during periodic amendments to royalty settlement agreements (called reopeners in the case of agreements with the three major oil producers on the North Slope).

Eight royalty audits completed in FY05.

Four royalty audits completed in FY04.

C3: Strategy - Ensure that the state receives full value for oil and gas royalty-in-value (reopeners).

Target #1: 100 percent of reopeners increase value.
Measure #1: Percent of reopeners that increase value.

Analysis of results and challenges: First quarter FY06: Current reopener is still in progress.

With additional commercial analysts on staff we will relieve the delay in dealing with royalty settlement reopeners and royalty relief applications caused by gasline work. Real revenue consequences for the state and permanent fund will result if additional funding is not provided.

The first half of the ExxonMobil reopener was successfully concluded in June 2005 when an arbitration panel found in the State's favor. The second half of the reopener will continue with an arbitration hearing.

Key Component Challenges

The Division of Oil & Gas manages the State's oil and gas resources with a staff of 93, 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 seven sections: administration; audit; commercial; leasing/permitting; resource evaluation; royalty accounting; and units. They strive to:

Encourage Exploration and Development by:

- Increasing the division participation in geological field work on the North Slope foothills and the Alaska Peninsula in support of DGGS field programs that promote exploration in these areas.
- Improving 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.
- Promoting and facilitating an increased role for independent oil and gas companies willing to develop new regions of the State.
- Fully evaluating the resource potential of the Alaska Peninsula for proposed oil and gas lease sales.

Maximize Benefits of Development and Production to the State by:

- Better evaluating Cook Inlet long term gas supply and deliverability.
- Minimizing or eliminating 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.
- Increasing the number of permitters/inspectors to oversee oil and gas operations in populated areas and increased Cook Inlet gas exploration and development.

Maximize Non-tax Revenue from State Oil and Gas Production by:

- Evaluating the project scope and commercial factors affecting proposed gas pipeline projects and negotiate with multiple parties: producers, pipeline companies, Alaska Natural Gas Development Authority (ANGDA), Port Authority, and others interested in various natural gas projects.
- Adding commercial and audit expertise to evaluate oil and gas pipeline tariff proposals, royalty reduction applications, North Slope gas fiscal systems and North Slope facility sharing models and to improve audit capabilities.
- Preparing for additional royalty in-kind (RIK) oil and gas sales.
- Improving and expanding 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.

Major activities occurring in or planned for FY06 - FY07 are discussed below. In the upcoming fiscal year, the division expects to see 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 and new entrants 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, except for activity in NPRA, they have been active in the development of satellite fields near existing infrastructure and viscous oil reservoirs within existing units and are proceeding with the initial permitting stages for the development of the Colville River Delta and NPRA. On the horizon is Liberty in the Beaufort Sea, Pioneer's Ooogurук project, Kerr McGee's Nikaitchuk project, new viscous oil drill sites and production facilities at Prudhoe Bay and Milne Point, and continued activity associated with West Sak

development in Kuparuk. This change in exploration effort from Majors to Independents was illustrated by the October 2004 North Slope and Beaufort Sea lease sale where ten independents and one major bid.
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. Activities relating to coalbed methane exploration and development in the Mat-Su Valley area are at a stand still as the program is undergoing a major policy change.

A. Encourage Exploration and Development:

- With the demand for additional areawide lease sales and exploration licenses 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. The division is also seeing success in the administration's efforts to bring new independents into the state, with a resulting increase in staff time assisting and educating new bidders and lessees.

- With regard to leasing and licensing, the division continues to review all mitigation measures for competitive lease sales and exploration licensing 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). The division is currently evaluating two exploration license proposals, in the Healy Basin and Holitna Basin, and completed the Final Best Interest Finding for the Alaska Peninsula Sale.

- In addition, exploration licenses and Cook Inlet lease sales 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. Consequently more staff time is required to educate the public. The split estate issue has led to appeals and litigation over the issuance of leases in these areas.

- 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 was a controversial program, especially in the heavily populated areas such as the Mat-Su Valley and on the Southern Kenai Peninsula, was repealed but pending applications were converted to or replaced by exploration license applications. Title work in these areas can be 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 preparation of title reports for oil and gas with other State projects. The division anticipates title work demands to remain high as a result of successful lease sales in FY05, two pending exploration license applications, and the first Alaska Peninsula Areawide Sale held this October.

Areawide Oil and Gas Lease Sales: The resource evaluation section will continue to provide geological, geophysical, and engineering support for the five annual areawide oil and gas lease sales on the State's current master lease sale schedule. This information is utilized to establish some of the bidding terms of the areawide lease sales. As during FY06, assessments of the Alaska Peninsula and North Slope Foothills areawide lease sale areas will continue to require additional surface and subsurface studies to provide improved assessments of their petroleum potential.

- Alaska Peninsula competitive areawide oil and gas lease sale: Following only two years of intensive technical and promotional preparation, the first of this series of areawide lease sales was held in October 2005. Two bidders, Shell Offshore, Inc. and Hewitt Minerals Corporation, exposed approximately $1,300,000 to acquire 37 tracts in the Port Moller area. In the two years prior to the lease sale this division and the Division of Geological and Geophysical Surveys (DGGS) were successful in acquiring and disclosing substantial geological information to educate the local populace and to encourage industry interest. Much remains to be learned, however, about the distribution and character of source, trap and reservoir rocks and the regional petroleum system. Assimilation of this information into the basin assessment should continue in preparation for follow-up lease sales. Others involved in the basin assessment include the Alaska DGGS, the Bristol Bay Native Corporation and the

U.S. Geological Survey (USGS). The U.S. Minerals Management Service might also become involved as it reassesses the petroleum potential of the offshore portion of the Bristol Bay Basin and the possibility of again offering leases in the adjacent offshore federal waters now subject to a federal leasing moratorium.

- North Slope Foothills areawide oil and gas lease sale: This large gas-prone area remains essentially unexplored despite the early high interest apparent in the initial foothills lease sale. Failure to timely resolve the gas pipeline issue resulted in return of many of the leases and cancellation or delay of several promising industry exploration programs. Recent congressional and federal actions, and negotiations with stranded gas owners and pipeline companies continue to be encouraging. Upon a decision to construct a gas line, the North Slope Foothills areawide lease sale area might become the hottest exploration play in North America. Collaborative field work there by the division, the DGGS, and the USGS during recent years has resulted in collection and publication of baseline geological data that should be expanded, compiled, and published in order to attract investors to the area. Those studies will continue during FY07.

- Alaska Gas Line: Upon agreement to construct a trans-Alaska gasline, resource evaluation geoscientists and engineers will have to assess the resource potential of gas-prone areas and possible conventional and unconventional gas reservoirs throughout State lands on the North Slope and in the Interior. North Slope Foothills area lessees and others have proposed, but delayed, extensive geophysical and drilling exploration projects there and can be expected to act quickly upon successful conclusion of a gas line contract. The extensive size of the foothills lease sale area and the large quantity of information expected to be received from proposed programs will require dedication of substantial resources from the section.

- Gas Hydrates Exploration and Development Technology: With an eye to future development of Alaska's resource base, the State has, and will, play a significant role in a federally funded five-year north Alaska gas hydrate exploration, production and development research program. While the State is not providing direct financial support to the program, resource evaluation section geoscientists and petroleum engineers are expected to play significant roles in designing exploration methods and development of production technology. Participation in this program is expected to begin during late FY06 and surely during FY07.

- Arctic National Wildlife Refuge: If a decision is made to open the refuge we expect the division, including the resource evaluation section, to be invited by federal agencies to participate in development of resource assessments and operational regulations.

- The division must continue to find and use innovative methods of outreach to attract new companies to Alaska. 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 continue to be focused on the Bristol Bay Basin/Alaska Peninsula lease sale.

- Public Outreach: During FY07, the division will remain a key player in the administration's program to attract new players to Alaska's oil patch. Resource evaluation staff plays a key role by compiling, formatting and distributing technical information of value to explorers. This information is produced in the forms of maps, charts, photographs and reports depicting and describing the petroleum potential and petroleum system character of petroliferous basins in the State. That involvement is expected to grow throughout FY07 as the division, often in collaboration with the Division of Geological and Geophysical Surveys, expands surface and subsurface studies. Most, if not all, of the information will be web-enabled to assure timely and equitable distribution to the public. The division will also continue to use this information as booth displays and handouts to promote Alaska opportunities at several national conventions throughout the year.

  - A frequent complaint in the past has been that the State resource agencies publish too little information regarding the petroleum potential of the State. Recent additions to the resource evaluation staff have provided the division with substantial expertise in several specialized fields of geology and allowed collection, analysis and publication of information to a degree previously not possible. This was evidenced by the value of the information published and distributed during the short time available to prepare for the Alaska Peninsula areawide lease sale. Collection, interpretation, and publication of such information remain division goals as we attempt to provide useful information for companies considering or conducting exploration in Alaska.

- The database management group within the resource evaluation section provides virtually all of the mapping, graphics, software and conventional and web-interfaced publication support for the division. In addition, this group prepares the graphics used by DNR and division management at their presentations to the administration and Legislature, other departments, and industry groups. It will continue to do so throughout FY07 to provide information to those interested in the status of petroleum activities in the State and in adding Alaska petroleum exploration programs to their company portfolios.

- While unable to identify specific FY07 outreach projects at this time, a safe assumption is that outreach projects related the gas pipeline, gas hydrates, and ANWR are likely to require substantial involvement of resource evaluation staff.

B. Maximize Benefits of Development and Production to the State:

- Increased demand for administration of oil and gas leases: The North Slope, Beaufort Sea, North Slope Foothills, Cook Inlet, and Alaska Peninsula areawide lease sales will continue to increase the number of leases the division issues. As a result of the increased areawide leasing activity, along with a decrease in the number of leases expiring (due to production and unitization), the number of leases being 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.

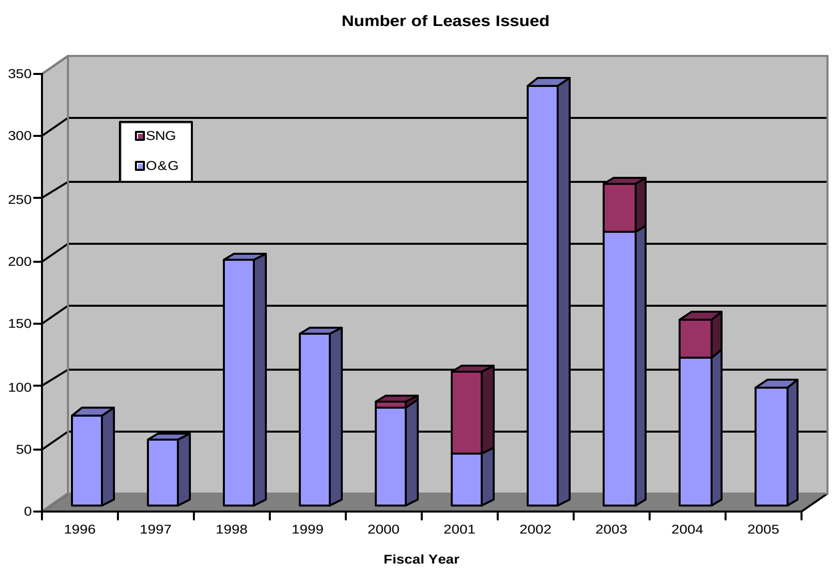

Figure 1

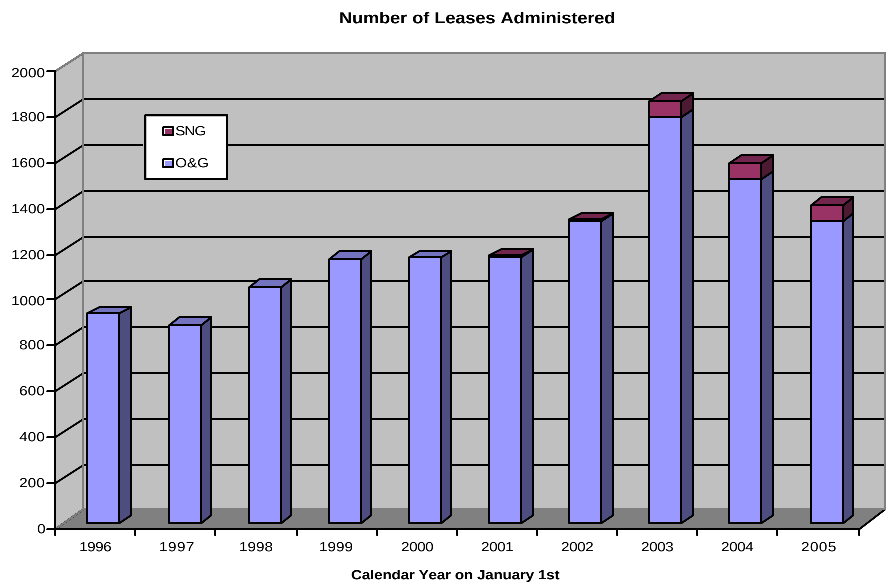

Figure 2

- 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 division is actively participating in the permitting for the Oooguruk and Nikaitchuk North Slope offshore development proposals. Offshore development projects continue to be a permitting challenge due to increased environmental and oil spill response issues. As instructed by the Legislature during the 2005 legislative session, DO&G is reviewing the subject of Cook Inlet platform abandonment. In addition, DO&G has independently undertaken a review of platform bonding for the purpose of developing regulations and guidelines.

- Successful involvement by new explorers has lead to an increased number of lease assignments. We expect this trend to continue. Rapid processing of assignments accelerates the Oil and Gas development process. Figure 3 shows the steady increase in the number of assignments over the past several years.

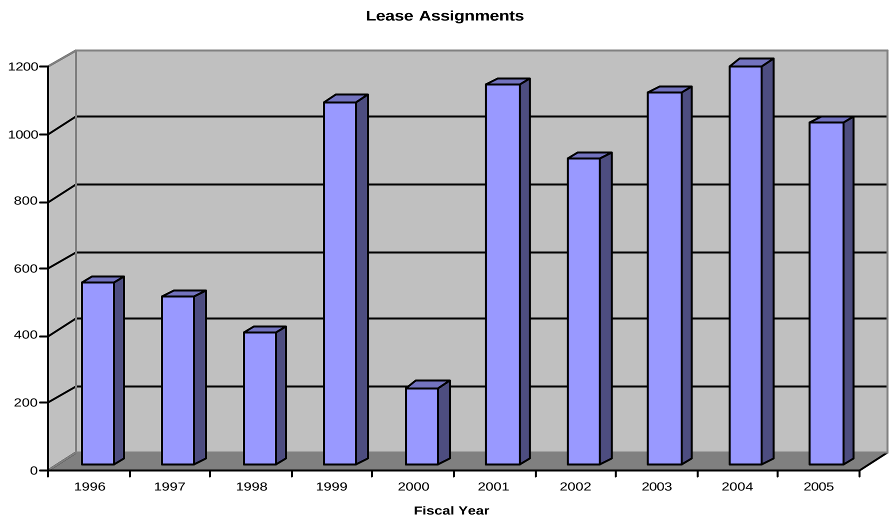

Figure 3

- Oil and gas units and participating areas (PAs) are the operating and commercial framework for most 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 lead to significant amounts of new production.

- As of October 2005, the division currently oversees 42 active units and 64 active participating areas. One hundred twenty four (124) unit actions were adjudicated last calendar year. Figures 4, 5, and 6 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 more companies are involved in requiring a more proactive effort from the division as new companies with little or no experience in Alaska become involved in unitization matters.

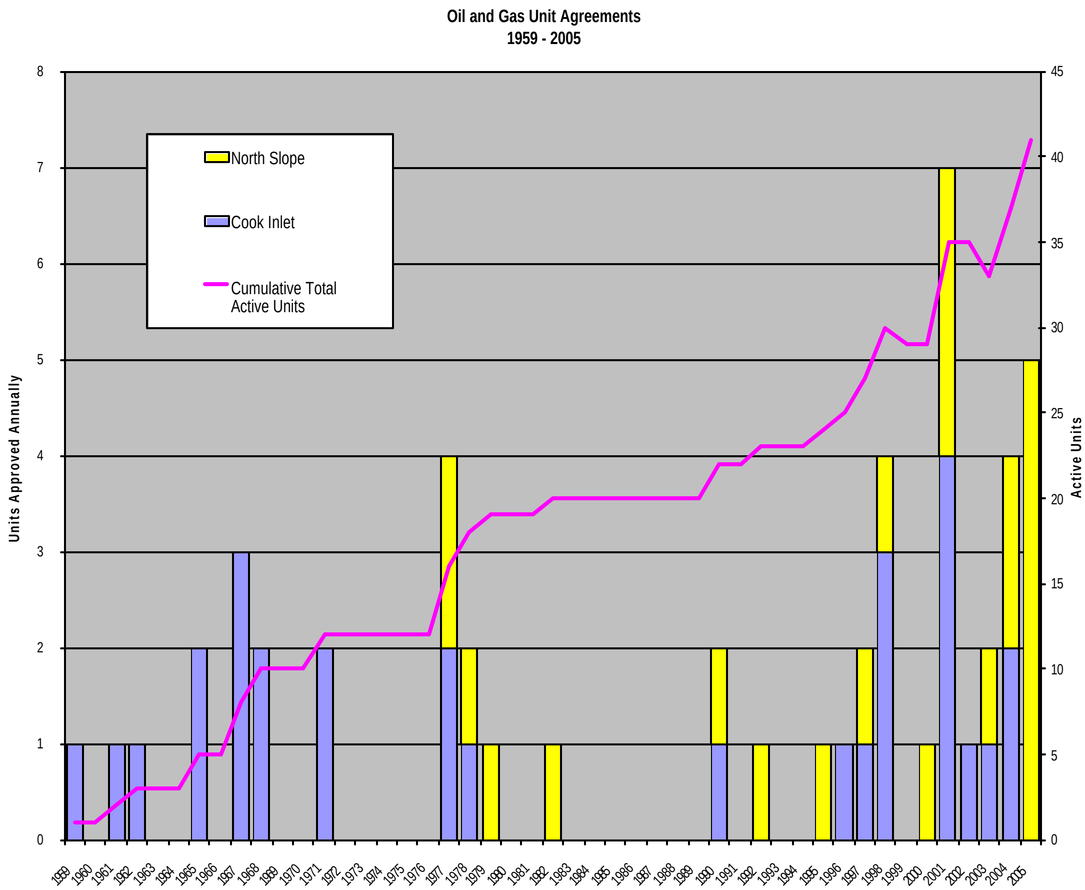
Oil and Gas Unit Agreements
1959 - 2005
North Slope
Cook Inlet
Cumulative Total Active Units
Units Approved Annually
Active Units

Figure 4

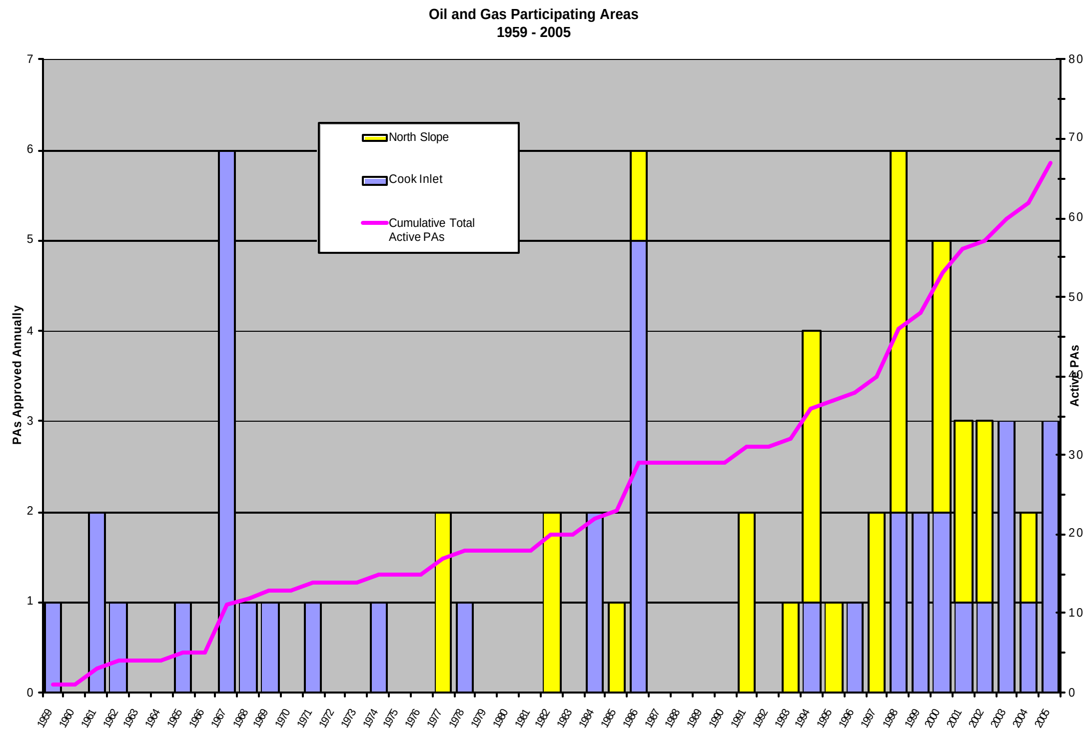

Figure 5

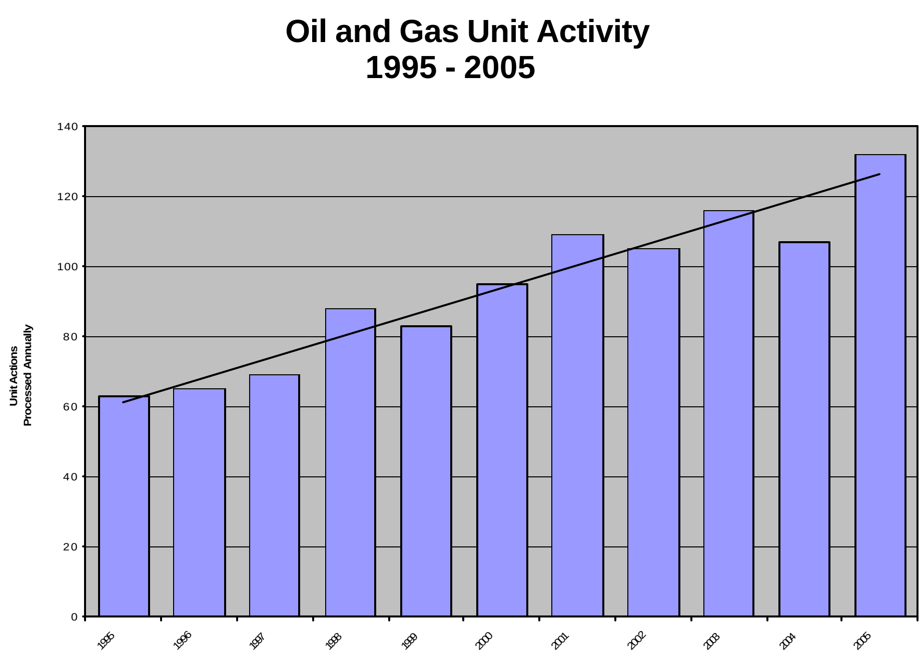

Figure 6

- Oil and gas production from satellite pools and new field start-ups is becoming an increasingly important part of North Slope output. In 2004, over 27 percent of ANS oil output was from new pools, new participating areas, and expansion areas of older participating areas that began production since 1995. (See Figure 7 and Figure 7A.)

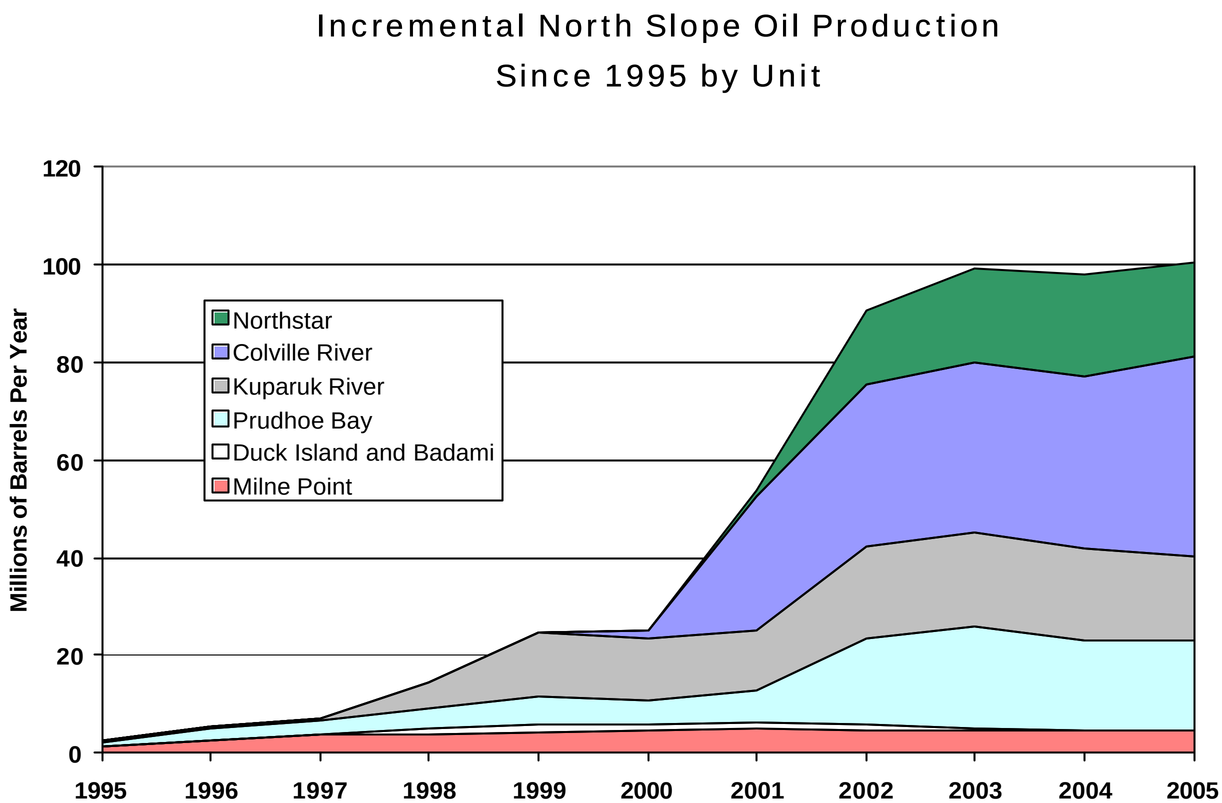

Figure 7

Year	Incremental Oil Production Since 1995 (Millions of Barrels)	Total North Slope Oil Production (Millions of Barrels)	Percentage of Incremental to Total Oil Production
1995	2.578	550.928	0.5%
1996	5.231	529.395	1.0%
1997	6.945	499.146	1.4%
1998	14.268	456.849	3.1%
1999	24.509	404.554	6.1%
2000	25.185	376.499	6.7%
2001	53.542	368.483	14.5%
2002	90.556	371.794	24.4%
2003	98.962	368.110	26.9%
2004	97.788	346.090	27.3%
2005est	100.439	328.470	30.6%

Figure 7A

- 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. 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.

- New lessees such as Pioneer and Kerr McGee are proposing development and production projects that involve facility sharing agreements with existing units. Preparing the required authorization forms to allow all parties to participate in facility sharing is the responsibility of the respective unit managers. Other new lessees such as Brooks Range Petroleum and ENI are contemplating such agreements, and Pioneer and Kerr McGee hope to execute additional agreements in the future.

- In connection with ongoing negotiations under the Stranded Gas Development Act, unit managers are identifying unit and lease terms (such as point of sale/delivery point, field costs, gas conditioning obligations and fees, take in-kind, and gas balancing) that potentially will need to be harmonized with any proposed new fiscal contract/system.

- The first coalbed methane unit (the Pioneer Unit) had several wells drilled to date. A new operator, Pioneer Resources, assumed control in the unit from Evergreen. Pioneer decided to terminate the unit, relinquish the leases and abandon the wells and facilities.

- 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, expansion, and timely development of units and participating areas. The section also supports the audit staff on issues related to the market of Alaska's oil and gas, the cost and profitability of marine and pipeline transportation, and other economic indicators.

- The commercial staff also provides analysis and data for the department either in support of the administration's legislative initiatives or to respond to information requests from Legislature on bills that may impact oil and gas development.

- <u>Resource Allocations and Assessments:</u> During FY07, the division, in addition to the normal procedure of verifying, initial tract allocations for all new units and participating areas, will be involved in final tract allocations for the Northstar field. Tract allocations are the process of determining actual and estimated production from beneath lease tracts and are the basis of equitable distribution of revenue to the landowner, lessee, and over-riding royalty, owners. Typically they require compilation of complex geological, geophysical, and reservoir engineering reservoir simulation models with which past production can be measured and future production estimated for the predicted life of a field. The process can take several months to complete, especially if the division's results differ from those proposed by the lessee.

  - <u>Northstar Unit Tract Allocation:</u> The final allocation of the Northstar field reserves, originally scheduled for FY06, was delayed by the operator's success at Northstar and the unexpected continuation of development drilling. It is now expected to occur early in the second half of FY07 due to the need to include production histories from late-drilled wells. Because both federal and State leases with differing leasing terms are included in the Northstar unit, the reallocation process will involve the U.S. Minerals Management Service as well as the Alaska Oil and Gas Conservation Commission.

  - <u>Three Mile Creek Unit Tract Allocation:</u> A participating area will be established in January 2007 requiring an initial tract allocation to properly distribute royalties to the two landowners (State of Alaska and the Cook Inlet Regional Corporation) and revenue to the two working interest owners (Aurora Gas LLC and Forest Oil Corporation).

  - <u>Resource Assessments</u>: Progress in the gas pipeline, gas hydrates and possibly ANWR leasing will undoubtedly require substantial investigations by resource evaluation staff during FY07. Given the amount of money made available for study of gas hydrate potential, resource evaluation staff will surely contribute to those studies. Resource assessments are also key decision elements when evaluating exploration licenses, land selections and surface access routes. Specific projects cannot be identified at this time.

- The resource evaluation section also provides the technical assistance needed to support leasing and unit applications and decisions after issuance of leases.

  - Various incentive programs offered by the State have encouraged several independents to invest in exploration and development opportunities across Alaska during FY05 and FY06. These operators, unlike the long-established majors, tend to explore and develop their lease holdings quickly in order to generate immediate cash flow. The impact on the resource evaluation section is expected to be more than the normal number of geological and reservoir assessments of unit and participating area applications as these operators develop new fields.

  - While it remains to be seen if high oil prices continue through FY07 and if exploration drilling increases as a result, accelerated development drilling is expected to continue. The now common use of technology such as multilateral horizontal completions generates much larger quantities of technical data than did the conventional drilling practices of the past. Compilation and interpretation of these data will increase the work load of resource evaluation staff when reviewing unit and participating area applications and when determining tract allocations.

  - As the primary term of many leases approach expiration, it has become common practice for lessees to attempt to secure lease term extensions through various last-minute means such as applying for unitization or alteration of unit boundaries. In our attempt to encourage petroleum exploration and development, the division sometimes approves such activities, but conditions approvals with performance commitments designed to ensure no loss of State revenue. Each of these unexpected proposals must be evaluated by resource evaluation staff within a very short time and, with other division staff, performance commitments developed.

- Royalty Reduction: The Commercial staff together with staff from the units and resource evaluation section, staff in the commercial section are evaluating a royalty reduction application for the Oooguruk Unit. A second application for the Nakiatchuk Unit may be soon submitted; discussions with Nakiatchuk owners have already begun. Resource evaluation, verification of reservoir engineering and performance, and modeling of project economics are underway. A commercial analyst, economist, and petroleum land manager are currently working nearly full-time on these efforts as of September 2005. FY07 may see additional applications.

C. Maximize Non-tax Revenue from State Oil and Gas Production

- The Royalty Accounting Section continues to accurately invoice royalty payments to the State. During FY05**,** the Royalty Accounting Section accurately invoiced $758.1 million to the State royalty-in-kind purchaser and processed and analyzed an additional $1,147.3 million in royalty-in-value, net-profit share lease, federal payments, rents, bonuses, and other fees for a total $1,905.4 million.

- Oil & Gas Leasing & Accounting Systems Integration. The Division of Oil and Gas entered a professional services contract in June 2004, which in the past year prepared an overall division-wide database model. This model integrates the data, application, and reporting processes for oil and gas Lease Sales and Administration, Units Administration, Royalty Accounting, Permitting and Well Data from Resource Evaluation. Applications to perform business processes were begun in the spring of 2005, including: Lease Sales, Lease Administration, Units Administration, Royalty Accounting, and Permitting and Best Interest Findings. These applications are being developed in parallel to one another to ensure the tightest integration possible. Since all of these processes have been manual except for Royalty Accounting, development is slower to allow for detailed evaluation of each process and its integration with associated business processes. The end result will be automation of lease assignments to increase the accuracy and information detail and decrease the processing time. Lease assignment information will be available to each lessee, through a secure on-line logon unique to each lessee or client. Unit applications and Permitting will also use secure on-line logon processes to gather Unit and Permit applications, both of which are establishing standardized formats and content tailored to individual lessee needs. This should eliminate paper processing for these activities over the next two to three years. Automated Royalty Reporting processes are also being upgraded to provide real-time reporting and error notification to lessees. This will enable lessees to file and make corrections of misfiled reports prior to end of the month filing deadlines, thus speed up royalty reporting processing, reduce errors, and promote increased reporting and payment accuracy. These applications are scheduled to be completed and implemented by the beginning of 2006.

- The audit section recovered approximately $4.7 million in audit claims during FY05. Another $1.0 million in audit claims was recovered during the first two months of FY06.

- The Legislature authorized the division to conduct royalty and net profit share lease audits in a statutory amendment effective July 1, 2003. The Department of Revenue had previously performed such audits, with substantial assistance from the division. Thus, FY04 was the first year that the division was authorized to independently plan, perform, and resolve royalty and net profit share audits. The audit group, which had been part of the commercial section, was reorganized into a separate section to take advantage of its new authority and capabilities. This has resulted in an accelerated process, which is beneficial to both the State and lessees. For example, DNR has been able to complete Cook Inlet audits within a four to five month period compared to the previous two to three year period prior to the Legislature delegating single audit authority to DNR.

- The division has a three-year contract with the U.S. Minerals Management Service to perform audits of federal oil and gas leases in Alaska. The audit section has one auditor who is exclusively engaged in audits of federal leases in Cook Inlet and another auditor who is extensively engaged in federal audits. The State receives between 50-90 percent of the audit recoveries obtained by the division's federal auditors, depending on where the federal lease is located. Additional Cook Inlet audits are planned for FY06 and FY07.

- The audit section was extensively engaged in an audit of Exxon's marine transportation costs during FY04 and FY05, and continues to devote substantial effort to the Exxon royalty reopener. An arbitration hearing concerning the company's marine transportation costs is likely to occur before the end of FY06, which may involve a major role for the audit section in both prehearing preparation and discovery, and representing the State's position in the hearing. The audit section also supports the division's royalty reopeners with other major North Slope producers, particularly with respect to analysis of marine transportation costs, which along with pipeline tariffs are the major deductions to arrive at the State's royalty value. A new auditor was hired in FY05, who is involved in State audits of oil company marine transportation costs.

- In addition, the audit section analyzed several bills during the legislative session, responded to questions from legislative committees, and in particular provided analysis concerning a bill establishing royalty values for a Cook Inlet gas producer that utilizes its own gas for its electric utility.

- Royalty reopeners and the value of North Slope royalty oil: In the early 1990s, the major North Slope oil producers and the State entered into royalty settlement agreements that tied each producer's royalty obligation to a market basket of seven crudes and provided for deductions for marine transportation, pipeline tariffs, and other adjustments. The settlements with BP and ARCO (now ConocoPhillips) have been occasionally amended to change the formulas used to calculate the lessees' royalty payments. 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 formulas 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 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.

- Lack of progress in negotiations with ExxonMobil through FY04 has compelled the division to proceed to arbitration on two fronts: the value of the State's royalty oil in its destination on the West Coast and the amount ExxonMobil may deduct for marine transportation. The division's resolve in this matter, combined with the in-house legal talent and outside experts hired by the Department of Law has lead to a successful conclusion on one of two issues in the arbitration process. In June 2005, an arbitration panel decided in the State's favor by choosing the State's methodology for calculation royalty value over ExxonMobil's proposal. Still pending is the question of how much ExxonMobil may deduct for the direct cost of marine transportation from Valdez to the West Coast. The direct cost reopener as it is called will likely go to an arbitration panel in the Fall 2005 or Winter 2006. Commercial staff and audit staff are collaborating in developing the State's case. Royalty accounting is also providing valuable assistance retrieving company data from the division's royalty accounting system.

- The successful negotiation of reopeners with BP and ConocoPhillips and the early success in arbitration with ExxonMobil illustrates how the State has benefited dramatically from pro-active management of its royalty revenues. While the division has always expressed a willingness to conclude these reopeners through amicable negotiation, it has also demonstrated that it is willing to exercise all of the State's rights under the royalty settlement agreements to press for the State's fair share.

- Royalty-in-kind sales: The division continues to supply royalty-in-kind (RIK) oil to the Alaska refining industry. The percentage of RIK to total royalty has increased over the past three fiscal years. In FY03, the division sold 38.3 percent of ANS royalty oil in-kind. In FY04 that percentage increased to 46.5 percent and in FY05 the percentage was 51.8%. Williams' departure from the State and its sale of its refinery to Flint Hills Resources Alaska (FHR) created an opportunity for the State to continue to supply RIK oil. The commercial section concluded negotiations with FHR and began delivering royalty-in-kind oil to the North Pole refinery in April 2004. The new contract incorporated innovative terms brought to the table by the Governor and should yield a substantial price premium to the State over what the State would have received for its royalty in-value oil. The commercial section is also tasked with monitoring the other terms of the sale including the promise by FHR to sell wholesale gasoline in Anchorage and Fairbanks at the same posted price. The commercial section continues to evaluate future RIK oil and gas sales and provides advice and recommendations to the commissioner on potential sale terms. Stranded Gas Development Act negotiations with various parties all have royalty-in-kind features that are under evaluation by the Commercial staff.

- Alaska North Slope Gasline: The division staff continues to devote a significant amount of time to promote ANS gas projects. For example, the division has devoted at least 10,000 staff hours to gas pipeline projects in FY05. The Commercial 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. The section continues to contract and provide contract management for major studies in gas price forecasting, royalty valuation, and commercial financing.

The Commercial Section has provided technical support to DNR management, the Governor, the Gas Cabinet, the Congressional Delegation, and contributed to the Stranded Gas Working Group to formulate the State's position in developing a stranded gas contract with the producers and other potential pipeline owners.

Significant Changes in Results to be Delivered in FY2007

A. Encourage Exploration and Development:

1) Due to competitive areawide leasing and the addition of the exploration license program, it currently takes the division many months after the sale/award to conduct title reviews and issue leases. The division's goal is to be able to issue leases nine months following a lease sale.

2) Develop and maintain staff of professionals that meet or exceed the best in the oil industry. The division has been very fortunate to be able to add a set of critical skills to the technical staff, skills and knowledge that will allow much more comprehensive and detailed assessments of the petroleum potential of sedimentary basins across the State and improved dissemination of those assessments through scientific publications. The addition of three geologists, all with substantial and recent industry experience, will provide the division with recognized expertise in the specialties of stratigraphic, sedimentary, structural and petrographic geology. All three also have significant project and program management experience. The division's geophysical staff now numbers three following employment of a geophysicist proficient in seismic data processing and interpretation, including analyses of 3-D attribute processing. Although limited in number, the division now has a scientific asset team the equal of any and superior to most of those found in the private sector. On the Commercial side

the division has filled its vacant petroleum investment manager position with a highly experienced gas marketer.

3) The division continues to manage costs by limiting 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 and eliminating the printing of excess copies of the Five-Year Oil and Gas Leasing Program. Costs have increased for travel to the Alaska Peninsula, Healy, and Holitna areas as a result of proposed lease sales and exploration license proposals. Increased travel is also required to inspect seismic and drilling activities in the Copper River and Nenana areas.

4) 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 are available over the counter.

B. Maximize Benefits of Development and Production to the State:

1) Oil and gas activities in the populated Mat-Su and Kenai areas have increased the public attention on our permitting and inspection program. The division’s goal is 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.

2) Work with lessees to commercialize undeveloped oil and gas on the North Slope.

C. Maximize Non-tax Revenue from State Oil and Gas Production

1) 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.

2) The first half of the ExxonMobil reopener was successfully concluded in June 2005 when an arbitration panel found in the State’s favor. The second half of the reopener will continue with an arbitration hearing scheduled for Fall 2005 or Winter 2006. Based on the outcome of these reopeners, a new reopener in FY07 is possible. These proceedings entail the extensive use of experts, voluminous document review, and negotiations and arbitration.

3) Professional and support staff will participate in more royalty and net profit share audits, evaluate Cook Inlet and North Slope oil and gas royalty reduction requests and rulings, analyze Cook Inlet gas valuation proposals and options for storage of Cook Inlet gas.

4) Assuming that a contract is approved under the Stranded Gas Development Act in FY06, considerable effort is still required from division staff to draft the detailed accounting, audit, measurement, LLC and commercial structure agreements that will be annexes to the contract or separate or stand alone agreements. Even if a contract is not finalized until sometime in FY07 or later, these same activities are still required once the contract is executed. The division must maintain the technical and commercial staff required to draft these critical agreements and then be prepared to implement them as a project moves forward.

Major Component Accomplishments in 2005

A. Encourage Exploration and Development:

1) With the Division of Geological and Geophysical Surveys conducted an additional geological field program on the Alaska Peninsula to gather geological information critical for evaluation of the area’s hydrocarbon potential. Published interpretive results in order to make information available to the public prior to the Alaska Peninsula areawide lease sale.

2) In similar fashion, collaborated with the Division of Geological and Geophysical Surveys to continue the resource assessment field program in the North Slope foothills lease sale area and arranged for continued support and participation by interested oil and gas companies.

3) Recruited and employed additional geological, geophysical, reservoir engineering, commercial, and technical support staff competent in disciplines such as sedimentology, petrography, and structural geology; seismic processing and interpretation; petroleum reservoir engineering; and GIS to supplement existing staff and to provide essential research capability necessary to support the division's expanding role as a source of technical information.

4) Four lease sales held, resulting in 625,086 acres being leased and the State receiving $13,700,061 in bonus bids.

5) Issued 162 oil and gas leases.

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

7) Prepared a Matanuska-Susitna Valley lease and land ownership atlas to provide information to support the conventional oil and gas leasing in that area.

8) Provided technical support to the Legislature and the Alaska Congressional Delegation on a variety of oil and gas issues including advances in arctic technology and practices, gas hydrates, and oil and gas incentives.

9) Addressed the U.S. Senate Committee on Energy and Natural Resources as well as the U.S. Senate Republican Conference on the potential of Alaska's natural gas hydrates. As a result of increased attention on this subject, Congress appropriated $165 million over a five-year period for methane hydrate research. In August 2005, DO&G along with DGGS, hosted an Alaska Gas Hydrates Planning Workshop with attendees from around the country.

10) 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 Bay Basin sale resource assessment.

11) 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 Bay Basin, Mat-Su Valley, and Kenai Peninsula “atlases” to support conventional and shallow natural gas leasing programs in those areas. 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.

12) Worked closely with new Cook Inlet and North Slope Explorers including Pelican, Alliance, Pioneer Oil & Gas, Pioneer Natural Resources, AVCG, Brooks Range Petroleum, UltraStar Kerr-McGee, ENI, Fortuna, and Armstrong to facilitate their exploration activities.

13) Preparation and dissemination of an information package and facilitation of a conference hosted by the Governor providing independent operators comprehensive information and guidelines regarding exploration, development and production activities in Alaska. Contributed to the study that resulted in a longer tundra opening on the North Slope, thereby extending the exploration season in that region.

14) With help of consultants, prepared a facility sharing study as a primer for North Slope explorers. Follow-up on this first study continues.

B. Maximize Benefits of Development and Production to the State:

1) Managed 42 active units and 64 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 and inclusion of royalty owners other than the State of Alaska.

2) Conducted geological reviews of virtually all unit and participating area management functions accomplished by the division's unit administration section. Many of these functions required determination or verification of tract allocations for equitable revenue distribution to the State and other stakeholders.

3) Continued "partnering" with the federal Minerals Management Service in management and oversight of jointly-owned lands in the Northstar 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 Peninsula region. In similar fashion, the division worked in close partnership with the Arctic Slope Regional Corporation to ensure continued development of the Alpine field and NPRA acreage and with the CIRI at Deep Creek, Three Mile Creek, and Ninilchik Units.

4) With ASRC, ConocoPhillips Alaska, and Anadarko Petroleum, established new tract allocations for the North Slope's Alpine field to adjust revenue distribution for the results of new in-field drilling and actual well production rates.

5) Participated in interdisciplinary meetings of State resource agencies (AOGCC, OPMP, OHMP, ML&W, DEC, and F&G) addressing issues such as well control and the critical issues of early North Slope tundra travel and the abbreviated winter drilling seasons.

6) Processed 1,185 oil and gas lease assignments.

7) Initiated the permitting process for North Slope offshore oil development projects at the Oooguruk and Nikaitchuk units.

8) Initiated analysis of royalty reduction applications submitted by lessees of the Oooguruk and Nikaitchuk units-technical data, subsurface information, economic information, production forecasts and cost projections.

9) Participated with the federal Bureau of Land Management and the federal Minerals Management Service in a promotional trip to Calgary, Alberta, Canada, to advise Canadian oil and gas companies of Alaska opportunities, regulatory framework and operational environment.

C. Maximize Non-tax Revenue from State Oil and Gas Production

1) In FY05, petroleum revenue collected by the Departments of Natural Resources and Revenue accounted for approximately 89 percent of general fund unrestricted revenue. Total royalty, settlement, rental, federal share, and bonus revenue collected by DNR was $1,905.4 billion. Distribution was as follows: $1,419.6 million General Fund; $476.3 million Permanent Fund; and $9.5 million School Fund. Revenue increased 34.4 percent from FY04 to FY05, largely due to the increased price of oil.

2) In FY05, the division resolved 11 years of oil and gas audits with Shell. The division also received payments for audit claims relating to Cook Inlet oil and gas producers.

3) Completed first half of the long-disputed royalty settlement agreement reopener arbitration with ExxonMobil.

4) Provided commercial, technical, and policy support to the Governor's gas pipeline team and the Legislature's gas pipeline committee.

5) Participated in numerous negotiating sessions and discussion groups with the Gasline sponsor group and interested pipeline companies and other project proponents in connection with applications and expressions of interest submitted under the Stranded Gas Development Act (SGDA).

6) Participated with staff from Departments of Law and Revenue to hire consultants to formulate State positions papers and formulate/analyze options available to the State with respect to ongoing negotiations under the SGDA.

7) Supervised several consultants hired by the State to formulate options for SGDA negotiations, prepare offers to project proponents, and analyze and model proposals submitted under the SGDA.

8) Built a complex, robust economic model to analyze multiple gas sale and pipeline options, and fiscal systems jointly with staff from Department of Revenue.

9) Worked with the Legislature to amend AS 38.05.180 to allow DNR to approve transfer prices established by the Regulatory Commission of Alaska as the royalty value for gas used by the producer's affiliated gas or electric utility.

10) Worked independently on audit planning, performance, and resolution of audit claims under the Legislature's transfer from the Department of Revenue to the Department of Natural Resources of 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 has produced greater government efficiency with respect to royalty and net profit share issues.

11) Continued to monitor progress and compliance by FHR under its royalty-in-kind oil contract.

Statutory and Regulatory Authority

AS 31.05.035
AS 38.05.020
AS 38.05.030
AS 38.05.035
AS 38.05.130
AS.38.05.131
AS.38.05.134
AS 38.05.135
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
11 AAC 02
11 AAC 03
11 AAC 04
11 AAC 82
11 AAC 83
11 AAC 89
11 AAC 96.210 - 96.240
11 AAC 110
11 AAC 112

Contact Information

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Oil & Gas Development
Component Financial Summary

All dollars shown in thousands

	FY2005 Actuals	FY2006 Management Plan	FY2007 Governor
Non-Formula Program:			
Component Expenditures:			
71000 Personal Services	6,336.9	9,899.7	10,811.0
72000 Travel	230.9	201.6	245.7
73000 Services	662.9	1,439.1	940.8
74000 Commodities	554.3	719.3	343.7
75000 Capital Outlay	84.9	65.6	48.6
77000 Grants, Benefits	0.0	0.0	0.0
78000 Miscellaneous	0.0	0.0	0.0
Expenditure Totals	**7,869.9**	**12,325.3**	**12,389.8**
Funding Sources:			
1002 Federal Receipts	160.3	152.8	188.2
1004 General Fund Receipts	4,667.8	8,659.8	8,543.7
1005 General Fund/Program Receipts	74.9	56.8	60.2
1007 Inter-Agency Receipts	8.0	0.0	0.0
1061 Capital Improvement Project Receipts	11.1	16.8	17.2
1105 Alaska Permanent Fund Corporation Receipts	2,750.5	2,930.9	3,063.0
1108 Statutory Designated Program Receipts	0.0	150.0	150.0
1153 State Land Disposal Income Fund	197.3	358.2	367.5
Funding Totals	**7,869.9**	**12,325.3**	**12,389.8**

Estimated Revenue Collections

Description	Master Revenue Account	FY2005 Actuals	FY2006 Management Plan	FY2007 Governor
Unrestricted Revenues				
General Fund Program Receipts	51060	38.4	0.0	0.0
Unrestricted Fund	68515	1,905,437.0	2,291,615.0	1,826,625.0
Unrestricted Total		**1,905,475.4**	**2,291,615.0**	**1,826,625.0**
Restricted Revenues				
Federal Receipts	51010	160.3	152.8	188.2
Interagency Receipts	51015	8.0	0.0	0.0
General Fund Program Receipts	51060	74.9	56.8	60.2
Statutory Designated Program Receipts	51063	0.0	150.0	150.0
Capital Improvement Project Receipts	51200	11.1	16.8	17.2
Permanent Fund Earnings Reserve Account	51373	2,750.5	2,930.9	3,063.0

Estimated Revenue Collections

Description	Master Revenue Account	FY2005 Actuals	FY2006 Management Plan	FY2007 Governor
State Land Disposal Income Fund	51434	197.3	358.2	367.5
Restricted Total		**3,202.1**	**3,665.5**	**3,846.1**
Total Estimated Revenues		**1,908,677.5**	**2,295,280.5**	**1,830,471.1**

Summary of Component Budget Changes
From FY2006 Management Plan to FY2007 Governor

All dollars shown in thousands

	General Funds	Federal Funds	Other Funds	Total Funds
FY2006 Management Plan	**8,716.6**	**152.8**	**3,455.9**	**12,325.3**
Adjustments which will continue current level of service:				
-ADN 10-6-5000 O&G Gasline Increased Workload Multi-year approp Sec7(d)(2), CH6, SLA2005, P11 L10 lapse date 06/30/06	-2,025.0	0.0	0.0	-2,025.0
-ADN 10-6-5000 O&G Gasline Increased Workload Multi-year approp Sec20(d)(2), CH3, FSSLA2005, P107, L11 lapse 06/30/06	-675.0	0.0	0.0	-675.0
-FY 07 Wage Increases for Bargaining Units and Non-Covered Employees	142.3	1.6	42.7	186.6
-FY 07 Health Insurance Cost Increases for Bargaining Units and Non-Covered Employees	12.5	0.2	3.7	16.4
-FY 07 Retirement Systems Cost Increase	269.9	3.0	80.3	353.2
Proposed budget increases:				
-Continuation of Oil & Gas and Gasline Increased Workload	1,933.7	0.0	0.0	1,933.7
-Increase Audits on Oil & Gas Royalties and Net Profit Share Lease Payments to Generate Revenue and Reduce Backlog	178.0	0.0	0.0	178.0
-Increase Federal Receipts to Match Agreement with Minerals Management Service	0.0	30.0	0.0	30.0
-Risk Management Self-Insurance Funding Increase	50.9	0.6	15.1	66.6
FY2007 Governor	**8,603.9**	**188.2**	**3,597.7**	**12,389.8**

Oil & Gas Development
Personal Services Information

Authorized Positions	FY2006 Management Plan	FY2007 Governor	Personal Services Costs	
			Annual Salaries	7,160,937
Full-time	93	95	COLA	189,934
Part-time	0	0	Premium Pay	0
Nonpermanent	3	3	Annual Benefits	3,639,387
			Less 1.63% Vacancy Factor	(179,258)
			Lump Sum Premium Pay	0
Totals	**96**	**98**	**Total Personal Services**	**10,811,000**

Position Classification Summary

Job Class Title	Anchorage	Fairbanks	Juneau	Others	Total
Accountant III	1	0	0	0	1
Accountant IV	3	0	0	0	3
Accounting Clerk II	1	0	0	0	1
Accounting Tech I	1	0	0	0	1
Accounting Tech II	3	0	0	0	3
Accounting Tech III	1	0	0	0	1
Administrative Assistant	1	0	0	0	1
Administrative Clerk II	3	0	0	0	3
Administrative Manager II	1	0	0	0	1
Analyst/Programmer IV	5	0	0	0	5
Cartographer II	3	0	0	0	3
Cartographer IV	1	0	0	0	1
Chief Petroleum Geologist	1	0	0	0	1
Commercial Analyst	8	0	0	0	8
Deputy Director	1	0	0	0	1
Division Director	1	0	0	0	1
Economist II	1	0	0	0	1
Geologist II	1	0	0	0	1
Geologist III	1	0	0	0	1
Geologist IV	0	1	0	0	1
Land Surveyor I	1	0	0	0	1
Micro/Network Tech II	1	0	0	0	1
Natural Resource Mgr I	1	0	0	0	1
Natural Resource Mgr II	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	2	0	0	0	2
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
Oil & Gas Revenue Auditor I	1	0	0	0	1
Oil & Gas Revenue Auditor II	1	0	0	0	1
Oil & Gas Revenue Auditor III	3	0	0	0	3
Oil & Gas Revenue Auditor IV	2	0	0	0	2
Oil & Gas Revenue Specialist	1	0	0	0	1

Position Classification Summary

Job Class Title	Anchorage	Fairbanks	Juneau	Others	Total
Operations Res Anl I	1	0	0	0	1
Petroleum Geologist I	5	1	0	0	6
Petroleum Geologist II	3	1	0	0	4
Petroleum Geophysicist	1	0	0	0	1
Petroleum Investments Manager	1	0	0	0	1
Petroleum Land Manager	4	0	0	0	4
Petroleum Manager	1	0	0	0	1
Petroleum Market Analyst	1	0	0	0	1
Petroleum Reservoir Engineer	3	0	0	0	3
Publications Spec III	1	0	0	0	1
Secretary	1	0	0	0	1
Student Intern I	3	0	0	0	3
Totals	**95**	**3**	**0**	**0**	**98**