

ALASKA STATE LEGISLATURE

Session

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SENATOR BILL WIELECHOWSKI

June 26, 2023

Commissioner John Boyle
State of Alaska – Department of Natural Resources
550 W. 7th. Avenue, Suite 1400
Anchorage, AK 99501

Attorney General Treg Taylor
State of Alaska – Department of Law
1031 West 4th Avenue, Suite 200
Anchorage, AK 99501

Dear Commissioner Boyle and Attorney General Taylor,

This letter requests your attention to a serious public interest matter adversely affecting hundreds of thousands of Alaskans along Alaska's Railbelt Corridor stretching from Homer to Fairbanks. These residents are reliant on Cook Inlet natural gas to meet their energy and heating needs, keeping their families safe and warm at home and their businesses in operation. But Hilcorp Alaska, LLC, the dominant gas producer in Cook Inlet, will likely fail to meet those needs nearly imminently. As the primary operator in the region, Hilcorp has been aware of this problem for years but apparently did not devote necessary resources and efforts attempting to prevent it.

With its initial discovery of deposits of oil and gas in 1958, Cook Inlet is Alaska's first and oldest oil and gas producing basin. It represents the vast share of all gas used by Alaskan communities and once even served as a significant source for gas exported overseas. Alaskans consume about 70 billion cubic feet (70 bcf) per year of Cook Inlet natural gas. Hilcorp began major operations in Cook Inlet in 2012 after acquiring Marathon Oil's assets and produces 85% of Cook Inlet gas supplies, which is used by more than half of Alaska's population.

In a meeting Hilcorp called in spring 2022, the company warned utility stakeholders along the 700-mile service corridor that its Cook Inlet reserves are depleting. While existing supply contracts would be honored, Hilcorp cannot reliably meet Railbelt community needs thereafter, so the utility providers should not expect contract renewals as they each expire—as soon as next year and through the coming decade. This information was also presented by utility company executives and the Department of Natural Resources last February to the Senate Resources Committee, where I serve as Vice Chair.

The grave news has left the utility companies with uncertainty and Alaska residents with stress and concern over their heat and energy source availability and affordability. The shortage threatens to skyrocket energy costs for Alaskans by more than 30%.

Hilcorp's notice prompted the six Railbelt gas utilities to form a working group with DNR and the Alaska Energy Authority to find solutions to alleviate the potential energy crisis, but so far no concrete plans have materialized. With existing infrastructure in place and a relatively short timeframe to address the problem, in the near-term the utilities must seek other sources of natural gas. North Slope gas exists in abundance, but its transportation to Southcentral Alaska is expensive; companies are also considering importing gas from Canada or elsewhere. These possibilities would also require costly construction or overhauling of storage and processing facilities, and possibly even pipeline installation. Alaskans would necessarily bear the burden of added costs.

While Hilcorp recently submitted portions of a plan of development to DNR for approval and states it will drill 17 development wells this year attempting to meet some state needs, the successes of these actions are not guaranteed.

Significant Gas Supplies in Cook Inlet Remain Unproduced

DNR's published report *2022 Cook Inlet Gas Forecast* on proved developed and proved undeveloped reserves estimates that availability of Cook Inlet natural gas in quantities to meet current use would last until the year 2027 or 2028. It's been reported in news sources and in legislative hearings that these supplies must be realized by drilling many development wells annually, as many as 15 to 23—actions which appear unlikely to be achieved even through the period of reserve availability to meet the demand in the short-term.

Moreover, in 2011 the U.S. Geological Survey (USGS)—the lead federal agency with expertise in estimating available undiscovered petroleum resources all over the world—published a report indicating that the Cook Inlet region likely held yet-undiscovered 19 trillion cubic feet of natural gas and 46 million barrels of natural gas liquids, along with 600 million barrels of oil. These supplies are considered technically recoverable—they can be produced with current technology.

The USGS estimates of available-but-unexplored gas would be sufficient to meet current Railbelt market demand for 200 years. Since USGS's calculating methodology is based in part on historic production and proven petroleum reserves, the unproven discoveries are likely considerably contained within Hilcorp lease boundaries.

In fact, last January DNR testified in the Senate Resources Committee on the necessity for exploratory drilling in Cook Inlet and the successes Alaska has historically experienced due to such actions. DNR's slide presentation on the Cook Inlet gas forecast advises: "The CI Basin depends on successful exploration." To demonstrate this, DNR explains that "[c]ontinuous exploration has led to 13 new oil and gas units coming online, and over 450 wellbores drilled since [the] year 2000" and that approximately 80% of all 2021 volumes of Cook Inlet gas produced were from wells drilled within just the last 20 years. Finally, DNR instructs that "[e]xploration/delineation within and outside the [producing] units is *crucial to continued security of gas supply* for the basin." (Emphasis added.)

Railbelt Utility Pleas for Enforcement of Hilcorp Lease Obligations

By letter to Governor Dunleavy in early April and provided to the presiding officers of the Alaska Legislature, leaders of four major Railbelt gas utility companies made a plea for the State to ensure enforcement of its rights under the terms of its Hilcorp leases. [Attachment A] The letter explains that the utilities have been working diligently with the governor's office, AEA, gas producers, and issue experts to resolve the crisis. Even earnestly exploring a range of solutions, the executives observe "[t]here is no doubt . . . that the least expensive way to ease our impending energy shortfall would be

to continue to ensure the production of gas from wells ‘capable of producing . . . gas’ under *existing leases* Hilcorp has with the State of Alaska.” (Emphasis added.)

The letter urges the governor to ensure that Hilcorp is acting “consistent with its leases,” especially in light of the State’s Article 8, Section 1 constitutional mandate to “encourage settlement of its land and development of its resources by making them available for maximum use consistent with the public interest.” The executives also note that Hilcorp made \$450 million in revenue in 2022 from Cook Inlet operations alone.

An Investigation into Violations of Lease Terms Must be Initiated

The Railbelt utility providers raise valid concerns. It’s likely that the looming exigency was caused by Hilcorp’s own inaction toward its lease obligations.

In the interest of Alaska, the State must investigate whether Hilcorp has violated any express or implied covenants of its Cook Inlet lease agreements and if so, seek damages or other appropriate remedies.

Offering no substantiating evidence, Hilcorp has insisted during testimony at legislative hearings that it needs substantial continued tax breaks in order to perform its production operations in Cook Inlet. But regardless of Hilcorp’s desire to maintain the unique preferential tax treatment it enjoys, Hilcorp knew of the promises it made to Alaska when signing its leases and has legal obligations to meet those lease terms.

1. Duty of a Reasonably Prudent Operator in Development, Production, & Marketing

Hilcorp likely failed to act as a reasonably prudent operator. All oil and gas companies holding land leases for production purposes must comport with this standard. The duty requires that the lease holder for extraction of oil or gas act with reasonable diligence regarding development, production, and marketing when the mineral product exists in paying quantities that would reasonably benefit both the landowner and leasee. The U.S. Supreme Court recognized this inherent duty as early as 1934. *See Sauder v. Mid-Continent Petroleum Corporation*, 292 U.S. 272, 279-281 (1934). Even if lease terms do not expressly mention this obligation, the jurisprudence of oil and gas jurisdictions imposes the standard universally.

Here, Hilcorp should have continuously pursued efforts toward development and production of its leases in areas of known reserves, like those proven, undeveloped deposits described in DNR’s 2022 report. There is a well-established market for the sale of Cook Inlet gas that has been reliant on this producing region for six decades. And unlike other states where individuals and entities own their own mineral rights, the State holds the mineral estate in trust for the people of Alaska and would benefit by both royalties and production taxes when oil and gas is extracted and sold. As an owner-state however, Alaska’s concern for Hilcorp’s Cook Inlet development extends far beyond its immediate financial interests—to the wellbeing of its residents, businesses, and the state’s economy.

2. Duty to Explore Unproven Areas of Leases

Hilcorp apparently frustrated the purposes of its Cook Inlet leaseholds by failing to further explore areas within their boundaries for undiscovered deposits of oil and gas—long before the supply shortage became dire. Oil and gas producers are bound by a duty to explore portions of lease areas beneath which it is unknown whether the mineral resources are contained. The exploration could

include seismic surveys and test drilling. Exploratory activities are necessitated by the lease because there is a high probability that resource deposits exist, yet the land is precluded from exploration and development by other operators. Modern leases—maybe even Hilcorp’s—may contain clauses establishing the duty outright. But even where no express term exists, the courts will subject lessees to an implied covenant effecting the duty.

In this case, given its failure to timely develop certain already-proven reserves, it does not appear that Hilcorp managed to meaningfully test or drill unexplored areas of its leases in accordance with this duty. With USGS’s expansive estimates of natural gas remaining unexplored and unproduced, and DNR’s public acknowledgment of past and future dependency of Cook Inlet gas supplies on new discoveries, Hilcorp was clearly aware that exploratory operations would be necessary to ensure continuing natural gas production. Hilcorp’s inaction over its many years holding Cook Inlet leases has caused great detriment to the State and to Alaskans.

The Cook Inlet Development Consent Decree Must be Reviewed for Breach

It appears Hilcorp has also violated express commitments of its ongoing consent decree with the State. The consent decree was agreed to by Hilcorp in 2012 when it intended to acquire all of the rights and assets of its Cook Inlet competitor, Marathon Oil. *See Alaska v. Hilcorp Alaska, LLC., et al., Consent Decree*, Case No. 3AN-12-10858CI, Alaska Sup. Ct. (Jan. 17, 2013). Concerned that the sale would effectuate an unlawful monopoly due to the established in-state market’s reliance on Cook Inlet, the State sought to impose constraints on Hilcorp’s subsequent business actions, including price caps on gas sales. The price caps expired in 2017, but through an extension signed by Hilcorp in 2016, the consent decree remains in force in all other respects through December 31, 2024.

Notably, the terms and conditions of the consent decree establish: “Hilcorp agrees to utilize commercially reasonable efforts to increase the production and development of natural gas from Hilcorp’s Cook Inlet Basin Properties.”

The recitals of the consent decree also inform the rationale for Hilcorp’s agreement to that pledge. For instance, one relevant recital states that “Hilcorp believes the Acquisition will create efficiencies and achieve meaningful synergies” that would: “[A]llow[] Hilcorp to use its expertise, experience, and capital to substantially increase reserves and production of natural gas in Cook Inlet”; “enable more streamlined and efficient discovery, development, and production of natural gas in a timely fashion”; and “encourage[] increased investment in the exploration, development, and production of natural gas resources.”

Another clause acknowledges the State’s role in providing financial incentivizing mechanisms to Hilcorp to increase investment and exploration in Cook Inlet and warns that “[w]ithout increased *exploration and production* . . . there is a risk that existing supplies of natural gas might be insufficient to meet project demand . . . in the future.” (Emphasis added.) The next clause expresses that “it is in the best interest of the Alaska to encourage as much exploration, development and production of existing and new natural gas reserves as possible”

A final pertinent recital states: “Hilcorp has pledged to act in good faith to ensure not only that the terms of the Consent Decree are complied with promptly, but to conduct its business as a *reasonable and prudent operator* in accordance with its lease obligations and by utilizing *commercially reasonable efforts to increase the production and development* of natural gas from Hilcorp’s Cook Inlet Basin Properties.” (Emphasis added.)

The consent decree demonstrates State’s significant concern with ensuring availability and affordability of Cook Inlet natural gas to Railbelt consumers well into the future through reasonable expectations of Hilcorp’s increased production and its continued exploratory progress toward new gas discoveries. In addition, the consent decree permits the Alaska Attorney General access to inspect and copy Hilcorp’s business records, including ledgers, accounts, and correspondence, as well as the ability to interview directors, officers, employees, and other agents, for the purposes of “determining and securing compliance” with the consent decree.

Hilcorp’s seeming failures or dilatory disposition run counter to its agreement with the State under the terms of the consent decree and the State must respond by seeking compensatory or other suitable remedies. As investigatory powers are expressly granted by the consent decree, the state’s best interest demands that the attorney general exercise this authority to genuinely assess Hilcorp’s accountability toward its legal obligations.

Factors Potentially Contributing to Hilcorp’s Neglect in Cook Inlet

In seeking answers to Hilcorp’s performance as a reasonably prudent operator and its duty to explore—whether under lease terms or the consent decree—the State should examine at least two possible contributing factors: (1) Hilcorp’s 2019 acquisition of BP Alaska’s assets, and (2) Hilcorp’s inexperience with exploratory operations.

1. Hilcorp’s 2019 Purchase of BP’s Assets

The State should review whether Hilcorp intentionally, or out of necessity, neglected its obligations in Cook Inlet to turn attention and devote fiscal resources toward its North Slope oil and gas production assets and its interests in the Trans-Alaska Pipeline, both purchased from BP Alaska in 2019. Given the extraordinarily profitable nature of North Slope oil production—in part due to certain generous statutory oil tax credits—such actions would be unsurprising as contributing factors for lack of focus on Cook Inlet. Yet these factors would not relieve Hilcorp of its legal obligations toward development and exploration in Cook Inlet.

2. Hilcorp’s Admitted Inexperience with Exploratory Work

It’s been shared many times in the public arena, including by media and by Hilcorp’s own testimony in legislative hearings, that Hilcorp’s specialty experience lies in petroleum extraction from aging fields and does not generally encompass exploratory surveying and drilling functions. Hilcorp’s aptitude in this less common area of industry has been mutually beneficial to the State and to Hilcorp and is appreciated in the circumstances in which Alaska finds itself as an historically oil-rich, production-dependent state with waning fields. But the duty to explore and develop new gas deposits under lease agreements and by the clear terms of the consent decree yet exist and are imposed by law upon Hilcorp.

The State should analyze whether the simple reality of lack of experience led to Hilcorp tending to avoid obligations toward performing exploratory activities. The determination would necessarily require investigating whether Hilcorp may have intentionally or inadvertently misrepresented its capacity and wherewithal to advance future development and production beyond known reservoirs when it fully acquired Marathon Oil in 2012, resulting in the State’s detrimental reliance.

Regardless of the reasons, inexperience does not negate Hilcorp’s duty as a reasonably prudent operator toward exploration of its lease extents and to ultimately seek development, production, and

marketing of new reserves of Cook Inlet gas. Lack of experience instead suggests that Hilcorp had a greater duty toward exploration by gaining necessary practice or by on-boarding other professionals or entities with expertise in that subject area for assistance.

For the foregoing reasons the State must assess, under the express or implied terms of its lease agreements and the provisions of the parties' consent decree, whether Hilcorp neglected or evaded its Cook Inlet duties as a reasonably prudent operator and in furtherance of exploratory activities in Cook Inlet. The State must seek appropriate legal recourse or demand other remedies for conduct contravening lease obligations, to compensate the State and the people of Alaska for consequential harms and to deter similar future conduct.

Alaskan families are experiencing unnecessary distress and facing extreme burdens in energy and heating costs due to Hilcorp's inaction as the primary leaseholder of the region serving the long-established and most expansive natural gas market across the state. The negative effects of those failures will ripple across Alaska. As servants of the public interest, Alaskans are relying on your staunch advocacy in resolving this very serious matter.

Thank you for your attention to these issues. Your response is appreciated.

Sincerely,



Senator Bill Wielechowski

Enclosure:

Attachment A - Railbelt Utilities Letter to Governor Urging Hilcorp Lease Terms Enforcement

Cc:

Laura Stidolph, Legislative Director, Office of the Governor
Joseph Byrnes, Legislative Liaison, Department of Natural Resources
Parker Patterson, Legislative Liaison, Department of Law

Via Email