STATE OF ALASKA

DEPARTMENT OF NATURAL RESOURCES

DIVISION OF OIL AND GAS

SEAN PARNELL, GOVERNOR

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July 26, 2011

Ms. Hyla Hurst
Regulatory Specialist
Office of Natural Resources Revenue
PO Box 25165
MS 61013C
Denver, CO 80225

Re: Advanced Notice of Proposed Rulemaking, Valuation of Oil and Gas Produced from Federal Onshore and Offshore Oil and Gas Leases, For Royalty Purposes

Dear Ms. Hurst:

The State of Alaska, Department of Natural Resources, Division of Oil and Gas is appreciative of the opportunity to provide the Department of Interior, Office of Natural Resources Revenue with the following comments regarding crude oil and natural gas valuation. Advanced notice of proposed rulemaking to amend existing regulations pertaining to oil and gas valuation was published in the *Federal Register* on May 27, 2011. The notice requested comments and suggestions from affected parties. Our comments to the specific areas of inquiry are provided below.

A. Use of Index Prices to Value Oil and Gas

In general, the State supports use of indexes in setting the value of commodities in markets with appropriate netback factors to arrive at the value of the commodity at the lease. For example, there is about 650,000 barrels per day of Alaska North Slope (ANS) crude produced from state lands. The vast majority of ANS is processed in refineries in Washington and California. Royalty Settlement Agreements (RSA) govern how most of this production is valued for royalty purposes. Each RSA is based on a netback method. The royalty formula is generally in the form of:

Royalty Value = DV - marine - pipeline - losses + quality

1) DV = Destination Value, the fair market value of the crude on the west coast (Washington and California)
2) Marine = Reasonable actual cost to transport ANS from Valdez to US West Coast
3) Pipeline = FERC tariffs on pipelines to transport crude from field to Valdez

4) Losses = Actual losses of petroleum (actually differences in measurement and vaporization) of crude in transport
5) Quality = Refining value difference in crude delivered from field as compared to what is delivered to US West Coast

The above methodology supports the use of index pricing. In the case of ANS, the DV above uses a commercial price index to establish the value of the crude in the appropriate geographic market. One important factor to consider is which index to use. Several different price reporting services exist (Platt's, Reuters, Argus, Dow Jones, Oil Daily, Gas Daily, ...). Each of these services has their own methodology to establish the daily quotes that they provide. The methodologies are distinct and on any given day the prices can be divergent by several dollars. Much of the difference is lost if the simple average of the daily quotes is used for a month. This is the approach that Alaska uses. There are still systematic differences between the methods used by the services when reporting ANS price. These differences are material and produce differences that are measured in dollars. We believe the service that provides the most accurate pricing is the service that has the methodology that most closely matches how ANS sales are actually transacted. That service is Platt's.

However, although indexing works well for ANS crude, the majority of our federal leases are in the Cook Inlet region. The Cook Inlet region primarily produces natural gas. There is not an index for Cook Inlet gas at this time. The market is small and there is no linkage to locations with index prices. Sales are limited and comparison with lower 48 gas indexes would not be reflective of the Alaska market.

In summary, the State supports the use of indexes. However, at this time there is not an index reflective of the Alaska Cook Inlet natural gas market. Indexing would simplify the valuation of the non-arm's length sales for all stakeholders.

B. Transportation Allowances

In some cases, published FERC tariffs may yield unreasonably high deductions due to the availability of discounts or contract rates that are available to knowledgeable shippers. It that case we use a pseudo tariff that represents what a sophisticated seller could reasonable achieve.

In Alaska, the transportation allowance may also include marine transportation to get the ANS to market. Many different variables are included in the marine cost per barrel calculation. It would be difficult to create a differential for the marine cost.

C. Processed Gas and Processing Allowances

No comments.

In summary, simplifying the regulations may yield less reported royalty. Based on current history we see that:

1) Current Federal regulations applied in Alaska tend to undervalue oil and gas compared to State of Alaska rules.
2) By their very nature, audits of oil and gas royalty filings are complex and require extensive, time consuming, and expensive reviews.
3) The Alaska state royalty audits typically identify significant royalty underpayments.

Thank you for your consideration of our comments and suggestions. The State of Alaska looks forward to future opportunities to participate in the regulatory review process.

Sincerely,

Lonnie D Hemons
for

William C. Barron
Director

Cc: Alan Dennis, DNR/DOG Asset Manager