

NIKOLAEVSK UNIT

DENIAL OF THE PROPOSED RED PARTICIPATING AREA

January 18, 2011

**Findings and Decision of the
Commissioner, of the Alaska Department of Natural Resources, and
the Director, of the Division of Oil and Gas**

I. SUMMARY OF DECISION

This is the decision of the Commissioner of the Alaska Department of Natural Resources (DNR) and the Director of the Division Oil and Gas (Division), Alaska Department of Natural Resources on the February 23, 2010 application of Union Oil Company of California (Union) to form the Red Participating Area (Red PA) in the Nikolavesk oil and gas unit (NU). The application to form the Red PA (Application) requests approval because it may help Union dispose of the NU and it might encourage development by unspecified 3rd parties. Union suggests that formation of the Red PA may encourage others to build a gas pipeline to the NU and that it will help Union's efforts to farmout¹ the NU development rights to a third party. The Application contains no commitment or proposal to produce the NU.

The Application is denied because the purpose of a participating area is to facilitate production and to equitably allocate production and costs among the leases. Participating area formation is not intended to facilitate marketing of state oil and gas leases in the absence of production. If there is no plan to place a participating area in production, then the formation of a participating area is premature. Union has neither submitted a plan nor made a commitment to put the NU into production. Participating area formation in the absence of sustained unit production is contrary to legislative intent underlying oil and gas leasing.

II. BACKGROUND

The NU was formed effective January 30, 2004 with a term of five years. It is located on the Kenai Peninsula near the unincorporated community of Nikolaevsk. The NU includes uplands in the upper drainages of the Chakok River and Clam and Stariski Creeks, southeast of the Deep Creek Unit and approximately ten miles northeast of the North Fork Unit.

The initial unit area encompassed approximately 16,588.63 acres within seven State of Alaska leases and two Cook Inlet Region Incorporated (CIRI) leases. The Division is responsible for the management of the NU. The seven State leases originally included in the NU were ADLs 388196, 388198, 388199, 388200, 388209, 389227, and a portion of ADL 2095, which was segregated and assigned ADL 390514. The two CIRI leases were C-061614 and C-373303.

The first NU plan of exploration (1st POE) was approved for a term of January 31, 2004 through January 31, 2007. The 1st POE described three Exploration Blocks, (I, II, and III), and specified seismic and drilling requirements for each Exploration Block. Under the 1st POE, failure to complete a specific drilling requirement resulted in the contraction of the Exploration Block and payment for the contraction acreage. The 1st POE included provisions for the automatic and voluntary terminations of the NU if Union did not meet work commitments.

In August of 2004, Union drilled and completed two exploration wells in Exploration Block I which is also known as the Red Prospect: Red well # 1 and Red well #2. Union also acquired, processed, and interpreted seismic data to satisfy the 1st POE requirement to acquire seismic data.

¹ Farmout occurs when an oil and gas lessee assigns or transfers oil and gas development rights in the leasehold to a third party.

On March 2, 2006, Exploration Block II and a portion of Exploration Block III contracted out of the unit per the terms of the 1st POE because no well was drilled in Exploration Block II. The state also received the stipulated payment for failure to complete the Exploration Block II well.

The Division approved the second NU plan of exploration (2nd POE) effective March 31, 2007 through March 31, 2008. The 2nd POE required Union to conduct geologic and engineering studies of analogous fields to better understand formation evaluation, completion/stimulation techniques, and resource estimation at NU. Union complied with these requirements.

The Division approved the first NU plan of development (1st POD) effective March 31, 2008 through March 31, 2009. The 1st POD required Union to drill or cause to be drilled a well in the Red Prospect by March 31, 2009, and a second well to be drilled into the Blue Prospect (the remaining portion of Exploration Block III) by March 31, 2010. The 1st POD provided that if the first well were not drilled, the Blue Prospect would contract out of the unit.

Union submitted the Second NU plan of development (2nd POD) to DNR for approval on January 12, 2009. It notified DNR that Union had (1) scaled back its 2009 Cook Inlet development efforts due to market conditions, (2) concluded that lack of a pipeline from the Red Prospect to market had impeded further development of the NU, and (3) no current work plans for the NU. On February 5, 2009, the Director approved the 2nd POD.

The Red Prospect well was not drilled as required by March 31, 2009. As a result, on April 1, 2009, the Division received a letter from Union relinquishing the Blue Prospect. The NU contracted down to the Red Prospect effective March 31, 2009, and Union voluntarily filed amended Exhibits A and B, (Attachments 1 & 2), to the unit agreement showing that the Blue Prospect leases were no longer part of the unit. After this contraction, the remaining NU is approximately 5,766 acres in size and consists of four State of Alaska leases: ADLs 388209, 389227, 390513, and 390514, and two CIRI leases: C-061305 and C-061614, and the Red Prospect included the entire unit area.

Thereafter, on January 26, 2009, Union applied for a twenty-six month extension of the NU Agreement (NUA), from January 30, 2009, through March 31, 2011. Union requested the extension, in part, on the grounds that the state had implicitly agreed to an extension of the NUA when it approved the 1st and 2nd PODs. More specifically, DNR approved the 2nd POD that provided if Union did not farmout the Red Prospect by March 31, 2010, Union would file an application to put Red Well #1 in shut-in status and also apply to DNR to form a participating area within the Red Prospect. Union contended that DNR's approval of the foregoing proposals entitled Union to an extension of the NU beyond its original expiration date in 2009. Union stated that it needed until March 31, 2011 to effect participating area formation. On May 11, 2009, the Division approved the requested extension.

On December 10, 2009, the Division received Union's proposed third NU plan of development (3rd POD). It covered the period March 31, 2010 through March 31, 2011. The 3rd POD did not include work plans for exploring, developing, or producing the unit. The plan stated that Union

was attempting to farmout the Red Prospect and that Union intended to establish an NU participating area as stated in the 2nd POD. The Division disapproved the 3rd POD on February 12, 2010 because the plan did not meet the requirements of 11 AAC 83.343 which requires that a unit plan of development set out unit work plans. The Division did suggest changes Union could make to the 3rd POD that would meet regulatory requirements.

Under 11 AAC 83.343(b), if the unit plan of development is disapproved, the Commissioner may propose modifications that would qualify the plan for approval. DNR proposed the following changes to the 3rd POD:

- by March 31, 2010, Union shall initiate permitting activities for a pipeline that will allow for production from the Nikolaevsk Unit;
- by September 30, 2010, Union shall secure a gas sales contract for Nikolaevsk Unit production; and
- by March 31, 2011, Union shall commence production from the Nikolaevsk Unit.

Union submitted the Application to DNR on February 23, 2010.² The Application stated two reasons for formation of the Red PA: (1) it would help Union to farm the unit out or to find a company to take over the Red Prospect from Union, and (2) an approved participating area might encourage unspecified third-parties to build a pipeline to the NU. No supporting facts were offered to support either claim. The Application did not state that the participating area was needed because Union intended to put the NU, the Red Prospect, into production.

On February 25, 2010, Union appealed from the Division decision to disapprove the 3rd POD. Union contended that DNR approved the 1st and 2nd PODs with notice that the only work commitments that Union agreed to were (1) in the 1st POD - to drill a well by March 31, 2010 and if the well were not drilled, to contract the Blue Prospect out of the unit, and (2) in the 2nd POD - to attempt to farmout the Red Prospect by March 31, 2010 and if Union could not find someone to take over the unit, to (a) contract the Blue Prospect out of the unit, (b) apply to DNR to put the Red well # 1 in shut-in status, and (c) apply to DNR to form the Red PA. In the 3rd POD appeal, Union contends that DNR should have approved the 3rd POD because Union complied with the 1st and 2nd PODs, and because the company needed until March 31, 2011, the end date of the 3rd POD, to consider and implement development options and to form the Red PA. Union is pursuing the appeal from denial of the 3rd POD even though, by separate decision, DNR granted Union's request to extend the unit term to March 31, 2011 which was also the proposed end date for the 3rd POD.

The NU is not in production, and it has never been in production. The NU has no participating area, and Union has never submitted a unit plan that proposed production.

² The Red PA application consists of a two page cover letter, a geologic and engineering report, and exhibits. Union has stated that the geologic and engineering report and exhibits contain proprietary information. Union has requested that DNR keep the report and exhibits confidential.

III. STATE STATUTE, REGULATIONS, AND NUA AGREEMENT PROVISIONS RELEVANT TO EVALUATION OF THE APPLICATION

This section sets out the provisions of state statute, state regulations, and NUA provisions relevant to this decision.

A. State statute

Legislative intent regarding the state oil and gas leasing program is set out in AS 38.05.180(a). It provides:

AS 38.05.180. Oil and Gas and Gas Only Leasing.

(a) The legislature finds that

(1) the people of Alaska have an interest in the development of the state's oil and gas resources to

(A) maximize the economic and physical recovery of the resources;

(B) maximize competition among parties seeking to explore and develop the resources;

(C) maximize use of Alaska's human resources in the development of the resources;

B. State regulations

State regulation 11 AAC 83.303 sets out decision criteria for deciding whether to grant an application to form participating area. It provides:

11 AAC 83.303. Criteria

(a) The commissioner will approve a proposed unit agreement for state oil and gas leases if he makes a written finding that the agreement is necessary or advisable to protect the public interest considering the provisions of AS 38.05.180 (p) and this section. The commissioner will approve a proposed unit agreement upon a written finding that it will

(1) promote conservation of all natural resources, including all or part of an oil or gas pool, field, or like area;

(2) promote the prevention of economic and physical waste; and

(3) provide for the protection of all parties of interest, including the state.

- (b) In evaluating the above criteria, the commissioner will consider
- (1) the environmental costs and benefits of unitized exploration or development;
 - (2) the geological and engineering characteristics of the potential hydrocarbon accumulation or reservoir proposed for unitization;
 - (3) prior exploration activities in the proposed unit area;
 - (4) the applicant's plans for exploration or development of the unit area;
 - (5) the economic costs and benefits to the state; and
 - (6) any other relevant factors, including measures to mitigate impacts identified above, the commissioner determines necessary or advisable to protect the public interest.
- (c) The commissioner will consider the criteria in (a) and (b) of this section when evaluating each requested authorization or approval under 11 AAC 83.301 - 11 AAC 83.395, including
- (1) an approval of a unit agreement;
 - (2) an extension or amendment of a unit agreement;
 - (3) a plan or amendment of a plan of exploration, development or operations;
 - (4) a participating area; or
 - (5) a proposed or revised production or cost allocation formula.

The following regulations should also be considered in connection with the Application.

11 AAC 83.351. Participating area

(a) At least 90 days before sustained unit production from a reservoir, the unit operator shall submit to the commissioner for approval a description of the proposed participating area, based on subdivisions of the public land or its aliquot parts. The participating area may include only the land reasonably known to be underlain by hydrocarbons and known or reasonably estimated through use of geological, geophysical, or engineering data to be capable of producing or contributing to production of hydrocarbons in paying quantities. If any portion of a lease is included in a participating area formed under a unit agreement, the entire leased land will be committed to the unit and the lease will not be severed. Under 11 AAC 83.371(a), the unit operator also shall submit to the commissioner for approval of a proposed division of interest or formula setting out the percentage of production and costs to be allocated to each lease or portion of lease within the

participating area. Upon approval by the commissioner, the area of productivity constitutes a participating area.

(b) A separate participating area must be established as provided in (a) of this section for each reservoir delineated, except that with the consent of the commissioner and all working interest owners, any two or more reservoirs or participating areas within the unit may be combined into one participating area. Separate participating areas may be established to distinguish between an oil rim and a gas cap within the same reservoir.

(c) A participating area must be expanded to include acreage reasonably estimated through use of geological, geophysical, or engineering data to be capable of producing or contributing to the production of hydrocarbons in paying quantities, and must be contracted to exclude acreage reasonably proven through use of geological, geophysical, or engineering data to be incapable of producing hydrocarbons in paying quantities, subject to approval by the commissioner. A revised division of interest or formula allocating production and costs must be submitted for approval under 11 AAC 83.371 at the time of expansion or contraction of a participating area.

11 AAC 83.356. Unit area; contraction and expansion

(a) A unit must encompass the minimum area required to include all or part of one or more oil or gas reservoirs, or all or part of one or more potential hydrocarbon accumulations.

(b) 10 years after sustained unit production begins, the unit area must be contracted to include only those lands then included in an approved participating area and lands that facilitate production including the immediately adjacent lands necessary for secondary or tertiary recovery, pressure maintenance, reinjection, or cycling operations. The commissioner will, in the commissioner's discretion, after considering the provisions of 11 AAC 83.303, delay contraction of the unit area if the circumstances of a particular unit warrant. If any portion of a lease is included in the participating area, the portion of the lease outside the participating area will neither be severed nor will it continue to be subject to the terms and conditions of the unit. The portion of the lease outside the participating area will continue in full force and effect so long as production is allocated to the unitized portion of the lease and the lessee satisfies the remaining terms and conditions of the lease.

(c) Any expansion or contraction of the unit area must be based on legal subdivisions of land as defined in 11 AAC 88.185.

(d) No land will be excluded from a unit area due to the depletion of hydrocarbons.

(e) Not sooner than 10 years after the effective date of the unit agreement, the commissioner will, in the commissioner's discretion, contract the unit area to include only that land covered by an approved unit plan of exploration or development, or that area

underlain by one or more oil or gas reservoirs or one or more potential hydrocarbon accumulations and lands that facilitate production as set out in (b) of this section. Before any contraction of the unit area under this subsection, the commissioner will give the unit operator, the working interest owners, and the royalty owners of the leases or portions of leases being excluded reasonable notice and an opportunity to be heard.

11 AAC 83.395, Definitions

Unless the context clearly requires a different meaning, in 11 AAC 83.301 - 11 AAC 83.395 and in the applicable unit agreements

(1) "conservation of the natural resources of all or part of an oil or gas pool, field or like area" means maximizing the efficient recovery of oil and gas and minimizing the adverse impacts on the surface and other resources;

(9) "sustained unit production" means continuing production of oil or gas from a reservoir in the unit area into a pipeline or other means of transportation to market, but does not include testing, evaluation or pilot production.

11 AAC 83.343 Unit plan of development

(a) A unit plan of development must be filed for approval as an exhibit to the unit agreement if a participating area is proposed for the unit area under 11 AAC 83.351, or when a reservoir has become sufficiently delineated so that a prudent operator would initiate development activities in that reservoir. All development operations must be conducted under an approved plan of development. A unit plan of development must contain sufficient information for the commissioner to determine whether the plan is consistent with the provisions of 11 AAC 83.303. The plan must include a description of the proposed development activities based on data reasonably available at the time the plan is submitted for approval as well as plans for the exploration or delineation of any land in the unit not included in a participating area. The plan must include, to the extent available information exists

(1) long-range proposed development activities for the unit, including plans to delineate all underlying oil or gas reservoirs, bring the reservoirs into production, and maintain and enhance production once established;

(2) plans for the exploration or delineation of any land in the unit not included in a participating area;

(3) details of the proposed operations for at least one year following submission of the plan; and

(4) the surface location of proposed facilities, drill pads, roads, docks, causeways, material sites, base camps, waste disposal sites, water supplies, airstrips, and any other operation or facility necessary for unit operations.

C. The NU Agreement Provisions

NUA Articles 1 on Definitions; 3 on creation and effect of a unit; 8 on unit plans; 9 on participating areas; 13 on unit expansion and contraction; and 17 on laws and regulations should also be considered in connection with the Application. Relevant portions of these articles are set out below:

ARTICLE 1: DEFINITIONS

1.9 Participating Area means all Unit Tracts and parts of Unit Tracts designated as a Participating Area under Article 9 to allocate Unitized Substances produced from a Reservoir.

1.10 Participating Area Expense means all costs, expenses or indebtedness, which are incurred by the Unit Operator for production from or operations in a Participating Area and allocated to the Unit Tracts in that Participating Area.

1.11 Paying Quantities means a quantity of Unitized Substances sufficient to yield a return in excess of operating costs, even if drilling and equipment costs will never be repaid and the undertaking considered as a whole will ultimately result in a loss. The quantity is insufficient to yield a return in excess of operating costs unless it will produce sufficient revenue, not considering transportation and marketing, to induce a prudent operator to produce it.

1.24 Unit Tract Participation means the percentage allocation credited to a Unit Tract in a Participating Area to allocate Unitized Substances.

ARTICLE 3: CREATION AND EFFECT OF UNIT

3.3 Except as otherwise provided in this Agreement, where only a portion of a lease is committed to this Agreement, that commitment constitutes a severance of the lease into unitized and non-unitized portions. The portion of the leased area not committed to this Agreement will be treated as a separate and distinct lease and may be maintained only in accordance with the terms and conditions of the lease, statutes, and regulations. Any portion of the leased area not committed to this Agreement will not be affected by the unitization, by operations in the Unit Area, or by a suspension approved or ordered by the Commissioner. If a lease has a well certified as capable of production in paying quantities on it before commitment to this Agreement, the lease will not be severed by unitization. If any portion of the Lease is included in a Participating Area formed under this Agreement, the entire Lease will remain committed to this Agreement and the Lease will not be severed.

3.4 Production of Unitized Substances in Paying Quantities from any part of a Participating Area shall be considered production from each Unit Tract in the Participating Area. It shall cause the portion of each Lease that is wholly or partially within the Participating Area to continue in effect as if a well were producing from each Unit Tract in the Participating Area.

ARTICLE 8: PLANS OF EXPLORATION, DEVELOPMENT AND OPERATIONS

8.1. Any Unit Plan and any amendment to a Unit Plan will not be effective until the Commissioner approves it. Approved Unit Plans are incorporated into this Agreement and become effective on the date of their approval.

8.1.2. A unit plan of development ("Plan of Development") shall include a description of the proposed development activities based on data available when the plan is submitted. Plans of Development shall comply with 11 AAC 83.343 and any successor regulation. The Unit Operator shall submit updated Plans of Development to the Commissioner for approval at least ninety days before the current Plan of Development expires.

8.2. The Unit Operator shall not explore, develop or produce on the Unit Area except in accordance with an Approved Unit Plan.

ARTICLE 9: PARTICIPATING AREAS

9.1. The Unit Operator shall submit a request for approval of the proposed initial Participating Area to the Commissioner at least six months before Sustained Unit Production from a Reservoir in the Unit Area. A Participating Area shall include only land that is reasonably known to be underlain by Unitized Substances and known or reasonably estimated through the use of geological, geophysical and engineering data to be capable of producing or contributing to production of Unitized Substances in Paying Quantities. The Unit Operator must receive approval from the Commissioner of a Participating Area before commencement of Sustained Unit Production. The Unit Operator shall notify the Commissioner of commencement of Sustained Unit Production within 10 days after commencement from each Participating Area.

9.2. Each application for approval of a Participating Area shall include Exhibits C, D, E, and G. Exhibit F is also required if the Unit Area includes Net Profit Share Leases. If approved by the Commissioner, the area described in Exhibit C and depicted in Exhibit D shall be a Participating Area, and the allocation of Participating Area Expenses and Unit Expenses described in Exhibits E and F shall be effective on the effective date of the Participating Area.

9.3. A separate Participating Area shall be established for each Reservoir in the Unit Area. If one Reservoir underlies another Reservoir in whole or in part, separate Participating Areas may be created for each Reservoir. Any two or more Reservoirs or Participating Areas may be combined into one Participating Area if approved by the Commissioner.

9.4. At the Unit Operator's election or if so directed by the Commissioner, the Unit Operator shall apply to expand or contract the Participating Area if expansion or contraction is warranted by geological, geophysical, or engineering data. Each application for expansion or contraction shall include Exhibits C, D, E, and G. Exhibit F is also required if the Unit Area includes Net Profit Share Leases. The application must be submitted to the Commissioner for approval. Before any directed expansion or contraction of the Participating Area, the Commissioner will give the Unit Operator reasonable notice and an opportunity to be heard.

9.5. The Commissioner will establish the effective date of the initial Participating Area. That effective date shall be no later than the date of the first Sustained Unit Production. The Commissioner will establish the effective date of each later Participating Area.

9.6. Land in a Participating Area shall remain in that Participating Area even if its Unitized Substances are depleted.

9.11. After giving written notice to the Unit Operator and an opportunity to be heard, the Commissioner will, in his or her discretion, require the Unit Operator to modify from time to time the rate of prospecting and development and the quantity and rate of production from a Participating Area.

ARTICLE 13: UNIT EXPANSION AND CONTRACTION

13.2. Ten years after Sustained Unit Production begins, the Unit Area must be contracted to include only those lands then included in an approved Participating Area and lands that facilitate production including the immediately adjacent lands necessary for secondary or tertiary recovery, pressure maintenance, reinjection, or cycling operations. The Commissioner will, in the Commissioner's discretion, after considering the provisions of 11 AAC 83.303, delay contraction of the Unit Area if the circumstances of a particular unit warrant. If any portion of a Lease is included in the Participating Area, the portion of the Lease outside the Participating Area will neither be severed nor will it continue to be subject to the terms and conditions of the unit. The portion of the Lease outside the Participating Area will continue in full force and effect so long as production is allocated to the unitized portion of the Lease and the lessee satisfies the remaining terms and conditions of the Lease.

ARTICLE 17, LAWS AND REGULATIONS

17.1 This Agreement is subject to all applicable State and federal statutes and regulations in effect of the Effective Date of this Agreement, and insofar as is constitutionally permissible, to all statutes and regulations placed in effect after the effective date of this Agreement. A reference to a statute or regulation in this Agreement includes any change in that statute or regulation whether by amendment, repeal and replacement, or other means. This Agreement does not limit the power of the State of Alaska or the United States of America to enact and enforce legislation or to promulgate and enforce

regulations affecting, directly or indirectly, the activities of the parties to this Agreement or the value of interests held under this Agreement. In case of conflicting provisions, statutes and regulations take precedence over this Agreement.

IV. CONSIDERATION OF THE 11 AAC 83.303(b) CRITERIA

State regulation 11 AAC 83.303(c) requires that subsection (b) criteria be considered in connection with an application to form a PA. This section addresses those criteria.

1. Prior Exploration Activities and Geological and Engineering Characteristics of the NU

After the NU was formed, Union drilled two wells into the Red Prospect. Union also acquired, processed, and interpreted seismic data to satisfy the seismic requirement stipulated in the 1st POE.

The Red #1 well (API 502312002100) was tested through perforations at 8,768-8,777; 8,795-8,820; and 9,056-9,075 feet measured depths at rates ranging from 3.2 – 6.8 mmcf/d for approximately 26 hours in August 2004. The well pressure ranged from 2,494 to 2,161 psi on chokes of 14/64” to 20/64”. The Red #2 well (API 502312002500) was drilled and completed in August 2004. The well was perforated at 6,732 to 6,792; 8,038 to 8,088; and 9,298 to 9,344 feet measured depths and tested at rates ranging from 0.195 to 0.230 mmcf/d during September 2004. The well pressure ranged from 560 to 518 psi on chokes of 7/64” to 10/64”.

Union submitted confidential geological, geophysical, engineering and economic data in support of their view that the hydrocarbons underlying the proposed Red PA are capable of being produced in paying quantities. The Red #1 well tested at rates which indicate the presence of hydrocarbons, however, the Red #2 well test results are not conclusive. Acreage justified for inclusion in a participating area must not only be underlain by hydrocarbons, but by hydrocarbons capable of being produced in paying quantities. 11 AAC 83.395(4) and Article 1.11 of the NUA define paying quantities as “quantities sufficient to yield a return in excess of operating costs, The quantity is insufficient to yield a return in excess of operating costs unless it will produce sufficient revenue, not considering transportation and marketing, to induce a prudent operator to produce it.” If the quantities would not induce a prudent operator to produce the well, the quantities are not paying quantities.

2. Union’s Plan for Development of the NU

Neither Union’s 2nd nor 3rd POD proposed any development work in the NU. There is no approved NU plan of development in effect at this time. State regulation and the NUA provide that no development work can occur in the unit except in accordance with a plan approved by DNR. 11 AAC 83.343, NUA Article 8. Therefore, there are no current plans to actually work in the NU to produce or develop the unit.

But the Division’s May 11, 2009 decision to approve extension of the unit term to March 31, 2011 gave Union until that time to consider development options which would support the sustained production necessary to justify a participating area application proposal set out in the

2nd POD. This does not mean, however, that the 3rd POD constituted a valid development plan.

DNR disapproved the 3rd POD because it contained no development or work plans for the NU. It made no commitment to produce or develop the NU. Instead, the 3rd POD stated that Union was attempting to find another entity to which to transfer the right to develop the Red Prospect. That representation did not meet regulatory or NUA requirements for an acceptable plan of development because a plan of development must set out in some detail Union's plan for developing the NU. 11 AAC 83.343, NUA Article 8. This means that the Application is not supported by a plan to put the unit into sustained production.

11 AAC 83.351 indicates that the purpose of a participating area is to facilitate sustained unit production. Sustained unit production is defined as "continuing production of oil or gas from a reservoir in the unit area into a pipeline or other means of transportation to market, but does not include testing, evaluation or pilot production." 11 AAC 83.395(9). NUA Article 9, section 9.1 provides that the unit operator must form a DNR approved participating area before the unit can be put into production. Union has not submitted a unit plan which proposes to put the NU into sustained production.

Consideration of 11 AAC 83.303(b)(4) unit plan factor indicates that the Application does not meet the requirements of 11 AAC 83.351 for participating area formation because there is no plan to put the unit into sustained production. Therefore, there is no legitimate purpose to be served by formation of a participating area.

3. Economic Costs and Benefits to the State

State regulations and the NUA provide that a unit will periodically contract down to the area of approved participating area or participating areas. 11 AAC 83.356. Property within a participating area will remain in the unit after the periodic contraction. *Id.* subsection (b). Therefore, once a participating area is formed, the leases committed to the participating area are extended and not subject to the periodic regulatory unit contraction. The Application proposes forming a participating area on the Red Prospect with no plan or commitment to produce the underlying hydrocarbons. Granting the application may allow Union to hold the leases without producing or developing the NU reservoirs.

Red PA formation would therefore give Union a great benefit by allowing it to retain state leases without developing them. But this benefit to Union would come at a cost to the state by depriving it of the benefits of issuing oil and gas leases on state land such as taxes, royalties, jobs, and local economic activity. The only potential benefit to the state would be if Union successfully farmed the unit out to someone else who effected NU development and production. But such speculation is not a valid basis for approving a participating area, and allowing Union to hold the leases for purposes of marketing them to a third-party would not meet DNR's statutory obligation to enhance competition for development of state resources. Reoffering the property at state oil and gas lease sale would better maximize competition for development.

Therefore, formation of a participating area in this case would be contrary to statutory intent regarding oil and gas leasing which is to maximize economic and physical recovery of resources,

competition among parties seeking to explore and develop resources, and local employment. AS 38.05.180(a). Consideration of the 11 AAC 83.303(b)(5) criterion indicates that formation of the Red PA may indefinitely deprive the state of the benefits of oil and gas leasing in contravention of state statute with no corresponding benefit to the state.

4. Environmental Costs and Benefits of Union's Plans for Development of the NU

Union does not propose any exploration, delineation, or development operations within the NU. Therefore, the section 11 AAC 83.303(b)(1) environmental criterion neither supports nor undercuts the Application.

5. Other Relevant Factors to Protect the Public Interest

It is appropriate to consider the state's efforts to work with Union on this matter. The state both agreed to extension of the unit term by more than two years and proposed curative modifications to the 3rd POD. Union has not taken advantage of either of these opportunities to bring the unit into production or to develop it.

Union originally agreed in the NUA that the unit would terminate in five years or by January 30, 2009. But Union asked the state to extend the deadline for unit expiration by 26 months to March 31, 2011 because Union felt it was entitled to that much time to file an application to form a participating area. The state granted the request to extend the unit term.

The decision to extend the unit term also gave Union until March 31, 2011 to consider development options. DNR also gave Union an opportunity to modify the 3rd POD to describe development and production commitments.

DNR responded to Union's 3rd POD that neither proposed unit production nor development by suggesting that Union commit to produce the unit and to build facilities to move the production to market. If Union had agreed to modify the 3rd POD to address the DNR suggestions or at least to propose development and sustained production appeared probable at a reasonably definite point in time, the Application could have been viable so long as it was not effective until the commencement of sustained production. But Union made no effort to modify the 3rd POD and made no commitment to develop or to produce the unit.

Thus the state has given Union significant additional time and opportunities to consider how to put the NU into production and to commit to NU production and development. Union did not respond with development commitments. Instead, Union stated it wanted to find someone else to take over the Red Prospect. But even if Union is successful in finding someone else to take over development rights, it doesn't mean the unit will be developed. Therefore, granting the Application would not be in the public interest.

V. FINDINGS

This section applies the 11 AAC 83.303(a) criteria for deciding whether to approve a participating area.

A. Promote the Conservation of All Natural Resources.

State regulations define “conservation” for purposes of oil and gas leasing as “maximizing the efficient recovery of oil and gas and minimizing the adverse impacts on the surface and other resources.” 11 AAC 83.395(9). Union proposes no production or unit development. The stated purposes of the Application are (1) that participating area formation would make the NU more attractive to third-parties that might be willing to take over development of the Red Prospect, and (2) that participating area formation might encourage third-parties to build a pipeline to the NU. I find that the 11 AAC 83.303(a)(1) criterion indicates the Application should not be granted. The participating area would not maximize the efficient recovery of oil and gas.

B. Promote the Prevention of Economic and Physical Waste.

I find that the Application does not meet the requirements of 11 AAC 83.303(a)(2). The Red PA is not proposed to support sustained unit production. It is proposed to facilitate marketing the Red Prospect to another entity. Since the Application does not propose production, it is not possible to evaluate whether it would promote the prevention of economic and physical waste.

C. Provide for the Protection of All Parties of Interest, Including the State

Red PA formation would protect Union by allowing it to hold the state oil and gas leases without producing or developing them. Presumably this would allow Union to continue to hold the property at minimum cost until a buyer could be found.

The public interest would not, however, be protected by formation of the Red PA. A majority of the State's general fund revenue is derived from oil and gas operations in the form of royalty, property tax, and corporate income tax. The legislature intended that oil and gas leases maximize production, competition amongst producers, and local employment. AS 38.05.180(a). Should the NU terminate, the area could be re-offered at lease sale by competitive bid thereby enhancing competition amongst parties seeking to develop and produce oil and gas resources. Allowing Union to continue to hold state leases it does not intend to develop by formation of the Red PA is contrary to the public interest and legislative intent because it deprives the state of the opportunity to realize revenue from the leases and to maximize competition and jobs.

VI. DECISION

The Application is denied because it is not in the public interest. Red PA formation as proposed by Union would allow the company to possibly deprive the state of the benefits of oil and gas leasing and to prevent DNR from complying with legislative intent. The Application does not meet the requirements of 11 AAC 83.303 and 11 AAC 83.351 because the Red PA is not proposed to facilitate sustained unit production. To the contrary, Red PA formation would allow Union to hold the unit without developing or producing its hydrocarbon reservoirs. It is not in

the state's interest to allow Union to continue to retain the unit without development or production until it can find a buyer for the property.

Union's Application is denied. This decision takes effect immediately.

A person affected by this decision may request reconsideration, in accordance with 11 AAC 02.030, and must request reconsideration in order to be eligible to appeal this decision to Superior Court. To be timely, a request for reconsideration must be received within 20 calendar days after the date of "issuance" of this decision, as defined in 11 AAC 02.040(c) and (d). The request may be mailed or delivered to Daniel S. Sullivan, Commissioner, Department of Natural Resources, 550 W. 7th Avenue, Suite 1400, Anchorage, Alaska 99501; faxed to 1-907-269-8918, or sent by electronic mail to dnr_appeals@alaska.gov. If reconsideration is not requested by the 20-day-deadline or if the commissioner does not act on a request for reconsideration within 30 days after issuance of this decision, it becomes the final administrative order and decision of the department on the 31st day after issuance for purposes of an appeal to Superior Court. This decision may be appealed to Superior Court within a further 30 days in accordance with the rules of the court, and to the extent permitted by applicable law. A person must make a timely request for reconsideration of this decision in accordance with 11 AAC 02 before that person is eligible to appeal this decision to Superior Court. A copy of 11 AAC 02 may be obtained from any regional information office of the Department of Natural Resources.



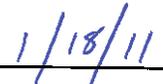
Kevin R. Banks
Director
Division of Oil and Gas



Date



Daniel S. Sullivan
Commissioner
Department of Natural Resources



Date

Attachments:

- Attachment 1: Nikolaevsk Unit Exhibit A
- Attachment 2: Nikolaevsk Unit Exhibit B
- Attachment 3: Nikolaevsk Unit Exhibit C
- Attachment 4: Nikolaevsk Unit Exhibit D

Attachment 1: Nikolaevsk Unit Exhibit A: Legal Description of Leases in the NU

Nikolaevsk Unit Exhibit A

Effective April 1, 2009

Tract	Tract Legal Description	Tract Acreage	Lease #	Mineral Owner	Mineral Interest	Royalty Percent	ORRI Owner	ORRI Percent	Working Interest Ownership	Working Interest Owner %
05	748, R13W, 5M, AK Section 3: All Section 6: GLO Low 1 and 2, S1/2NE1/4, SE1/4 Section 7: E1/2 Section 18: GLO Lots 1 through 4 Inclusive, N1/2NE1/4, N1/2SE1/4 NE1/4, NW1/4SW1/4SE1/4 NE1/4, SW1/4NE1/4, NW1/4SE1/4, E1/2SW1/4, E1/2NW1/4	1,788.69	UOC # 1033445 ADL # 389227	State of Alaska, Department of Natural Resources	100.00%	12.50%	Alliance Energy Group LLC Nappi Trust Keith G. Sumnar J. Lawrence Sheaf	5.00% 3.00% 0.500% 0.500%	Union Oil Company of California	100.00%
06	748, R13W, 5M, AK Section 4: All Section 9: All Section 16: All	1,923.28	UOC # 1035951 ADL # 390513	State of Alaska, Department of Natural Resources	100.00%	12.50%	Alliance Energy Group LLC Nappi Trust Walter J. Hinkel Verona W. Hinkel Robert E. Hinkel William A. Hatto Spencer K. Olford Keith G. Sumnar J. Lawrence Sheaf	4.975% 4.500% 1.500% 1.500% 1.000% 0.325% 0.325%	Union Oil Company of California	100.00%

Tract	Tract Legal Description	Tract Acreage	Lease #	Mineral Owner	Mineral Interest	Royalty Percent	ORRI Owner	ORRI Percent	Working Interest Ownership	Working Interest Owner %
07.1	T4S, R13W, S34, AK SECTION 8 - NE1/4, E1/2NW1/4, SW1/4NW1/4, SW1/4, N1/2SE1/4, SW1/4SE1/4	560.00	UDC # 1035938 ADL # 390514	State of Alaska Department of Natural Resources	100.00%	12.50%	Alliance Energy Group LLC	3.660%	Union Oil Company of California	100.00%
				Neppi Trust				3.311%		
				Newton H. Neustadler Trust				2.500%		
				William A. Hitts				0.730%		
				Waller J. Hildal				0.500%		
				Vernon W. Hickey				0.500%		
				Robert E. Hickey				0.500%		
				William H. Stevens				0.250%		
				Spencer E. Offord				0.239%		
				Keith G. Summar				0.239%		
				J. Lawrence Stead				0.239%		
				Clyde T. Broyer				0.125%		
				Erik Paschall				0.063%		
				Conrad Paschall				0.063%		

Tract	Tract Legal Description	Tract Acreage	Lease #	Mineral Owner	Mineral Interest	Royalty Percent	ORRI Owner	ORRI Percent	Working Interest Ownership	Working Interest Owner %
07.2	T4S, R13W, S14, AK SECTION 8, SE1/4SE1/4	40.00	UOC # 1035938 ADL # 390514	State of Alaska, Department of Natural Resources	100.00%	12.50%	Alliance Energy Group LLC	3.954%	Union Oil Company of California	100.00%
				Neggi Trust				3.576%		
				Newton H. Neustadler Trust				2.500%		
				William A. Hutto				0.795%		
				Walter J. Hinkel				0.393%		
				Vernon W. Hinkel				0.593%		
				Robert E. Hinkel				0.393%		
				Spencer K. Dufford				0.258%		
				Kath G. Sumner				0.258%		
				J. Lawrence Scaud				0.258%		
				William H. Stevens				0.197%		
				Clyde T. Boyer				0.098%		
				Eric Paschal				0.049%		
				Conrad Paschal				0.049%		

Tract	Tract Legal Description	Tract Acreage	Lease #	Mineral Owner	Mineral Interest	Royalty Percent	ORRI Owner	ORRI Percent	Working Interest Ownership	Working Interest Owner %
07.3	T4S, R13W, S14, AK SECTION 8, NW1/4NW1/4	40.00	UOC # 1035936 ADL # 390514	State of Alaska, Department of Natural Resources	100.00%	12.50%	Alliance Energy Group LLC	3.371%	Union Oil Company of California	100.00%
				Newton H. Naumeder Trust				2.500%		
				Nappi Trust				1.975%		
				William A. Hutto				0.439%		
				Walter J. Hiebel				0.203%		
				Vernon W. Hiebel				0.203%		
				Robert E. Hiebel				0.203%		
				Spencer K. Olford				0.143%		
				Keith G. Summar				0.143%		
				J. Lawrence Shread				0.143%		
				William H. Stevens				0.102%		
				Clyde T. Boyer				0.051%		
				Eric Paschall				0.025%		
				Conrad Paschall				0.025%		
08	T4S, R13W, S14, AK Section 6: Lots 3 thru 7, S1/2SW1/4, S81/4NW1/4 Section 7: Lots 1 thru 4, S1/2W1/2	636.48	UOC # 1035844 ADL # 388209	State of Alaska, Department of Natural Resources	100.00%	12.50%	Alliance Energy Group LLC	4.975%	Union Oil Company of California	100.00%
				Nappi Trust				4.500%		
				Walter J. Hiebel				1.200%		
				Vernon W. Hiebel				1.500%		
				Robert E. Hiebel				1.500%		
				William A. Hutto				1.000%		
				Spencer K. Olford				0.325%		
				Keith G. Summar				0.325%		
				J. Lawrence Shread				0.325%		

Attachment 2: Nikolaevsk Unit Exhibit B: Map of the NU

Attachment 3: Nikolaevsk Unit Exhibit C: Legal Description of Leases Proposed for the Red PA and Allocation Factors

Exhibit C
Red Participating Area
Nikolaevsk Unit
March 1, 2010

Tract	Tract Legal Description	Tract Acreage	Lease #	Tract Percentage	Mineral Owner	Mineral Interest	Royalty Percent	ORRI Owner	ORRI Percent	Working Interest Ownership	Working Interest Owner %
05	T4S, R13W, 5M, AK Section 5: S1/2, 3/4 acres Section 6: SE1/4SE1/4, 40 acres, Section 7: NE1/4, N1/2SE1/4, 240 acres.	600.00	UOC # 1035843 ADL # 385227	44.156900%	State of Alaska, Department of Natural Resources	100.00%	12.50%	Alliance Energy Group LLC Neppi Trust Keith G. Summar J. Lawrence Smead	5.000000% 3.000000% 0.500000% 0.500000%	Union Oil Company of California	100.00%
07.1	T4S, R13W, 5M, AK SECTION 8: NE1/4, E1/2NW1/4, SW1/4NW1/4, N1/2SW1/4, 560 acres.	560.00	UOC # 1035928 ADL # 390514	41.213200%	State of Alaska, Department of Natural Resources	100.00%	12.50%	Alliance Energy Group LLC Neppi Trust Newton E. Neustadter Trust William A. Herito Robert E. Hinkel Walker J. Hinkel Vernon W. Hinkel William H. Stevens J. Lawrence Smead Spencer K. Offord Keith G. Summar Clyde T. Boyer Conrad Paschal Erik Perchal	3.660300% 3.310811% 2.500000% 0.735744% 0.500000% 0.500000% 0.250049% 0.239119% 0.239119% 0.123029% 0.062519% 0.062519%	Union Oil Company of California	100.00%

Tract	Tract Legal Description	Tract Acreage	Lease #	Tract Percentage	Mineral Owner	Mineral Interest	Royalty Percent	ORRI Owner	ORRI Percent	Working Interest Ownership	Working Interest Owner %
073	T4S, R13W, S8M, A4 SECTION 8: NW1/4NW1/4, 40 acres.	40.00	UOC # 1035918 ADL # 390514	2.943800%	State of Alaska, Department of Natural Resources	100.00%	12.50%	Alliance Energy Group LLC Newton H. Neenan/der Trust Neppi Trust William A. Hinkel Robert E. Hinkel Vernon W. Hinkel Walter J. Hinkel Keith G. Summar J. Lawrence Sneed Spencer K. Offord William H. Stevens Clyde T. Boyer Erik Paschal Conrad Paschal	3.37095% 2.50000% 1.97535% 0.43897% 0.20331% 0.20331% 0.14266% 0.14266% 0.10166% 0.05983% 0.02341% 0.02541%	Union Oil Company of California	100.00%
08	T4S, R13W, S8M, A4 Section 7: Lots 2 and 3, SE1/4NW1/4, NE1/4SW1/4, 158.79 acres.	158.79	UOC # 1035844 ADL # 388209	11.686100%	State of Alaska, Department of Natural Resources	100.00%	12.50%	Alliance Energy Group LLC Neppi Trust Vernon W. Hinkel Robert E. Hinkel Walter J. Hinkel William A. Pasco J. Lawrence Sneed Spencer K. Offord Keith G. Summar	4.97500% 4.50000% 1.50000% 1.50000% 1.50000% 1.00000% 0.32500% 0.32500% 0.32500%	Union Oil Company of California	100.00%

Total PA Acreage	1,338.79	Working Interest Owners	Unaccounted Union Oil Company of California	PA %	0.0000% 100.0000%
Total Tract Percentage	100.000000%				

Attachment 4: Nikolaevsk Unit Exhibit D: Map of the Proposed Red PA

Cook Inlet Nikolaevsk Unit Red Participating Area Exhibit D

