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March 16, 2005

The Honorable Frank Murkowski  
Governor, State of Alaska  
P.O. Box 110001  
Juneau, Alaska 99811-0001

RE: March 8, 2005 - Oil Industry Incentives Meeting

Dear Governor Murkowski:

The purpose of this letter is to respond to your request for information on possible incentives, which will spur oil and gas exploration, development, and production in the Cook Inlet area. Specific items of interest to Union Oil Company of California (Unocal) addressed in this letter have already been communicated to the Kenai legislative delegation (Senator Wagoner, Representatives Chenault and Olson) at a Joint House and Senate Resources Committee hearing held February 11, 2005, in Kenai, Alaska.

Unocal has had numerous conversations with the Kenai legislative delegation over the last couple of years and is currently working with them on specific legislation to address some of our concerns expressed during the February 11, 2005, hearing. Additionally, Unocal has spoken to Bob Favretto (Gas Task Force) regarding Cook Inlet gas supply and operational matters. Both the Kenai legislative delegation and the Mr. Favretto can provide you with specifics about those conversations. We encourage your administration to work closely with both the House and Senate Resource Committee's staff to coordinate incentive legislation.

During the March 8 meeting, many issues were discussed regarding Cook Inlet gas supply. The topics included pipeline access and jack-up rigs. Although these are serious issues, the most important issues facing the Cook Inlet energy sector are new resource identification, oil and gas exploration and development, and management of the existing reserve base. The market system in Cook Inlet is working, and supply and demand will control the pace of development. Gas will find its way to consumers that are able to pay the market clearing price. There is a direct correlation between reserve development, supply, and pricing. However, appropriate incentive legislation can have a positive influence on the pace of reserve development and will aid increased gas deliverability.

Identification and development of new oil and gas reserves in the Cook Inlet basin are required if we are to sustain the economy of south-central Alaska. Industry and businesses, both large and small, rely on gas supplied from the Cook Inlet area. Additionally, the Cook Inlet oil and gas industry is a large employer. Unocal directly employs approximately 300 Alaska residents to support its offshore oil platform, and its gas exploration and production. By far the majority of the employees are devoted to supporting the 10 oil platforms that we operate. Now is the time to consider what additional measures could be taken to extend the life of these platforms. If we defer, it will become more difficult to take effective action as these platforms reach their end of life.

Management of the existing reserve base is critical in the near term. In its recent study of Cook Inlet natural gas, the Department of Energy emphatically noted the important role of gas storage stating, "Gas storage can contribute to management of short-term shortfalls during high-demand periods but cannot provide a long-term solution to the declining reserves. It is expected to become a critical part of the solution because the spare production capacity may no longer be adequate to meet the high peak demand that frequently occurs in winter in Alaska" (June 2004 South-Central Alaska Natural Gas Study page 35.) Storage will benefit all consumers because it provides significant additional deliverability on peak demand days. Unocal is the only company with storage capabilities in Cook Inlet. Currently, we are working with BLM and the USF&WS on an expanded storage program in the Swanson River Field. Although we do not seek any particular assistance at this time, it is important for your administration to be aware of the critical importance storage will play in the future of Cook Inlet natural gas deliverability. Unocal believes it is time to investigate options to enhance gas storage, including possible deferral of royalties on state owned royalty gas in a storage reservoir or providing tax credits for storage wells.

As previously mentioned, Unocal has discussed the following issues as items of interest:

- Investment incentives such as the 2003 Cook Inlet Royalty Reduction bill helped prevent the premature shut in of the Bruce Platform in the Cook Inlet in 2003 / 2004. Although SB 185 has not yet increased the reserve base of an existing field or platform, it did help extend the economic viability and prolong the utility of the existing infrastructure, whereby leading to the ultimate recovery of more reserves. Equally important is the possibility for royalty reduction to increase the attractiveness for making additional investment in a field which might lead to an increase in the overall recoverable reserve base of that field.
- Tax incentive credits which have the potential to identify new gas reserves by providing predictable and quantifiable credits to help lessen the inherent risk of costly exploration. These credits could be approved in advance for work to be conducted. This would provide certainty, while expediting and simplifying the process. The increased tax revenue from additional hydrocarbon production will more than offset the initial financial impact from the tax credit. Add-ons and enhancements to these types of incentives should be explored and truly work to create added wealth for the state. Any horizon not previously penetrated and produced in a field (such as a deeper pool or untested zone), or any step-out exploration well that expands the proven area of a field should qualify for tax incentive credits. Consideration should also be given to providing incentive credits to "tight gas" reservoirs. These reservoirs have not been significantly exploited in the Cook Inlet, but may have a large reserve base if proven commercially viable.
- The exploration incentives passed in 2003 were aimed at remote basins and locations, but there is significant exploration potential near existing fields that need to be accelerated. Near-field and infield drilling incentives need to be developed through state risk sharing as a means of increasing the reserve base. Elimination of the current three (3) mile limitation on the exploration and production incentive in Cook Inlet would be a positive incentive for additional exploration.

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- The State of Alaska should consider a positive incentive program in order to promote exploration and development of new and/or smaller marginal accumulations of oil and gas. Alaska could reduce the royalty rate on new field exploration or eliminate royalty until payout. Allowing the recovery of all capital costs by the risk bearing parties before the state receives its royalty share, would result in increased marginal field development. The recovery of capital costs by an investing party, before the non-investing party participates, is a standard in the industry and a solid concept in joint venture partnerships. Granting such incentives appears possible under current regulations. Today's economics call for a reexamination of the utility of these incentives and the flexibility inherent in existing regulations.

In summary we should take steps to address the much larger issue of the health of the oil and gas industry in Cook Inlet before it is too late. Pipeline ownership, capacity and infrastructure accessibility are matters to be resolved commercially among the owners and within the regulatory environment. The state can play a role in being receptive to infield development incentives and investment credits for "tight gas" sands development.

The state's overriding philosophy must demonstrate flexibility and a willingness to work with industry in trying to maximize each field's ultimate potential. Unocal does not believe any one particular incentive will be the answer to all problems for all fields, or the answer to all problems for any one company. I very much appreciate your concern for the Cook Inlet oil and gas industry and associated businesses that it supports. It is an industry full of challenges; however, we believe that if industry and government work together we can meet those challenges for the ultimate benefit of the people of Alaska.

Sincerely,



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General Manager, Unocal Alaska

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Cc via Email: Tom Wagoner, Senator  
Mike Chenault, Representative  
Kurt Olson, Representative  
Mike Menge, Governors Office  
Bill Noll, Commissioner, Dept. of Commerce  
Bill Van Dyke, DNR