

**Prepared remarks of Attorney General David Márquez to the joint hearing of the Natural Resources committees of the House and Senate (may differ from as presented).**

**August 18, 2006**

Good morning. For the record my name is David Marquez and I am the Attorney General for the State of Alaska. Thank you for inviting me to discuss with you the legal issues surrounding the recent events regarding the corrosion, spills and consequent curtailment of production at Prudhoe Bay. I know this matter is one of deep concern and interest to all the people of Alaska, and to you and all the members of the legislature. Thank you for calling this hearing so that the public can be better informed about these important issues. Hearings like this should provide assurances to the people of Alaska and also to the people of the United States that the administration of Governor Murkowski and the members of the legislature are diligent and vigilant in overseeing the responsible development of Alaska's important natural gas and oil resources; that Alaska can be depended upon to continue, with the development of older fields like Prudhoe Bay and new fields like Alpine and those that will be discovered in the NPRA and hopefully ANWR to deliver much needed supplies of oil and clean burning natural gas to Americans.

I'd like to introduce Susan Parkes Deputy Attorney General of the Criminal Division of the Department of Law; Steve Mulder, Chief Assistant Attorney General and Section Chief of the Environmental Section of the Department of Law; and Ken Diemer, an assistant attorney general with the Oil, Gas and Mining Section of the Department of Law. These attorneys are members of the task force I created to advise me on this matter. Also present are Breck Tostevin and Randy Ruaro. Breck is an assistant AG that works in Steve's section and has long experience in spill related matters. Randy is the legislative liaison for the department of law. They are present to help me respond to any questions you may have. Should you have questions or requests for more information following this hearing please do not hesitate to call on Randy, or any of us, for assistance.

Our message is simple. A thorough fact-finding investigation of BP's management of the North Slope oil field is taking place. After the investigation is complete, appropriate legal action will be taken to protect Alaska's interests.

We need to consider the corrosion issues both in terms of the past, present, and future – that is how we were and continue to be damaged – and, perhaps more important, the future – how we can make sure that the risk that this will ever happen again is significantly reduced or eliminated.

First, I'll talk about the actions we're taking in terms of assessing and exploring what justice needs to be rendered for any wrongs that have been committed and what remedies we may seek for all damages that the State has suffered. At the outset, we need to understand all the facts and circumstances surrounding this matter. To that end, we issued yesterday– through DEC's administrative authorities -- subpoenas to BP and other holders of the Prudhoe Bay leases to preserve all documents related to this occurrence and pipeline corrosion going back to 1996.

After BP announced the then complete shut down of the Prudhoe Bay field, Governor Murkowski announced the formation of a special cabinet team, headed up by DNR Commissioner Menge, and including the commissioners of DEC, DOR, myself and John Katz to protect the environment, develop an action plan and get oil production up & running

Before his announcement I had already formed an internal task force within the department of law headed by the two deputy attorneys general, Susan Parkes of the Criminal Division and Craig Tillery of the Civil Division and composed of senior and experienced attorneys in several legal disciplines to examine thoroughly the proper legal courses of action it would recommend that we pursue and then at the proper time implement those recommendations. Using this team of experts, the Department of Law at the direction of Governor Murkowski, is reviewing the state's legal rights, particularly the full

extent to which BP and possibly other parties can be held legally responsible for losses incurred by the state. We are working with the state agencies represented at this table to ensure that all regulatory and enforcement options available have been fully explored and acted upon.

We appreciate BP's efforts to address quickly the effects and causes of the corrosion and consequent spills. The candid statements and apologies of their executives and managers acknowledging the shortcomings of their maintenance and corrosion control programs reflect favorably on their intentions to address this very serious situation. And we have to acknowledge that billions of barrels of oil have flowed through this system and down TAPS safely and reliably. Our highly skilled and trained fellow Alaskans go to work everyday with the best of intentions to perform their jobs on the North Slope and on TAPS to monetize safely and in an environmentally sound manner our natural resources. Nonetheless like many Alaskans and at least all of the legislators in this room, I am deeply concerned about the practices that led to this current situation.

Apologies are not enough - we must be sure that this problem is corrected and BP takes all necessary efforts to ensure that other existing problems are identified and resolved so that future situations, like this one, are avoided.

There is an ongoing criminal investigation into both the March and August spills involving DEC investigators and the Department of Law environmental prosecutor. I cannot talk about the investigation in order to preserve its integrity and also because we are working cooperatively with the federal authorities. Pursuant to Federal Rule of Criminal Procedure 6 the subject matter of a federal grand jury investigation is confidential – disclosure of any information is prohibited except under specific exceptions. By the way this hearing is not such an exception .

Any successful criminal prosecution at the state level will require that the State prove that the actions taken, or omitted, were “criminally negligent.” Criminal negligence is defined in AS 11.81.900 but is

essentially “a gross deviation from the standard of care that a reasonable person would observe in the situation.”

Title 46 of the Alaska statutes contains several provisions related to oil spills. Violations are criminalized in AS 46.03.790. You should have as handouts copies of the relevant statutes. AS 46.03.790 makes any criminally negligent violation of a DEC statute, regulation, order or permit a misdemeanor. The criminally negligent spilling of oil is also a crime – it becomes a felony if it is 10,000 barrels or more; these recent incidents are well below that threshold.

Under these provisions, the maximum penalty for an individual, for a misdemeanor is: 1 year in jail; a \$10,000 fine

For an organization, the maximum penalty for a misdemeanor is: a fine up of \$200,000 or up to 3 times the pecuniary gain to the defendant or up to 3 times the damage or loss caused by the defendant’s conduct, whichever is greater.

For a felony offense the penalty for an individual is up to 5 years in jail and a \$100,000 fine. For an organization the penalties for a felony are a fine of \$1 million or 3 times the pecuniary gain to the defendant or up to 3 times the damage or loss caused by the defendant’s conduct, whichever is greater.

Let me turn now to some of the civil remedies that are available to the state. The State has several remedies under state statutes regarding the assertion of claims and the recovery of damages resulting from the conduct in this matter.

Under Alaska law, a person who discharges petroleum into or upon the waters or land of the state in violation of AS 46.03.740 is liable in a civil action, to the State, for a sum assessed by the court in an amount not more than \$100,000 for the initial violation, nor more than \$5,000 for each day the violation continues. The award shall reflect, when applicable, reasonable compensation for adverse environmental effects, costs incurred by the state in detection, investigation, and attempted correction of the violation, and the

economic savings realized by the person in not complying with the requirement. In addition to liability under AS 46.03.760 (a), a person who violates AS 46.03.740, is liable to the state under AS 46.03.822 for the full amount of actual damages caused to the state by the violation, including direct and indirect costs associated with the abatement, containment or removal of the pollutant, restoration of the environment, and all incidental administrative costs. *See* AS 46.03.760(d).

A person found liable under any other state law for an unpermitted discharge of crude oil in excess of 18,000 gallons faces a potential civil penalty up to a maximum of \$500,000,000. For example, a person is to be charged a penalty of \$8 per gallon for the first 420,000 gallons of crude oil discharged and \$12.50 per gallon for amounts in excess of 420,000 gallons. *See* AS 46.03.759(a)(1), (2). And, subject to the \$500,000,000 statutory maximum, the court shall assess four times the penalty if it finds that the discharge was caused by the gross negligence or intentional act of the person. *See* AS 46.03.759(c)(1).

Additionally, pipeline owners and operators are strictly liable for the State's response costs. *See* AS 46.03.822. Owners and operators also are liable for damages, including injury to property, loss of income, loss of means of producing income, or loss of economic benefit. *See* AS 46.03.822, .824. If the State sues for assessments of civil penalties, then it may recover full reasonable attorney fees and costs. *See* AS 46.03.763. And, the operator must pay restoration damages to restore the environment to its pre-spill condition. *See* AS 46.03.780. Owners and operators are liable for natural resources damages, such as damages to the tundra, under AS 46.03.822.

The owners and operators of a facility from which there is a release of oil are strictly liable jointly and severally under AS 46.03.822 for "damages" "resulting from an unpermitted release." "Damages" are statutorily defined in AS 46.03.822/.824 as including "loss of income, loss of the means of producing income, or the loss of an economic benefit." If the field shutdown and resulting loss of tax and royalty

revenue is seen as the result of the release, then AS 46.03.822 would provide a cause of action for lost tax and royalty revenue. The Alaska Supreme Court in *Kodiak Island Borough v. Exxon Corp.*, 991 P.2d 757 (Alaska 1999) recognized that the legislature intended .822 to allow for broader damages to government entities than those compensable at common law.

There are also enforcement tools available to the state. A person responsible for discharge of oil must immediately contain and clean it up and DEC must approve the cleanup plan. AS 46.04.020. DEC may takeover the cleanup if it is not adequate. AS 46.04.020(c). DEC can investigate spills and issue subpoenas to preserve records and evidence. AS 46.03.020. DEC has authority to obtain search warrants to investigate actual or suspected pollution incidents. AS 46.03.860. DEC may inspect oil terminal facilities, pipelines, and exploration and production facilities to ensure pollution control. Absent timely and adequate inspections by other agencies, DEC may perform its own inspection of the structural integrity and operating and mechanical systems of pipelines and oil facilities. AS 46.04.060(b). DEC can issue a Notice of Violation (NOV) requesting the violator to cease and desist the violations; state why the violation occurred and how it will cleanup or repair of the problem.

In addition, the Department of Law is reviewing the state's rights under the various leases, unit agreements, state statutes and the common law. Some of the claims most likely to arise will be those based upon principles of contract law; specifically, those claims that are based on breach of both the express and implied terms of the applicable oil and gas lease (DL-1 lease) and the Unit Agreement. Copies of those documents are among my handouts.

Section 19 of the lease expressly provides that the lease "contemplates the reasonable development of said land for oil and gas as the facts may justify," and that upon discovery of oil or gas in paying quantities on the land, the lessee "shall drill such wells as a reasonably prudent operator would drill having due regard for the interest of the Lessor (that's the state) as well as the interests of the Lessee (that's the oil companies)." The "reasonably prudent

operator” is someone who represents him or herself to possess an expertise in matters relating to the technology and operating practices of the oil and gas industry that most persons do not have, and must consider the lessor’s interests while pursuing his or her own.

To that end, section 20 of the DL-1 lease correspondingly provides that the lessee “shall exercise reasonable diligence in drilling, producing and operating wells on said land unless consent to suspend operations is temporarily granted by [the] Lessor.” This section further provides that the lessee “shall carry on all operations in a good and workmanlike manner in accordance with approved methods and practices, having due regard for the prevention of waste of oil and gas.” This mandate also is echoed in section 4.2 of the Unit Agreement, which requires that working interest owners “shall with due diligence develop the Unit Area in accordance with good engineering and production practices. In this case, the matter of what constitutes “good and workmanlike manner” and “reasonableness and prudence” are issues of fact to be determined later.

Ordinarily, lessees are bound by implied terms (or covenants) in addition to express terms in leases, and the DL-1 leases at issue here include implied duties. Addressing the relationship between the State and its oil and gas lessees, the Alaska superior court, Judge, now Justice Carpeneti, in the *ANS Royalty Litigation* held that the oil and gas producers have an obligation to act as reasonably prudent operators in performing their duties under the DL-1 lease.

The reasonably prudent operator standard obliges the operator: “(1) to act in good faith; (2) with competence; and (3) with due regard to the interest of the lessor as well as its own interest.” This obligation includes reasonableness and prudence regarding the technology and operating practices of the industry.

Judge Carpeneti, explained that lessors cannot take actions that injure a lessee’s rights to recover the benefit under a lease.

The prudent operator standard imposes an affirmative duty to do certain things in a given factual scenario. In the same scenario, the covenant of good faith and fair dealing commands the lessee to *refrain* from doing anything to injure the lessor's right to receive benefits under the oil and gas lease.

The covenant to conduct operations with reasonable care and due diligence is of particular relevance to the instant case. In this matter, the types of claims that generally fall under this covenant are: (1) that the lessee has damaged the royalty interest by operating negligently, carelessly or incompetently; and (2) that the lessee failed to use advanced production techniques. An argument may also be available that BP's breached the covenant to conduct operations with reasonable care and due diligence by failing to use advanced production techniques to detect the corrosion.

In conclusion, the State may have causes of action under the express and implied covenants in the DL-1 lease that BP breached the covenant to conduct with reasonable care and due diligence all operations on the leasehold that affect the State's royalty interest, a.k.a. the implied covenant of diligent and proper operation.

There may be extra costs due to decreased flow through TAPS. The State's royalty and tax interests in North Slope production are calculated on the wellhead value of the oil. The wellhead value for oil that is shipped interstate is determined by subtracting the transportation costs—TAPS tariff (plus any tariffs for shipment upstream of pump station one) plus tanker costs—from the market price at the purchasing refineries. Higher TAPS tariffs thus result in a lower wellhead value on which State royalties and taxes are calculated.

Because the current TAPS tariff rates are throughput driven, any reduction in total barrels shipped on TAPS may result in higher cost per barrel tariff rates applied to remaining throughput. In turn, these higher tariff deductions would result in lower State royalties and

taxes on all remaining TAPS-shipped oil even if no additional costs are incurred to TAPS operations from the corrosion problem. Of course additional costs arising from the corrosion problem may show up in the tariffs also. Lost revenues to the state therefore may be consequential damages caused by BP's conduct and that of others.

We all need to be careful not to treat BP unfairly at this stage of the investigation or unjustifiably raise the expectations of the public and the legislature with regard to the opportunities to recover damages under these theories. The State will have to establish the facts as events further unfold, will need to assess the relevant industry standards and review BP's and other documents in order to determine whether its conduct fell below those standards. And if there can be developed support for the claim that BP damaged the state's interests by operating negligently, carelessly or incompetently under the covenant to conduct operations with reasonable care and due diligence, the question of allowable damages remains.

Monetary damages generally are measured by lost royalties or taxes (*i.e.*, those monies that would have been paid had production continued uninterrupted). A difficulty in the application of the damages remedy is the "proper measure of the damages." For example, where the breach results in no permanent loss of oil or gas and the action is for failure to produce the oil now rather than later, the value of the royalty or tax that would have been paid on the production from the well had it been operating properly at the time may be considered double recovery, since the State may receive a royalty or tax once again when the oil is eventually produced. However other measures of damages may recognize the interest on the sum that would have been paid the State if no breach had occurred, the time value of the money received in royalties and taxes later rather than now, and the fact that oil received later may realize a lower price than that received now. Further with the possibility of a the start of gas production that would change the oil production profile, some oil lost now may never be recovered. There is also a concern whether production can resume to the level it was prior to the shutdown after production is resumed.

Overall, it is difficult at this point in time to ascertain the precise measure of damages from BP's or others acts or omissions until the field comes back into full production. We are examining, in addition to the previously discussed remedies, whether there may be more attenuated damage claims.

We are also following other litigation, such as the shareholder derivative suit filed against BP. These kinds of suits have mushroomed in recent years upon any news of potential wrongdoing. There may be merit to it, but it's something we'll need to look into, and taking some time to look at this lawsuit, as well as gathering the facts regarding the present ongoing situation, should not prejudice our rights to whatever future recovery we may be entitled to as BP shareholders.

It is important to keep in mind that BP has the opportunity to mitigate damages. It should act quickly and get the field up and running to the capacity it was prior to the shutdown as soon as safely possible.

I want to conclude my testimony today by addressing briefly another charge I gave to my department task force: looking to possible future legislation, regulations and other actions. We want to make sure that State agencies have all the authority with all the clarity and remedies they require, and we do not want any regulatory holes between federal and state authority. We are reviewing the present level of the criminal and civil sanctions as to their appropriateness. We are also reviewing our oil and gas leases – which have been amended many times over the years – to see whether future leases should have provisions that more expressly deal with these types of maintenance situations and more explicitly set forth our rights and remedies as lessor.

That concludes my testimony. I'll be happy to try to answer any questions you may have.