BACKGROUND

The high cost of energy in the Interior is a chronic public policy issue facing the State of Alaska that has local, regional and statewide implications. Arctic Slope Regional Corporation is Alaska's largest homegrown company with over 630 employees and 700 shareholders residing in the Interior, so this issue strikes at the core of our organization. ASRC seeks a seat at the table to be part of a comprehensive solution to address the high cost of energy statewide; and, specifically for the purposes of this discussion, in the Interior region of Alaska.

This concept paper highlights the issue, desired outcome, potential unintended/unanticipated impacts of introducing natural gas into the Interior market to consumers and businesses, and potential options/solutions to be considered by the State of Alaska. ASRC hopes that this information will be considered throughout the decision making process engaged in by the State of Alaska. ASRC values its relationship with the State of Alaska on many issues and continues to work to preserve a positive working relationship with the Parnell Administration; therefore, representatives of our organization will remain ready to discuss the high cost of Interior energy, as well as any other energy issues statewide.

THE ISSUE

The high cost of energy in the Interior region of Alaska. This has a material economic impact on Alaskans and Alaska businesses.

DESIRED OUTCOME

Orderly delivery of affordable energy options to the Interior region of Alaska and statewide.

POTENTIAL IMPACTS

It is imperative that the State of Alaska understand that one option being considered - the delivery of natural gas to the Interior - may have negative impacts on some consumers and businesses. This section will address the unintended impacts and the risks to these consumers, heating fuel distributors, and TAPS dependent refineries.

- ***Unintended Impacts Of State-Subsidized Natural Gas Proposals***

Introduction of natural gas into the Interior market will severely shrink the heating oil market in the Interior. This, in turn, will impact the following sectors:

(1) *HEATING OIL CONSUMERS*

Remaining heating oil customers will be faced with a cost structure in which delivery costs are high and distributor operating costs generally will have to be absorbed by a diminished customer base. Indeed, as distributors are forced out of business, these cost increases will be compounded for remote or unconnected consumers.

Distributors with statewide operations may be able to absorb increases in their costs of doing business and survive, but the increased cost of doing business in the Interior will drive up their overall cost of doing business statewide. Suddenly, what appeared to be an isolated, regional energy issue will have transformed into a larger, statewide challenge.

(2) *HEATING OIL DISTRIBUTORS*

Build-out of a centrally located natural gas distribution system will displace a customer base for heating oil distributors, which are generally small businesses. The loss of a centrally located customer base will increase the costs of doing business as their deliveries are limited to customers beyond the gas distribution system.

Even within natural gas build-out areas, heating oil distributors will face working capital constraints.

(3) *INTERIOR REFINERS*

Replacement of heating oil with natural gas will shrink the market for one of the principal products of Interior refiners.

The Alaska refiners along TAPS already are weakened because of the dual pressures of high ANS crude oil prices and crippling penalties imposed upon them by the TAPS Quality Bank. Seventy five percent of the cost of a gallon of heating oil comes from the cost of crude oil and Quality Bank.

ABOUT ANS CRUDE

The refiners along TAPS have no choice but to buy ANS crude, and it currently is one of the highest-priced crude oils in the country. The TAPS Quality Bank was designed to compensate for the impact of refinery return streams on the price of ANS crude, but it has grown to be the second highest cost to TAPS refiners—higher than process fuel—and a major profit center for the ANS producers. Moreover, as the extraordinary price of ANS demonstrates, any effect that the refinery return streams have on ANS prices are negligible at best. Indeed, the high price of ANS crude has prompted several refineries in the Pacific Northwest – including one owned by a North Slope producer - to invest in the infrastructure to transport Bakken crude from North Dakota by rail to their refineries rather than purchase ANS crude delivered by tankers.

ABOUT QUALITY BANK

The TAPS Quality Bank is regulated principally by the Federal Energy Regulatory Commission (FERC) and to a lesser extent by the Regulatory Commission of Alaska (RCA). Alaska refiners have learned from experience that they will not prevail at FERC against the major producers. Indeed, when the Quality Bank was litigated in a months-long proceeding in 2002, the FERC ultimately settled on a Quality Bank methodology that made the refiners pay the oil producers more than any party requested, and the RCA concurred. This led directly to the excessive Quality Bank penalties that are imposed on the TAPS refiners today.

Heating oil and jet fuel are two of the most important products made by the TAPS refiners. The combination of high ANS crude prices and excessive Quality Bank penalties have already made it impossible for the TAPS refiners to profitably compete with fuel imported into the Anchorage jet fuel market from the Pacific Northwest or Far East, as evidenced by the closure of two out of three Flint Hills crude processing units in recent years. The introduction of cheap natural gas into the Interior will only exacerbate the refiners' poor economics that have resulted from the jet fuel problem. This is particularly ironic, since, were crude oil and quality bank costs lower, the TAPS refiners could replace lost heating oil demand by selling more commercial jet fuel.

- ***Risks To TAPS Dependent Refineries: Wider Risks To Alaska Consumers And Institutions***

Natural gas introduction to the Interior market may have impacts on the Interior refiners that could threaten their viability, and any further weakening of instate refining will have significant ripple effects statewide. The failure of any of the TAPS dependent refineries would decrease competition within Alaska fuel markets, and remove most of the existing brakes on prices.

Failure of the Interior refineries would eliminate any local source of military jet fuel for Eielson AFB and of commercial jet fuel for the Fairbanks International Airport. The former could make closing Eielson more attractive to the Defense Department, and the latter could raise costs—and lower attractiveness—of Fairbanks to commercial air carriers.

Failure, or further contraction, of Interior refineries would severely impact the Alaska Railway, which in turn will have a negative impact on the Interior economy as a whole.

POTENTIAL SOLUTIONS

ASRC has raised important unintended consequences, and we offer the following potential solutions to consider. We believe in a comprehensive approach to lowering Interior energy costs, rather than piece-meal solutions that ignore the potential for unintended consequences. At this time, we do not know what approach the State of Alaska is planning to take. While there is no easy fix, we are confident that the State will take measured steps to address both the current cost burden borne by Interior Alaskans and the potential consequences that cheap natural gas will have on some Alaska consumers and businesses in the Interior. This section will address an *Energy Cost Equalization* program that will mitigate the consequences of State action on "beyond build-out" consumers as well as on Alaska businesses.

- ***Energy Cost Equalization***

We propose consideration of a *new* comprehensive program designed to assist the State of Alaska in having a viable lower-cost energy program for the Interior. This program could be called *Energy Cost Equalization (ECE).* ECE is a program with two linked components. The first component is designed to directly reduce the space heat costs of Alaskans who will be beyond the reach of the Interior natural gas build-out. We envisage this as operating in a manner analogous to that employed by the Power Cost Equalization program. Essentially, the State would subsidize individual consumers' space heat expenditures by paying heating oil distributors a portion of the consumers' bills. This assistance would prevent the creation of a separate "beyond build-out" group of Alaskans who would be forced to endure high energy costs while their neighbors enjoyed low-cost natural gas. Without this assistance, suburban and rural Alaskans would endure space heat cost that would be increased by the effects of natural gas deliveries. The ECE would directly address this issue.

The second component of the ECE would consist of production incentives for jet fuel production by the TAPS refiners and would work in concert with the first. The incentives would partially offset the effects of high crude oil prices and the Quality Bank, and allow the TAPS refiners to compete effectively in the Anchorage commercial jet fuel marketplace. By thus providing an alternative market for volumes that now are being sold as heating oil, this would directly mitigate some of the impact of making cheap natural gas available in the Interior, and this second part of ECE would complement the first by keeping those program costs down. In addition, by reducing the producers' overall costs, it would help the TAPS refiners compete more effectively throughout Alaska, which could create state-wide benefits. This aspect of the ECE would both directly address the refiners' concerns and act to hold down the cost of necessary direct consumer assistance.

The complete ECE thus would provide the following benefits:

1. Protect "beyond build-out" consumers and lower cost to consumers

2. Support the Alaska Railroad as the carrier for healthy quantities of jet fuel

3. Benefit to the airline industry by encouraging competition for jet fuel sales

4. Help protect Eielson from BRAC closure or force reduction

5. Ensure the future viability of in-state refiners, and especially Interior refiners

The two components, as mentioned earlier, are inextricably linked. The first component is necessary to address "beyond build-out" space heating costs and minimize the problems that inevitably will occur during build-out. The second component is necessary to keep the in-state refining industry viable and avoid the catastrophic consequences that would follow further loss of Alaskan refining capacity. In addition, the second component will play an integral part in keeping heating oil costs down for Interior consumers and thereby will mitigate the costs of direct subsidies to those customers.

- ***Mitigation Measures for Consumers, Employees and Distributors***

Market conditions will not support a heating oil distribution industry sector in the Interior at current levels if cheap natural gas is introduced into the market. The State of Alaska must consider how affected businesses can continue to participate in the Alaska economy and transition into new lines of businesses if they cannot continue. An attractive option would be for the State of Alaska to assist heating oil suppliers by providing low-or no-interest loans to pay off capital investments whose earning power will be eroded, and/or support to finance transitions to new lines of business.

In addition to financing options for capital investments or sector transitions, the State of Alaska should also consider how it will ensure an orderly transition from heating oil to natural gas, without adversely impacting current distributors. Business closures or contractions will have a direct impact on hard-working Alaskans. Employees of heating oil suppliers may fall victim to closures or contractions. The State should consider funding retraining and job search assistance, and if necessary extended unemployment benefits.

CONCLUSIONS

Through the *Energy Cost Equalization* program outlined above, the transition to natural gas in the Interior may be accomplished with a minimum of disruption and a continued healthy refining sector in the State. ASRC is interested in participating in developing this type of solutions that benefits all affected parties. Only when this is done will it be possible to avoid the worst of the unintended consequences of addressing the needs of one group without considering all the broader, state-wide impacts.

Finally, based on the information available to date- ASRC understands that the State of Alaska may be interested in purchasing/constructing/owning/operating/ a natural gas liquefaction facility on the North Slope. This is in ASRC’s backyard and, consequently, we believe that ASRC might be uniquely positioned to become an important participant in the process. For this reason, we commit to reviewing this project, as information is made publically available, and to engage in our standard due diligence process to assess the project’s commercial viability and the potential for a meaningful public-private partnership.