Proposed Sale of the State's Royalty Oil to Tesoro: House Bill 373

Presented to House Resources Committee
March 28, 2016

Alaska Department of Natural Resources
Division of Oil and Gas

Royalty In-Kind versus Royalty In-Value

- The State has a choice to take its royalty in-kind (RIK) or in-value (RIV)
- When the State takes its royalty as RIV, the lessees who produce the oil also market the State's share along with their own production and pays the State the value of its royalty share.
- When SOA takes its royalty share as RIK, the SOA assumes ownership of the oil, and the DNR Commissioner disposes of it through the sale procedures prescribed by AS 38.05.183.
- Currently, the SOA receives all royalties as RIV; historically, the SOA has regularly taken royalties as RIK.

Non-Competitive RIK Sale Process

- Before taking RIK, the DNR Commissioner must find it is in the State's best interest.
- DNR must decide whether to sell RIK pursuant to a competitive auction or a non-competitive, negotiated sale.
- Solicitation of Interest issued January 2015 to prospective purchasers to gauge market interest.
- DNR determined that there was not competition allowing for a competitive sale, and proposes to enter into the negotiated 5-year contract with Tesoro.

Commissioner’s Decision Criteria

AS 38.05.183(e) states that the commissioner must sell the State’s royalty oil to the buyer who offers “maximum benefits to the citizens of the state.” In making this determination, the commissioner must consider:

1. The cash value offered
2. The projected effects of the sale on the economy of the state
3. The projected benefits of refining or processing the oil in state
4. The ability of the prospective buyer to provide refined products for distribution and sale in the state with price or supply benefits to the citizens of the state
5. The eight criteria listed in AS 38.06.070(a), as reviewed by the Royalty Board

Approval Process for the RIK Sale

- DNR must make a Best Interest Finding (BIF) in support of the sale
  - Preliminary BIF issued February 2016; final BIF issued in March 2016.
- DNR presented the sale to the Royalty Board on March 15, 2016; the Board reviewed the BIF and the contract, and unanimously voted to recommend the Legislature approve the sale to Tesoro.
- Prior to finalizing the RIK contract, the Legislature must pass a bill ratifying the contract with Tesoro (HB 373; SB 205).

Royalty Board’s Decision Criteria

AS 38.06.070(a) states that the Alaska Royalty Oil and Gas Development Advisory Board must consider:

1. The revenue needs and projected fiscal condition of the state;
2. The existence and extent of present and projected local and regional needs for oil and gas products;
3. The desirability of localized capital investment, increased payroll, secondary development and other possible effects of the sale;
4. The projected social impacts of the transaction; and
5. The projected additional costs and responsibilities which could be imposed upon the state and affected political subdivisions by development related to the transactions.

Royalty Board's Decision Criteria Cont.

AS 38.06.070(a) states that the Alaska Royalty Oil and Gas Development Advisory Board must consider:

6. The existence of specific local or regional labor or consumption markets or both which should be met by the transaction;
7. The projected positive or negative environmental effects related to the transactions; and
8. The projected effects of the proposed transaction upon existing private commercial enterprise and patters of investment.

Tesoro RIK Contract Terms

- 5 year contract for 20,000 to 25,000 barrels per day.
- The RIK sales price uses a netback formula and provides higher revenue to State compared to RIV.
- If Tesoro nominates zero barrels for 3 consecutive months, the contract terminates.
- Security: Tesoro shall provide a letter of opinion from a financial analyst or a stand-by letter of credit equal in value to 90 days of ANS royalty oil (if rating falls below BBB- and Baa3).
- In-state processing: Tesoro to use “commercially reasonable efforts” to manufacture refined products from the ANS royalty oil.
- Employment of Alaska residents: no discrimination against AK companies and residents.

RIK Contract Price

ANS Spot Price - $1.95 – Tariff Allowance +/- Quality Bank Adjustments – Line Loss

- ANS Spot Price = Average US West Coast Price for Alaska North Slope oil (reported by industry trade publications Platts and Reuters)
- $1.95 RIK Differential
  - Destination value minus marine costs so RIK $\geq$ RIV.
- Tariff Allowance = TAPS and Pipelines upstream of PS-1.
- Quality Bank Adjustments = as reported by TAPS Quality Bank Administrator.
- Line Loss (loss of volume between PS1 and the VMT).

Contract is in the State's Best Interest

- DNR estimates the State will receive **$45 to $56 million** in additional revenue over taking RIV.
- Producers deduct around $3.30 to $3.70 from the west coast value as a "transportation deduction" in arriving at the price for RIV.
- The proposed Tesoro contract will deduct only $1.95 as a "location differential" from the west coast ANS value.
- The proposed sale provides crude to Tesoro's refinery at Nikiski with associated economic and social benefits to Alaska's economy:
  - Tesoro employs approximately 210 Alaskans
  - Tesoro produces 59,000 bpd refined products at its Nikiski refinery
  - Tesoro refinery's estimated contribution to the local economy is $127mm

Additional Royalty Oil Sales

- Additional royalty oil volumes are available for the other in-state refiner, Petro Star; helping maintain a competitive in-state refining industry.
- DNR is currently negotiating sales with Petro Star of remaining royalty oil under similar contractual terms.
- The proposed Tesoro contract and forthcoming Petro Star contract will allow for additional sale oil nominations to maximize royalty oil sales if the State has more royalty oil than is currently forecasted.