**Report to the Alaska Legislature**
**from the**
**Alaska Royalty Oil and Gas Development Advisory Board**
**March 15, 2016**

According to AS 38.06.070(c), the Alaska Royalty Oil and Gas Development Advisory Board ("Royalty Board") "…shall make a full report to the legislature on each criterion specified in (a) or (b) of this section for any disposition of royalty oil or gas that requires legislative approval. The board's report shall be submitted for legislative review at the time a bill for legislative approval of a proposed disposition of royalty oil or gas is introduced in the legislature." This document is the Royalty Board's report regarding the sale by the Department of Natural Resources to sell up to 25,000 barrels per day of royalty oil to the Tesoro Refining & Marketing Company LLC under a proposed contract titled, "Agreement for the Sale of Royalty Oil between and among the State of Alaska, and Tesoro Corporation, a Delaware Corporation and Tesoro Refining & Marketing Company LLC, a Delaware Limited Liability Company" ("Proposed Contract").

The Royalty Board reviewed the Preliminary Best Interest Finding and Determination for the Sale of Alaska North Slope Oil to Tesoro Refining & Marketing Company LLC ("Preliminary Finding and Determination") submitted to the Royalty Board by the Department of Natural Resources ("DNR") via email on February 4, 2016 and provided in hard copy to the Royalty Board members at the public hearing, and considered a list of amendments to be made to the Preliminary Finding and Determination necessary to convert that document into the Final Best Interest Finding and Determination for the Sale of Alaska North Slope Oil to Tesoro Refining & Marketing Company LLC.

AS 38.06.070(a) and (b) lists several criteria that the Royalty Board must consider when making a recommendation to the legislature for the sale of royalty oil. Below each criterion is listed in boldface type followed by the Royalty Board's findings. The data and information below draws extensively from DNR's Preliminary and Final Finding and Determination.

**AS 38.06.070(a)(1) the revenue needs and projected fiscal condition of the state**

The State's projected fiscal condition is dire, and based on current DOR forecasts oil and gas revenues are expected to remain below 2015 levels. In this projected scenario, the State will continue to draw funds from the Constitutional Budget Reserve Fund (CBRF), which will likely be exhausted over the next few years. The sale of royalty oil under the Proposed Contract is projected to generate between $45 million and $57 million in State revenue. The Proposed Contract can be expected to yield revenues that are greater than what would have been realized had the State's royalty been left in value. While the incremental revenue generated through the proposed sale are small compared to projected budget deficits, the proposed sale will improve the State's revenue picture.

**AS 38.06.070(a)(2) the existence and extent of present and projected local and regional needs for oil and gas products and by-products, the effect of state or federal commodity allocation requirements which might be applicable to those products and by-products, and the priorities among competing needs**

The proposed sale of royalty oil will help ensure continued in-state processing with its potential price and labor market benefits. Products from in-state refiners supply a substantial proportion of the state's needs for refined petroleum products. It should be noted that the declining production on the North Slope with resulting decline in available for sale RIK oil restricts DNR's ability to satisfy demand by all potential in-state RIK buyers. The majority of the end-use products refined at the Tesoro's facility will be consumed by the Alaska market. Nearly all of the jet fuel produced will be transported via pipeline to Anchorage, with the majority of Anchorage-bound jet fuel consumed at Ted Stevens Anchorage International Airport. Tesoro will supply ultra-low sulfur diesel and gasoline to both Southcentral and Interior markets, with product transported to the Interior via the road system.

The absence of the in-state refining capacity provided by Tesoro would also have direct, indirect, and induced labor market impacts in Alaska. Tesoro currently employs 210 Alaskans in high paying positions, positions that would not exist without the presence of the refinery.

**AS 38.06.070(a)(13) the desirability of localized capital investment, increased payroll, secondary development and other possible effects of the sale, exchange, or other disposition of oil and gas or both**

The Proposed Contract will, in and of itself, require no additional capital investment, induce no change in payroll, yield no secondary development and have few other consequences. During negotiations, Tesoro indicated that the North Slope royalty oil delivered by the State would be used in a status-quo fashion. Royalty oil will replace private sources of feedstock to run the operations at the Nikiski refinery. If the State's RIK is used in such a fashion, there will be little incremental capital investment, payroll, secondary development, or other effects.

**AS 38.06.070(a)(4) the projected social impacts of the transaction**

Beyond the direct revenue impact, the Proposed Contract is unlikely to have any incremental social impact. The royalty oil sold under the Proposed Contract is unlikely to materially impact refinery operations. As such, no long-run population redistribution, change in the utilization of social services, or other social impacts are expected.

**AS 38.06.070(a)(5) the projected additional costs and responsibilities which could be imposed upon the state and affected political subdivisions by development related to the transaction**

The proposed sale, in and of itself, is expected to generate negligible additional cost or responsibilities for the State or the Kenai Peninsula Borough. The State's royalty oil is expected to simply displace crude secured from the private market. The proposed sale is unlikely to materially impact the operations of the Nikiski refinery. However, as was discussed above, when the State sells its RIK it faces counterparty risk. While the State has a long and successful history selling its royalty oil to Tesoro, there exists a non-zero probability that Tesoro could, for a host of reasons, fail to fulfill its obligations under the Proposed Contract. Such a failure could expose the State to financial loss. The Proposed Contract recognizes this risk and mitigated it through a security arrangement that may require Tesoro to post a stand-by letter of credit whose value is equal to the expected value of ninety days of royalty oil.

**AS 38.06.070(a)(6) the existence of specific local or regional labor or consumption markets or both which should be met by the transaction**

The Proposed Contract is unlikely to induce substantial new hiring. However, refinery operations support multiple local labor and consumption markets. The refinery directly employs 210 Alaskans, and 20 to 30 contracts at the Nikiski refinery. Tesoro also generates labor demand and satisfies the need of multiple local consumption and labor markets through its 31 company-owned Tesoro 2Go retail outlets, 44 Tesoro-branded stations, and 4 USA Gasoline stations. The refined product from Nikiski also supplies the Anchorage International Airport, and other in-state refiners.

With respect to consumption markets, it should be recognized that demand for refined product is quite seasonal. The proposed sale preserves a valuable volumetric option. By exercising this option, Tesoro may align their crude inventory with seasonal fluctuations in demand for refined product. Such an alignment may be of use in meeting seasonal fluctuations in consumption demand in an economically optimal fashion.

**AS 38.06.070(a)(7) the projected positive and negative environmental effects related to the transaction**

The projected environmental effects of the sale, insofar as the sale will maintain the status quo, will be negligible. However, in the absence of the current locally produced refined products, there could be increased environmental impacts associated with the transportation of imported petroleum products and the substitution of wood generated heat for relatively clean-burning petroleum home heating fuel.

**AS 38.06.070(a)(8) the projected effects of the proposed transaction upon existing private commercial enterprise and patterns of investments**

The Proposed Contract is unlikely to demonstrably impact the operations at the Nikiski refinery. As has been mentioned before, the crude supplied under the proposed sale will likely simply displace crude from the private market. As such, the Proposed Agreement is expected to have very little impact on existing private commercial enterprise and patterns of investment. However, the continued operation of the Nikiski refinery will allow Tesoro to continue to supply its customers, including Ted Steven International Airport and regional wholesale and retail markets. The continued operation of the Nikiski refinery will sustain the demand that Tesoro generates among its vendors and servicers.

In addition to the above criteria, the Royalty Board also verified that conditions of AS 38.06.070(b) had been achieved through the Proposed Contract. AS 38.06.070(b) says, “When it is economically feasible and in the public interest, the board may recommend to the commissioner of natural resources, as a condition of the sale of oil or gas obtained by the state as royalty, that

**(1) the oil or gas be refined or processed in the state;**

Article IV in the Proposed Contract has an explicit provision that “Buyer agrees to use commercially reasonable efforts to process the Sale Oil at its refinery in North Pole, Alaska.”

**(2) the purchaser be a refiner who supplies products to the Alaska market with price or supply benefits to state citizens; or (3) the purchaser construct a processing or refining facility in the state.**

The Tesoro Nikiski refinery has been in continuous operation since 1969 and has provided a slate of refined products for Alaska residential and commercial customers. Royalty oil has been an important supply of feedstock from the very beginning. First, royalty oil was supplied from State leases in the Cook Inlet through 1984 and then from State leases the North Slope through 1997. From 1997 to 2013, Tesoro has relied on private suppliers but had an RIK sales contract in place from 2014 till January, 2016. The Proposed Contract will provide Tesoro with royalty oil supplies for a term of five years from August 1, 2016 to July 31, 2021.