Report to the Alaska Legislature
from the
Alaska Royalty Oil and Gas Development Advisory Board
August 31, 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." The Alaska Department of Natural Resources ("DNR") is proposing the sale of royalty oil in-kind to Petro Star Inc. under two contracts for a combined period of five years. The first contract will start delivery of royalty oil on January 1, 2017 and end on December 31, 2017. The second contract will have a term of four years, beginning on January 1, 2018 and ending on December 31, 2021. Alaska Statute 38.06.055(b) allows the commissioner to enter into a sale of royalty oil without the prior approval of the Alaska Legislature if the sale is for one year or less and is entered into to relieve market conditions. Contracts longer than one year require recommendation of the Royalty Board and legislative approval. Upon issuance of the Final Best Interest Finding, DNR intends to execute the first contract. Upon the recommendation of the Royalty Board, DNR anticipates that the Governor will propose a bill to the legislature seeking approval for the second contract. This document is the Royalty Board's report regarding the sale of North Slope royalty oil by DNR to Petro Star Inc. ("Petro Star") under the proposed four-year contract titled "Agreement for the Sale of Royalty Oil between and among the State of Alaska, and Petro Star Inc., and Arctic Slope Regional Corporation" ("Proposed Contract").

The Royalty Board reviewed the Preliminary Best Interest Finding and Determination for the Sale of Alaska North Slope Oil to Petro Star ("Preliminary Finding and Determination") submitted to the Royalty Board by the DNR by mail on July 28, 2016 and provided in electronic form at the Division of Oil and Gas website. Additionally, DNR received no comments from the members of the public regarding this proposed sale. In this way, the Royalty Board's review and recommendation are inputs that DNR uses to convert the Preliminary Finding and Determination into the Final Best Interest Finding and Determination for the Sale of Alaska North Slope Oil to Petro Star.

Alaska Statute 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 from DNR's Preliminary Finding and Determination.

A potentially deleterious precedent and risk identified by the Royalty Board concerned Article VI of the proposed contracts; particularly whether a letter of credit or surety bond equal in value to 50 days of royalty oil is sufficient to mitigate the risk to the State of Alaska if the buyer defaulted on its obligation to pay for the royalty oil delivered to, and nominated on behalf of, Petro Star. After discussion, the Royalty Board concluded that the benefits of the proposed contracts outweigh these risks and that they do not present a precedent that locks the State into this security arrangement in future contracts.

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

The State's projected fiscal condition has deteriorated with respect to previous projections. Based on the latest forecasts from the Alaska Department of Revenue (DOR), oil and gas revenues are expected to remain below 2016 levels and may be even lower than previous forecasts. DNR projects that the sale of North Slope royalty oil under the Proposed Contract will generate between $22 million and $27 million in revenue to the State that is in addition to what would have been obtained had these quantities of royalty oil been taken in value. While the incremental revenue generated through the sale of royalty in the Proposed Contract is small compared to the projected budget deficit in the next fiscal year, the proposed sale will undoubtedly 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 the continued in-state processing of crude oil into refined products with its potential price and labor market benefits. Even though the declining crude oil production on the North Slope entails a reduction in the available royalty oil that could be taken in-kind, DNR attempts to satisfy, at least, part of the demand by all potential in-state royalty in-kind (RIK) buyers because the in-state refineries supply a substantial proportion of the state's needs for refined petroleum products. It should be noted that the majority of the end-use products refined at the North Pole and Valdez refineries, which are operated by Petro Star, will be consumed by the Alaska market. In a typical year, roughly 33 percent of the refined product produced by Petro Star will be ultra-low and low sulfur diesel, approximately 56 percent will be jet fuel, and the remainder will consist primarily of home heating fuel. Petro Star supplies jet fuel to both military and civilian customers, with the majority of the civilian jet fuel being consumed at Ted Stevens Anchorage International Airport. Petro Star also supplies between 50 percent and 60 percent of the home heating fuel that is sold in the Alaska Interior, and supplies the Golden Valley Electric Association plant with naphtha for use as local power generation. Additionally, Petro Star began construction of an asphalt plant at its North Pole refinery in October 2015 to provide a local source of asphalt for road construction and repair in the Alaska Interior.

AS 38.06.070(a)(3) 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 the negotiations, Petro Star indicated that the North Slope royalty oil to be delivered by the State under the Proposed Contract would be used in a status-quo fashion. Royalty oil will replace private sources of feedstock to run the operations at the North Pole and Valdez refineries. If the State's RIK is used in such a fashion, there will hardly be any significant 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 costs or responsibilities for the State, the Fairbanks North Star Borough, or the Valdez-Cordova census area. 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 North Pole or Valdez refineries. However, when the State sells its RIK, it faces counterparty risk. There exists a possibility that the RIK buyer could, for a host of reasons, fail to fulfill its obligations under the Proposed Contracts. Such a failure could expose the State to financial loss. The Proposed Contract recognizes this risk and mitigates it through a security arrangement that may require the Petro Star to provide either a letter of opinion from a financial analyst approved by the State or an annually renewed, continuously maintained stand-by letter of credit or surety bond equal to the expected value of fifty 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 any substantial new hiring given that the royalty oil would be likely used to substitute private sources of North Slope oil to Petro Star. As of 2014, the Petro Star refineries directly employed 44 Alaskans. Petro Star also generates labor demand and satisfies the need of multiple local consumption and labor markets through its North Pacific Fuel and Sourdough Fuel subsidiaries dedicated to operate gas stations, convenience stores throughout Alaska, provide the marine industry with petroleum products and dockside services, distribute heating oil and diesel, and provide supplies of jet fuel to military facilities throughout Alaska.

With respect to consumption markets, it should be recognized that demand for refined products is quite seasonal. The proposed sale preserves a valuable volumetric option. By exercising this option, Petro Star 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 North Pole and Valdez refineries. As has been mentioned before, the crude supplied under the proposed sale will likely simply displace crude from the private sources of Alaska North Slope (ANS) crude. As such, the proposed agreements are expected to have very little impact on existing private commercial enterprise and patterns of investment. The continued operation of the North Pole and Valdez refineries will allow Petro Star to continue to supply its customers, including the Ted Stevens International Airport and regional wholesale and retail markets. The continued operation of those refineries will sustain the demand that Petro Star generates among its vendors and services. In addition to the above criteria, the Royalty Board also considered that the intent of AS 38.06.070(b) had been achieved through the Proposed Contract. Alaska Statute 38.06.070(b) provides:

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

Article IV, "In-State Processing," in the Proposed Contract has an explicit provision that "Buyer agrees to use commercially reasonable efforts to process the Sale Oil at its refineries in Valdez and 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

The North Pole refinery was built in 1985, and the Valdez refinery was completed in 1993. They have provided a slate of refined products for Alaska residential and commercial customers. Royalty oil has been an important supply of feedstock to the Petro Star refineries. The State sold North Slope royalty oil to Petro Star's North Pole refinery from December 1986 through December 1991. In total, the State supplied Petro Star's North Pole refinery with just over three million barrels of North Slope royalty oil under that five-year contract. From that year until now, Petro Star has relied on private suppliers of ANS. The Proposed Contract will provide Petro Star with royalty oil supplies for a four-year term from January 1, 2018 to December 31, 2021, and a one-year contract will provide royalty oil from January 1, 2017 to December 31, 2017.

(3) the purchaser construct a processing or refining facility in the state

Since the delivery of North Slope royalty oil will likely replace private sources of ANS crude oil, the proposed sale is not conditioned on the requirement that the RIK buyer construct a processing or refining facility in the state.