Report to the Alaska Legislature
from the
Alaska Royalty Oil and Gas Development Advisory Board
March 15, 2022

Pursuant 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 in-kind ("RIK") oil to Petro Star Inc. ("Petro Star") under a contract for a period of five years. Delivery of royalty oil will start on January 1, 2023 and end on December 31, 2027. Pursuant to Alaska Statutes ("AS") 38.06.050 and 38.06.055, before entering into a contract for the sale of royalty oil, the DNR Commissioner must obtain review of the proposed sale by the Royalty Board and approval of the legislature. Limited exceptions to this rule are set forth in AS 38.05.055(b) but do not apply in this instance. Upon the recommendation of the Royalty Board, DNR anticipates that the Governor will propose a bill to the legislature seeking approval for this contract. This document is the Royalty Board's report regarding the sale of North Slope royalty oil by DNR to Petro Star under the proposed five-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 Inc. ("Preliminary Finding and Determination") made available to the Royalty Board by the DNR via a link to the Division of Oil and Gas website and by email on January 31, 2022. Additionally, in accordance with 11 AAC 03.020(c)(2), DNR established a thirty-day public comment period that ended on March 2, 2022. 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.

AS 38.06.070(a)-(b) lists the 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 draw from DNR's Preliminary Finding and Determination.

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

Royalties and taxes related to the oil and gas sector (i.e., petroleum revenue) have historically been an important source of revenue to the State of Alaska from its role as resource owner and taxing authority. The contribution of petroleum revenue of total unrestricted general fund revenue held steady in the 60-90% range between fiscal years 2012 and 2018. This changed in 2019 with legislation which created a Percent of Market Value ("POMV") framework for using a portion of the earnings of the Alaska Permanent Fund to support government operations with deposits to the unrestricted general fund. With this change, the contribution of petroleum revenue of total unrestricted general fund revenue has decreased to the 20-30% range between fiscal years 2019 and 2021.

The fiscal condition of the State has changed drastically in the last year with the infusion of federal funds primarily due to COVID relief and now the recent oil price increases. The Spring 2022 forecast projects petroleum revenue to provide between 29% and 53% of unrestricted revenue over the next 10 years. The forecast also projects budget surpluses every year for the next 10 years based on the Governor's proposed fiscal year 2023 budget. DNR projects that the sale of North Slope royalty oil under the Proposed Contract will generate between $17 million and $19 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. This proposed sale will add to the improved State revenue outlook.

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 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 most 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. Currently, approximately 65% of the refined product produced by Petro Star is jet fuel and the remaining output is ultra-low sulfur diesel, asphalt, and heating oil. Petro Star supplies jet fuel to both military and civilian customers, with most of the civilian jet fuel being consumed at Ted Stevens Anchorage International Airport. Petro Star does not produce gasoline. Jet fuel refined at the Petro Star North Pole refinery is transported to Anchorage via the Alaska Railroad while the fuel produced at the Petro Star Valdez refinery is delivered to Anchorage via barge. Most of Petro Star's refined products are consumed in Alaska. Petro Star will occasionally evaluate contract opportunities to sell fuel to Canada and the Pacific Northwest. Although Petro Star does not audit where all its sold products are ultimately consumed, it estimates that 99% of the products were consumed in Alaska in 2021.

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 it would use the North Slope royalty oil delivered by the State under the Proposed Contract 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 royalty oil in-kind, 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 Contract. 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 Petro Star to provide either: (1) a letter of opinion from a financial analyst approved by the State in conjunction with a parental guaranty, or (2) an annually renewed, continuously maintained stand-by letter of credit or surety bond equal to the expected value of 50 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 likely be used as a substitute for private sources of North Slope oil to Petro Star. The Petro Star refineries directly employ more than 80 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 operating 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 its 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. The continued operation of those refineries will sustain the demand that Petro Star generates among its vendors and services.

Additional considerations.

A. AS 38.06.070(b)

In addition to the above criteria, the Royalty Board also found that the intent of AS 38.06.070(b) is achieved through the Proposed Contract. AS 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**
>
> **(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 began to sell North Slope royalty oil to Petro Star in December 1986 through December 1991 and then since 2017. In total, the State supplied Petro Star's North Pole refinery with just over 27 million barrels of North Slope royalty oil. During this time, Petro Star has also relied on private suppliers of ANS. The Proposed Contract will provide Petro Star with royalty oil supplies for a five-year term from January 1, 2023 to December 31, 2027.

> **(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.

B. Recent volatility in the crude oil market

The Royalty Board also inquired about the recent volatility in the crude oil market with respect to higher prices for the commodity and potential supply constraints and whether this could impact the value received from the Proposed Contract. The DNR staff responded to this inquiry by saying that the Proposed Contract is designed to reflect the market determination of the price of ANS oil at the U.S. West Coast by considering the daily assessments and using the monthly average for the purpose of arriving at the price of royalty oil in the North Slope. In principle, the valuation of a barrel of royalty oil in-value follows the same process. In this way, a higher price of crude oil would equally affect the pricing of RIK and RIV oil. Additionally, a higher price of crude oil could translate into higher total revenue for the royalty oil sold. However, it is possible that, over the medium or long term, the RIK buyer (i.e., the refinery) may reduce its demand for crude oil (and royalty oil) if a sustained increase in the price of crude oil leads to a reduction in the quantity demanded of refined products by Alaskans. Thus, the net effects of rising crude oil prices on the proceeds of the contract are uncertain. The Royalty Board considered and accepted the explanation of the DNR staff on this point.

Additionally, the North Pole and Valdez refineries get their crude oil supply from the North Slope fields. If supply constraints arise from foreign sources of crude oil, this is not expected to directly affect the operations of the North Pole and Valdez refineries to the extent that they do not affect North Slope production and the royalty that the State derives from it. Currently, the State expects to have at least 10,000 bpd of royalty oil available in addition to what it is contemplating to deliver under the Proposed Contract. To this end, Article II of the Proposed Contract contains a provision allowing for the nomination of Additional Sale Oil. Should there be interest on purchasing RIK oil from other parties in the future, including export outside of Alaska, DNR believes its current forecast of royalty oil available to take in-kind could accommodate other potential sales provided that the DNR commissioner makes a written determination that a future potential contract for sale of RIK oil is in the best interest of the State.

C. The Royalty Board's 2016 review.

Five years ago, in the Royalty Board's 2016 Report to the Alaska Legislature for the corresponding sale of royalty oil to Petro Star, the Royalty Board took note of Article VI of the Proposed Contract. Article VI required a letter of credit or surety bond equal in value to 50 days' worth of royalty oil; the same requirement exists in the present contract. The Royalty Board in 2016 considered whether the 50 days measurement was sufficient to mitigate the risk to the State of Alaska if the buyer were to default on its obligation to pay for the royalty oil delivered to, and nominated on behalf of, Petro Star. The Royalty Board viewed this value measurement as a "potentially deleterious precedent and risk." The Royalty Board ultimately concluded that the benefits of the proposed contract outweighed the risks. While the 50-day value measurement remains the same in the present contract, DNR believes that the benefits of the proposed contract outweigh these risks. Additionally, future contract negotiations with Petro Star could further mitigate this risk by establishing a more comprehensive coverage of these risks.

Conclusion

For these reasons, the Royalty Board recommends that the Proposed Contract be approved.