

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

March 28, 2016

1:02 p.m.

MEMBERS PRESENT

Representative Benjamin Nageak, Co-Chair
Representative David Talerico, Co-Chair
Representative Bob Herron
Representative Kurt Olson
Representative Paul Seaton
Representative Andy Josephson
Representative Geran Tarr
Representative Mike Chenault (alternate)

MEMBERS ABSENT

Representative Mike Hawker, Vice Chair
Representative Craig Johnson

COMMITTEE CALENDAR

HOUSE BILL NO. 373

"An Act approving and ratifying the sale of royalty oil by the State of Alaska to Tesoro Corporation and Tesoro Refining and Marketing Company LLC; and providing for an effective date."

- MOVED HB 373 OUT OF COMMITTEE

HOUSE BILL NO. 253

"An Act requiring the electronic filing of a tax return or report with the Department of Revenue; establishing a civil penalty for failure to electronically file a return or report; relating to exemptions from the mining license tax; relating to the mining license tax rate; relating to mining license application, renewal, and fees; and providing for an effective date."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 373

SHORT TITLE: APPROVAL OF SALE OF ROYALTY OIL TO TESORO

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

03/23/16 (H) READ THE FIRST TIME - REFERRALS
03/23/16 (H) RES, FIN
03/28/16 (H) RES AT 1:00 PM BARNES 124

BILL: HB 253

SHORT TITLE: ELCTRNC TAX RETURN;MINING LIC. TAX & FEES
SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

01/19/16 (H) READ THE FIRST TIME - REFERRALS
01/19/16 (H) RES, FIN
02/15/16 (H) RES AT 1:00 PM BARNES 124
02/15/16 (H) Heard & Held
02/15/16 (H) MINUTE(RES)
02/17/16 (H) RES AT 1:00 PM BARNES 124
02/17/16 (H) Heard & Held
02/17/16 (H) MINUTE(RES)
02/19/16 (H) RES AT 1:00 PM BARNES 124
02/19/16 (H) Heard & Held
02/19/16 (H) MINUTE(RES)
02/23/16 (H) RES AT 1:00 PM BARNES 124
02/23/16 (H) Heard & Held
02/23/16 (H) MINUTE(RES)
02/24/16 (H) RES AT 8:30 AM BARNES 124
02/24/16 (H) Heard & Held
02/24/16 (H) MINUTE(RES)
03/28/16 (H) RES AT 1:00 PM BARNES 124

WITNESS REGISTER

JAMES SHINE, Special Project Assistant
Office of the Commissioner
Department of Natural Resources (DNR)
Anchorage, Alaska

POSITION STATEMENT: On behalf of the governor, provided a PowerPoint presentation entitled, "Proposed Sale of the State's Royalty Oil to Tesoro: House Bill 373."

CORRI FEIGE, Director
Division of Oil & Gas
Department of Natural Resources (DNR)
Anchorage, Alaska

POSITION STATEMENT: On behalf of the governor, answered questions related to HB 373.

GREG BIDWELL, Commercial Analyst
Commercial Section
Division of Oil and Gas

Department of Natural Resources (DNR)
Anchorage, Alaska

POSITION STATEMENT: Answered questions related to HB 373.

FRED PARADY, Deputy Commissioner
Office of the Commissioner
Department of Commerce, Community & Economic Development (DCCED)
Board Member
Alaska Royalty Oil and Gas Development Advisory Board
Juneau, Alaska

POSITION STATEMENT: Testified in support of HB 373.

MATT GILL, External Affairs Senior Manager
Tesoro Alaska Company
Anchorage, Alaska

POSITION STATEMENT: Testified in support of HB 373.

DAMON VANZANDT, Senior Director
North American Crude Oil Strategy and Trading
Tesoro Petroleum Corporation
San Antonio, Texas

POSITION STATEMENT: Answered questions related to HB 373.

JULIE MORRIS, Staff
Representative David Talerico
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: During the hearing of HB 253, explained the changes made to the bill by the proposed committee substitute, Version N.

JERRY BURNETT, Deputy Commissioner
Office of the Commissioner
Department of Revenue (DOR)
Juneau, Alaska

POSITION STATEMENT: Answered questions related to HB 253.

ACTION NARRATIVE

[1:02:37 PM](#)

CO-CHAIR BENJAMIN NAGEAK called the House Resources Standing Committee meeting to order at 1:02 p.m. Representatives Olson, Josephson, Tarr, Herron, Talerico, and Nageak were present at the call to order. Representatives Chenault (alternate) and Seaton arrived as the meeting was in progress.

HB 373-APPROVAL OF SALE OF ROYALTY OIL TO TESORO

[1:03:07 PM](#)

CO-CHAIR NAGEAK announced that the first order of business is HOUSE BILL NO. 373, "An Act approving and ratifying the sale of royalty oil by the State of Alaska to Tesoro Corporation and Tesoro Refining and Marketing Company LLC; and providing for an effective date."

[1:03:42 PM](#)

JAMES SHINE, Special Project Assistant, Office of the Commissioner, Department of Natural Resources (DNR), said HB 373 would affirm the contract of sale of royalty oil to [Tesoro Corporation and Tesoro Refining and Marketing Company LLC ("Tesoro")]. To review the bill's provisions he provided a PowerPoint presentation entitled, "Proposed Sale of the State's Royalty Oil to Tesoro: House Bill 373."

MR. SHINE displayed slide 2, "Royalty In-Kind versus Royalty In-Value," and explained that the State of Alaska has a choice to receive its royalty share of oil production in-kind (RIK) or in-value (RIV). A presumption in statute is that the state take its royalties in-kind unless it is found in the state's best interest to take it in-value. Conversely, the commissioner also has to make a best interest finding when the state takes royalty in-kind. He advised that when the state does a royalty in-kind process the department must perform a solicitation of interest to gauge market demand. A letter was sent last January to the five companies with in-state refineries: BP Exploration (Alaska) and ConocoPhillips Alaska each have a North Slope topping plant; Petro Star Inc. has refineries in North Pole and Valdez; Tesoro has a refinery in Nikiski; and Flint Hills Resources, even though it ceased operations in June 2014. Two responses, one from Petro Star and one from Tesoro, sought to refine the state's oil within the state. The Tesoro response met the demands of price contained within DNR's solicitation, whereas Petro Star responded affirmatively to purchase royalty oil but proposed a different pricing structure that was not as advantageous to the state. Thus, the department elected to proceed on a non-competitive contract negotiation with Tesoro. Historically since 1979, the state has elected to choose its royalty in-kind, although not all portions of the oil have been taken in-kind. He clarified that since February 1, the state has been taking all of its royalty in-value because the state's

most recent Tesoro contract terminated on January 31, 2016. Up to that point, commencing in 1979, the state has disposed of a significant volume of its royalty oil to Petro Star, Tesoro, Flint Hills, Williams, and other in-state users.

[1:06:38 PM](#)

MR. SHINE turned to slide 3, "Non-Competitive RIK Sale Process." He advised that DNR elected to proceed with Tesoro and started commercial negotiations with Tesoro in February or March 2015. The contract in the committee packet is the culmination of those commercial negotiations. He explained that when the commissioner elects to take the royalty in-kind it is necessary to make a Best Interest Finding (BIF) that what is being done is maximizing the benefits and the value of the state's resources for the citizens of the state. Showing slide 4, "Commissioner's Decision Criteria," he said that under AS 38.05.183(e) the commissioner must consider the cash value offered, the economic benefits, the benefits of refining in-state, meeting in-state demands, as well as the criteria that the Alaska Royalty Oil and Gas Development Advisory Board ("Royalty Board") considers as directed by the legislature in AS 38.06.070.

[1:08:04 PM](#)

MR. SHINE displayed slide 5, "Approval Process for the RIK Sale," and noted that DNR goes through the BIF process outlined in statute on why the royalty in-kind (RIK) election is in the state's best interest. He said this process commenced in January 2015 with a solicitation of interest, and then a lengthy commercial negotiation with the Division of Oil & Gas and Tesoro. The department then presented the proposed contract and a preliminary BIF for public comment in early February 2016 for 30 days, and comments were received only from Petro Star and Arctic Slope Regional Corporation (ASRC). Subsequent to receiving those comments, DNR revised the contract to address the concerns raised in those comment letters. After addressing the concerns the next step was presenting it to the Royalty Board on March 15, 2016. The division's Commercial Section provided the overview of the contract and walked through the process. The Royalty Board voted unanimously to approve the contract and forward its recommendation to the legislature to ratify the contract. Included within the committee's bill packet are a resolution signed by the board members and a report to the legislature on why this proposed contract meets the best interests of the state.

MR. SHINE moved to slides 6-7, "Royalty Board's Decision Criteria," and said the report outlines the reasons why the proposed contract meets the statutory criteria that the Royalty Board considers in its deliberation. The eight criteria are similar to what the DNR commissioner considers in regard to economic and price issues with respect to how they impact the state.

[1:10:16 PM](#)

MR. SHINE reviewed slide 8, "Tesoro RIK Contract Terms." He advised that the goal of the proposed five-year contract that is before the committee is to commence deliveries on August 1, 2016. The state would sell to Tesoro between 20,000 and 25,000 barrels per day over the course of the contract. There are some safeguards and other provisions within this contract, one of which is if Tesoro nominates zero barrels over the course of three months, the contract terminates. Some of these provisions are customary for what has been done in the past with RIK contracts. For example, in 2013 the legislature ratified a contract with Flint Hills. When Flint Hills terminated its operations in spring 2014, the state's RIK contract ceased to exist after that point. The state has provided security - if Tesoro's credit rating falls below a certain level it then has to provide a Letter of Opinion from a financial analyst or a Letter of Credit equal to the value of 90 days' worth of Alaska North Slope (ANS) oil. The purpose of that security provision is essentially if the state is delivering oil and for some reason someone goes out of business, then the state at least has the Letter of Credit that provides the state some security that it is not going to be providing oil and not receiving any compensation. This has not happened to date but is still something that is included in the state's contracts.

MR. SHINE pointed to two other provisions in the contract. In-state processing is a consideration that the commissioner makes in issuing the Solicitation of Interest for meeting in-state demand. Therefore, the contract provides that Tesoro use commercially reasonable efforts to use the refined products of ANS royalty within the state. Over the last two years, Tesoro has been purchasing royalty oil from the state and has refined them in its Nikiski facility. The department has been told that nothing is changing with respect to this contract, that these barrels are intended to be refined within the state as well.

[1:12:38 PM](#)

REPRESENTATIVE SEATON, with regard to the 90 days of ANS royalty oil on slide 8, inquired as to whether that is looking forward or the situation where if there was a bankruptcy the bankruptcy court could go back 90 days before and ask for those being preferential payments and therefore claw them back.

MR. SHINE understood the 90-day value of ANS royalty is if the purchaser falls below a certain credit rating; then the purchaser would be required, per this contract, to provide the value of 90 days of ANS crude. He said he assumes that that would be 90 days' value of ANS crude as it currently exists at that time, not at today's dollars. In the event this happened in 2019 or 2020, the [contract] would look at the value of the crude at that point and require that 90-day payment.

REPRESENTATIVE SEATON said his point was not that current dollar value. He asked whether that is looking backwards so that 90 days before that date, payments that were made to the state would not be subject to recapture from a bankruptcy court, or is it going forward from that date so Tesoro would have to post that so it has money on file for oil that would be being purchased from that point on where it would have to post a Letter of Opinion.

MR. SHINE replied he does not have an understanding of how it works in a bankruptcy proceeding. He said this particular term is intended to address a situation in which under the contract the state is selling and Tesoro is purchasing oil on a daily basis. If Tesoro's credit rating fell below a certain threshold, at that point the state would require a 90-day payment, essentially a bond payment, to backstop any potential shortfall the state would experience through a non-payment. He reiterated that the state has never had to implement this provision but it is a safeguard the state includes in its RIK contracts to ensure that should a purchaser not meet a certain credit threshold that the state does have some protection for the purpose of the royalty barrels that have already occurred.

[1:15:28 PM](#)

MR. SHINE returned to his presentation, addressing the last bullet point on slide 8 with respect to employment of Alaska residents. He explained that while the state cannot require Alaska hire in the contract it does encourage Alaska hire.

MR. SHINE turned to slide 9, "RIK Contract Price," and advised that the valuation methodology for RIK takes the ANS spot price,

which is essentially the monthly average of the daily average of the two reporting agencies Platts and Reuters, and then nets back from that point to get the RIK price. The \$1.95 is the actual RIK differential deducted from the spot price, and the other deductions or adjustments from that point onward are the same ones that would be seen in an RIV valuation, which includes the tariff allowance for transportation in the Trans-Alaska Pipeline System (TAPS), Quality Bank adjustments per any direction from the Quality Bank administrator, as well as any subtraction in line loss from Pump Station 1 to the Valdez Marine Terminal (VMT). He noted that the biggest differential between RIK and RIV would be with respect to the RIK location differential as it relates to what would be experienced in an RIV world, which is a marine transportation deduction. Currently, the marine transportation deduction on average is about \$3.50 per barrel. The delta between the \$3.50 deduction from a barrel of RIV to the \$1.95 deduction for RIK is where the state will see the most benefit in this contract over the status quo of RIV. Based on predictions, the department estimates that the delta between RIV and RIK will bring the state approximately \$45 million to \$56 million more than it would have realized if it had taken these barrels in-value over the course of this contract. So, approximately \$10 million per year more will be realized as a result of this contract.

[1:17:37 PM](#)

MR. SHINE explained that slide 10, "Contract is in the State's Best Interest," goes into more detail about the location differential and transportation deduction. Criteria the Royalty Board and the commissioner considers are the economic and social benefits to the economy. Tesoro employs 210 Alaskans, provides \$127 million in benefits to the local economy, and refines approximately 59,000 barrels per day at Tesoro's Nikiski refinery. Eighty percent of each barrel that is produced at the refinery is put back into the local economy through jet fuel, home heating fuel, and ultra-low sulfur diesel (ULSD) fuel.

MR. SHINE said slide 11, "Additional Royalty Oil Sales," outlines another provision that DNR added to the contract with Tesoro. The department is also including this provision in the contracts it is currently negotiating with Petro Star. This provision is that if the state has additional volumes of royalty oil available that are not under contract, there is a nomination period 100 days prior to a purchaser taking possession of those barrels where the state would offer those additional barrels on an equal basis to the two in-state refiners to purchase so that

the state maximizes the value of its resources and also provides more royalty oil to the local refining industry.

[1:19:21 PM](#)

REPRESENTATIVE SEATON referred to slide 9 and asked whether the line loss, the loss of volume between Pump Station 1 and the Valdez Marine Terminal, is mainly from temperature.

MR. SHINE replied that it is a formulaic multiplier intended to represent loss due to temperature and processing. He deferred to the Division of Oil & Gas to answer the question further.

CORRI FEIGE, Director, Division of Oil & Gas, Department of Natural Resources (DNR), deferred to Greg Bidwell of the Commercial Section. She said he was involved in the calculation and contract drafting and would be able to speak to line loss estimations specifically.

GREG BIDWELL, Commercial Analyst, Commercial Section, Division of Oil and Gas, Department of Natural Resources (DNR), responded that the definition of line loss that was provided is fine. It is a measurement error as well and is something that has been part of the TAPS tariff since inception, so it has been there as part of the item for paying royalties and value in-kind.

REPRESENTATIVE SEATON asked whether there is a loss in getting to the Valdez Marine Terminal from processing and, if so, what is the processing. He further asked whether there are other types of loss, or a calculation of an assumed percentage of loss, or a temperature volume consideration that is adjusted.

MR. BIDWELL answered that he thinks it is primarily temperature and measurement rather than processing. He explained that the first four pump stations run off of natural gas from the North Slope and the rest of the pump stations use diesel, but not diesel from the oil itself. There is not any processing, it just temperature measurement oriented differences that are applied through the system.

[1:22:58 PM](#)

REPRESENTATIVE JOSEPHSON observed that the Arctic Slope Regional Corporation's (ASRC's) letter of March 7, 2016, argues that there should have been proportional proration. He requested the department to speak to this.

MR. SHINE responded that that is correct. With respect to the original contract presented to the public in early February, Petro Star and ASRC raised two primary concerns. The first concern was the proration preference granted to Tesoro through the course of commercial negotiations, and that has since been removed. He explained that the department typically, when it is selling royalty, if there is for instance a service interruption or seasonal maintenance work that happens and there is a reduction in royalty volumes available to meet the state's contractual demands or contractual obligations, then all RIK purchases will be prorated down proportionate to their percentage of purchasing of the state's royalty oil. Through the course of negotiations, Tesoro reduced its maximum nomination volume to make more room, so to speak, for Petro Star's ability to purchase royalty oil from the state. In exchange for that the state granted the proration preference, but after public comments and internal deliberation the department decided to strike that term from the contract. So, there is no longer a proration preference, it went back to the status quo in which if there is any proration required it comes down proportionate to each purchaser. There is no preference for any RIK purchasers at this time. The second concern raised by Petro Star and ASRC with respect to the draft contract was the term of the contract. The proposed contract that went out for public comment had a five-year initial term with the option to extend for five years among consent of the state and Tesoro. That extension has since been struck from the contract. Thus, the contract before the committee has a five-year term, no extensions, and no proration preference.

[1:25:29 PM](#)

REPRESENTATIVE SEATON returned to slide 9 and the \$1.95 RIK differential comparison to the \$3.50 marine transport for RIV. He inquired whether that means the \$1.95 is basically marine transport between Valdez and Tesoro's terminal. He further inquired whether that also applies then to the other buyers and whether they have the same \$1.95 in their term whether they do marine transport or not.

MR. SHINE answered that the \$1.95 RIK differential is meant to represent the selling of crude within Alaska, not marine transportation per se. He said he is unsure of Tesoro's actual cost to ship between the Valdez Marine Terminal and its Nikiski refinery. Regarding the second question, he said this absolutely applies to Petro Star; these are the same RIK prices on which the state is currently negotiating contracts with Petro

Star, which is meant to represent the cost of selling a barrel of oil in the state, exclusive of marine transportation.

1:26:58 PM

REPRESENTATIVE TARR referred to the overall use of RIV or RIK, and noted the transmittal refers to the remaining volume being available for Petro Star. She recalled that in 2013 the state signed a contract with Flint Hills and asked whether that is still in place as far as the overall distribution.

MR. SHINE answered no, that contract is terminated since Flint Hills has ceased operating. The legislature ratified that contract in 2013 and the volumes were 18,000-30,000 barrels per day over the course of five years. When Flint Hills ceased operating in June 2014 that contract terminated. Currently, the state does not have any RIK barrels under contract and is taking everything in value. There have been a couple periods in the course of history starting in 1979 that this has occurred, but primarily the state sells its available volumes in RIK, which is what is before the committee.

REPRESENTATIVE TARR surmised that when talking about the total volume available, it would be between these two at this time.

MR. SHINE replied that the Commercial Section has reviewed the production forecast and current production levels and estimated that the state has approximately 50,000-52,000 barrels of royalty oil currently available. With current production forecasts and only considering current production that is on line today without considering potential new projects, that decline curve over the course of this contract will come down to approximately 36,000-38,000 barrels per day. Therefore, the 20,000-25,000 barrels the state is selling to Tesoro today represents approximately 55-60 percent of the state's overall royalty volume available for purchase. Over the course of the next five years, that percentage will increase as production forecasts continue to fall.

1:29:15 PM

REPRESENTATIVE OLSON asked what the current Quality Bank adjustment is under this contract.

MR. SHINE responded he does not know what the actual adjustment is in dollar figures right now because that is something that happens through the Quality Bank administrator. Those

adjustments are considered in this contract through the department's evaluation process that takes into account what comes from the Quality Bank administrator for Quality Bank adjustments, whether they are up or down.

REPRESENTATIVE OLSON therefore surmised that if he wanted to compare it to what it was for Flint Hills, it would not be something the committee could receive today.

MR. SHINE answered he does not have that figure at his fingertips right now, but said he does not imagine that it would be much different than under the Flint Hills contract of 2013. It is the same provision that was allowed for in the last contract, but the Quality Bank administration is something that happens exclusive to how the department operates.

1:30:23 PM

REPRESENTATIVE OLSON understood the adjustment was originally for companies like Flint Hills that were putting a waste product into the pipeline. Given Tesoro is not doing that he questioned how they could be similar.

MR. SHINE replied that Representative Olson is correct. Flint Hills and Petro Star take their main fee stock for their refining off of TAPS and then refine it and then have to reinject the residual or the heavy ends of the barrel. They do pay a Quality Bank penalty for putting that lower quality oil back in and it gets co-mingled among the other streams that are not taken out and refined. So, they are subject to a different Quality Bank adjustment than, for instance, would be Tesoro as an end-stream user at the Valdez Marine Terminal. Tesoro, just because of its location, would not necessarily be paying the same kind of penalty as Petro Star's North Pole facility or Flint Hills' former facility.

REPRESENTATIVE OLSON remarked that what he is getting at is how they could almost be the same, in that one is flushing the toilet and the other is the mixing zone.

MR. SHINE allowed he misspoke in not considering the location between the two refineries. What he meant to allude to was that the Quality Bank adjustment is not something the state controls, it is determined by the Quality Bank Administer. He explained that when he is comparing RIV versus RIK, the barrels that get to the Valdez Marine Terminal are purchased by Tesoro or sent to the West Coast on the state's behalf by the producers in an RIV

situation. The netback formula for both of those situations will include a Quality Bank adjustment that will be the same.

1:32:27 PM

REPRESENTATIVE CHENAULT, regarding Mr. Shine's statement that the Quality Bank adjustment will be the same, posited that Flint Hills would pay more for the Quality Bank end and Tesoro could actually see a credit, because the quality of the crude oil is less at the Valdez Marine Terminal than at Pump Station 1. So, for any draw, he said, Flint Hills or Petro Star would have to pay more for the Quality Bank versus Tesoro at the other end of the line.

MR. SHINE responded that that is his understanding as well.

1:33:30 PM

CO-CHAIR NAGEAK opened public testimony on HB 373.

FRED PARADY, Deputy Commissioner, Office of the Commissioner, Department of Commerce, Community & Economic Development (DCCED); Board Member, Alaska Royalty Oil and Gas Development Advisory Board, noted that in addition to his position as deputy commissioner of DCCED, he is the designee to the Royalty Board. He related that the Royalty Board carefully considered this contract and made appropriate revisions to it during its board meeting and the board supports the recommendation that is before the committee. He pointed out that the declining volumes in throughput through TAPS are resulting in declining royalty barrels for in-kind purposes in this proposed contract and said "the amendments that were worked to it takes care of both our in-state refining facilities."

1:35:03 PM

MATT GILL, External Affairs Senior Manager, Tesoro Alaska Company, testified in support of HB 373. He paraphrased from his March 18, 2016, letter to the House Resources Standing Committee, which reads as follows [original punctuation provided]:

I am writing to you in support for House Bill 373 "An Act approving and ratifying the sale of royalty oil by the State of Alaska to Tesoro Corporation and Tesoro Refining and Marketing Company LLC; and providing for an effective date."

Tesoro Corporation is a Fortune 100 company and is an independent refiner and marketer of petroleum products. Tesoro's refining operations started Alaska with the purchase of the Kenai refinery back in 1969.

Our Kenai refinery has the operational capacity to produce up to 72,000 barrels per day and is primarily focused on Jet and Diesel production followed by gasoline and gasoline blendstocks, heating oil and heavy fuel oils, propane and asphalt. We operate a 68-mile, common-carrier products pipeline that transports jet fuel, gasoline and diesel fuel to the Port of Anchorage and the Anchorage International Airport. The wholesale delivery of our products occurs through our terminals in Kenai, Anchorage, our Nikiski dock and the Port of Anchorage.

In addition to being the largest taxpayer in the Kenai Peninsula Borough, Tesoro is also able to provide around 225 family wage jobs at the refinery, along with about 30 full-time contractors that are working in and around the refinery year round. We provide retail fuels at our company-owned Tesoro 2-Go retail outlets as well as at numerous branded and unbranded outlets. We employ operators who work at our terminals in the Port of Anchorage and in Nikiski.

We are a major supporter of the Cook Inlet Regional Citizens Advisory Council (CIRCAC) and the largest member of the Cook Inlet Spill Prevention & Response team (CISPRI).

We actively support a wide range of local events and programs - from employee fundraising for the United Way to youth sports programs. Each year we sponsor all of the 5th and 6th grade classes on the Kenai Peninsula to conduct a mission at the Kenai Challenger Learning Center and we are the Signature Sponsor of "Caring for the Kenai" program.

Tesoro strongly urges you to support House Bill 373, "An Act approving and ratifying the sale of royalty oil by the State of Alaska to Tesoro Corporation and Tesoro Refining and Marketing Company LLC; and providing for an effective date."

This legislation is the result of constructive dialog and productive negotiations between the Department of Natural Resources and the Tesoro Corporation. By all accounts, our company was very impressed with the State's ability to understand our issues and arrive at a mutually beneficial agreement that is truly a win-win for both parties as well as accommodating to the other refineries in the State.

For the State, the DNR estimates that it will continue to receive a price for its Royalty-in-Kind oil that exceeds the price it would have receive if it elected to keep its Royalty Oil in Value.

For Tesoro, this five year contract will provide us with a stable supply of ANS crude while also giving us the volumetric flexibility to help accommodate seasonal fluctuations in demand for refined products. The availability, flexibility and stability that this contract offers will have a positive impact on our ability to maintain our ongoing operations at our Kenai refinery.

In order to accommodate the needs of the other in-state refiners, Tesoro and the State modified this contract to reduce volumes as well as eliminate a proration clause and a five year extension option.

Tesoro believes in Alaska's future and is committed to being an active corporate citizen. We look forward to continuing to provide Alaskans with clean burning fuels to keep your homes warm and your cars, boats and snow machines traveling across this great state.

I urge you to support House Bill 373.

[1:39:14 PM](#)

REPRESENTATIVE SEATON inquired whether the calculation of the sales price is a daily or monthly value.

MR. GILL deferred to Damon VanZandt to answer the question.

DAMON VANZANDT, Senior Director, North American Crude Oil Strategy and Trading, Tesoro Petroleum Corporation, offered his belief that the contract references two pricing sources, Platts and Reuters, and they publish a price for the Alaska North Slope

(ANS) crude which is actually a West Coast (WC) delivered price. That is a daily assessment, they produce a high and low price and the contract takes the average of those highs and lows for one day, and then takes a monthly average where it computes the average daily price for the entire month of delivery. That establishes the monthly average price that Tesoro pays.

MR. VANZANDT addressed an earlier question regarding how the marine transportation discount of \$1.95 was arrived at. He pointed out that that price is a U.S. West Coast delivered price, so it is a price that represents cargos of ANS that trade down into California and the Pacific Northwest. That \$1.95 marine discount represents the marine transportation to those delivery destinations from Valdez. So, taking the \$1.95 off arrives back at the Valdez price.

1:41:20 PM

REPRESENTATIVE SEATON appreciated that the price is averaged monthly. He understood that \$3.50 is the average transportation charge between Valdez and West Coast port, and asked whether the \$1.95 is related to transportation from Valdez to Nikiski.

MR. VANZANDT offered his belief that the \$3.50 is representative of the royalty in-value marine discount, which is the reason the royalty in-kind contract is basically \$1.55 better. "Royalty in-value contracts that you sell, it costs you another \$1.55 to sell those back to the producers," he continued, and actually Tesoro just deducts the \$1.95, which is the same discount that Tesoro and Petro Star take off the ANS published price.

1:42:28 PM

REPRESENTATIVE JOSEPHSON recalled Mr. Shine's testimony that since 1979 there has been the rare occurrence where the state has taken royalty in-value. He asked Mr. Gill's understanding of this gap and whether it is avoidable in the future.

MR. GILL offered his understanding that it became very difficult to buy royalty oil in the past, there were netbacks and the coming back on contracts Tesoro had with additional fees year after year after the fact. That appears to have been alleviated recently. Tesoro engaged two years ago in its first royalty contract in many years, and Tesoro is very satisfied with terms it came up with and extended it for one year and that expired in January. Tesoro has had a great working relationship and the majority of the issues have been ironed out that kept Tesoro

from engaging in royalty oil in the past. Tesoro is happy to be back in business with the state.

MR. SHINE clarified that there has been only a few instances where the state has taken all of its royalty in-value (RIV); the state always takes a certain portion of its royalty in-value, at least 5 percent. In that manner the state is still given market information and netback pricing so the state can ensure it is still receiving better than RIV. He reiterated that the state has been selling royalty in-kind (RIK) since 1979, a portion of the state's overall volume, but that fluctuates depending upon who is purchasing, the actual production, and how many barrels the state has available. With respect to the state's current situation, it was a combination of market factors with Flint Hills. The state had 18,000-30,000 barrels under contract with Flint Hills before it shut down. So when Flint Hills ceased operation in 2014 the state had a one-year contract with Tesoro which was subsequently extended and terminated January 31, 2016. Given the lengthy public process, there was a long lead time involved in these commercial negotiations to get the state to where it is today. The state cannot essentially flip a switch and start selling RIK oil for long-term contracts when things become available, it takes longer than that.

[1:45:04 PM](#)

REPRESENTATIVE TARR, regarding the five-year extension and Mr. Shine's explanation about the amount of lead time, inquired as to how much time that actually will take. She further inquired whether the state will start that process somewhere mid-way through this contract so that the state is not pushed up against any deadline and whether that is how it would naturally occur if the Flint Hills anomaly had not taken place.

MR. SHINE replied correct, the lead time based upon what has been seen in this process is approximately 14 months. The state went out for solicitation in January 2015 and now it is toward the end of March 2016 with the contract before the committee. If Tesoro is interested in purchasing RIK volumes after this five-year contract terminates, that conversation will start in advance of the termination of this contract. At that time the division will go out for an additional public solicitation and gauge market demand to determine which entities are interested in purchasing at whichever volumes the state has available at that time. In an earlier statement he mentioned that the state is currently negotiating a contract with Petro Star and is doing a one-year contract; concurrently the state is negotiating a

four-year contract so that that would commence at the end of the one-year contract. So, both entities will have five-year contracts terminating at approximately the same time in 2021. At that time the state will have a better handle on production forecasts and which royalty volumes the state has available to sell to the market. If all goes well, the committee will have a Petro Star contract before it next spring.

REPRESENTATIVE TARR understood that the shorter term contracts can be done without the same kind of legislative approval and surmised this is why the legislature was not so closely involved in what took place during the gap with Flint Hills and Tesoro.

MR. SHINE responded correct. Under AS 38.06.055, a contract of less than 365 days does not require legislative ratification, and contracts of one year or longer require legislative ratification. To meet Petro Star's near-term demands, and for the state to deliver royalty barrels to Petro Star in 2016, the state is now seeking to do a short-term, less than one year, contract while currently negotiating a new four-year contract that would extend past when the one-year contract terminates.

[1:47:59 PM](#)

REPRESENTATIVE OLSON noted the cheapest Tesoro gas on the Kenai Peninsula is about one-half mile from the refinery. He asked whether it is being trucked out from Anchorage or being trucked over from the refinery.

MR. GILL offered his belief that it is being trucked over from the refinery.

REPRESENTATIVE OLSON remarked that there has been a lot of speculation on that.

MR. GILL said he has heard a lot of stories.

[1:48:26 PM](#)

REPRESENTATIVE TARR understood that the in-state use of Tesoro's refined products is predominantly jet fuel and not retail fuels. She inquired about the numbers for the in-state products.

MR. GILL replied that pretty much all of Tesoro's gasoline and all of its jet diesel is consumed in the state. When Flint Hills shut down the demand for gasoline picked up and Tesoro was able to fill that. About the only thing that goes out [of

state] is the bottom one-third of the barrel, the heavy bottoms that Tesoro cannot do anything with because of how the refinery is configured. So, it has to be stored and a home found for it somewhere down south.

[1:49:21 PM](#)

REPRESENTATIVE OLSON asked whether there is another federal mandate coming down on production, like the ultra-low sulfur diesel mandate that came down a few years ago.

MR. GILL offered his belief that Tier 3 gasoline standards will go into effect this year. It is volumetric and requires extra hydro treating of the gasoline to pull out additional sulfur, and Tesoro is prepared to meet those standards.

[1:49:58 PM](#)

REPRESENTATIVE JOSEPHSON recalled that this issue has come up with the cruising industry and that the cruising industry has highlighted the impact on its market and prices.

MR. GILL answered that that is different, it is heavy bunker fuel and what is allowed to be used in the ships. He understood that ships within three miles [of the coast] must use cleaner burning fuels, which are more expensive. That is what is driving some of the cargo companies to switch over to liquefied natural gas (LNG), he posited.

CO-CHAIR NAGEAK closed public testimony after ascertaining that no one wished to testify.

[1:51:01 PM](#)

REPRESENTATIVE TARR said she is pleased that the committee has something before it, because it appears the RIK will bring in roughly \$50 million more in value, which is good news.

REPRESENTATIVE OLSON commented that this is probably the most non-controversial bill the committee has had all session.

REPRESENTATIVE HERRON remarked it is the most unamended bill.

[1:51:56 PM](#)

CO-CHAIR TALERICO moved to report HB 373 out of committee with individual recommendations and the accompanying fiscal notes.

There being no objection, HB 373 was reported from the House Resources Standing Committee.

[1:52:32 PM](#)

The committee took an at-ease from 1:52 p.m. to 2:01 p.m.

HB 253-ELCTRNC TAX RETURN;MINING LIC. TAX & FEES

[2:01:05 PM](#)

CO-CHAIR TALERICO announced that the final order of business is HOUSE BILL NO. 253, "An Act requiring the electronic filing of a tax return or report with the Department of Revenue; establishing a civil penalty for failure to electronically file a return or report; relating to exemptions from the mining license tax; relating to the mining license tax rate; relating to mining license application, renewal, and fees; and providing for an effective date."

CO-CHAIR NAGEAK moved to adopt the proposed committee substitute for HB 253, Version 29-GH2924\N, Nauman, 3/17/16, as the working document.

REPRESENTATIVE HERRON objected for discussion.

[2:01:50 PM](#)

JULIE MORRIS, Staff, Representative David Talerico, Alaska State Legislature, reviewed the changes that would be made to the original bill by the proposed committee substitute (CS). Under Version N: Section 1 is deleted, thereby eliminating the penalty if a taxpayer fails to electronically submit a return; Section 2 is deleted, thereby eliminating the requirement that taxpayer returns be submitted electronically; Section 3 is amended to leave a three year exemption rather than a three and one-half year exemption; Section 4 is amended by changing the 9 to 8 of the excess net income over \$100,000; Section 5 is not changed; Section 6 is not changed; Section 7 repeals the deletion to the exemption as related to the bill for the period of exemption in Section 3; Section 8 is amended to reflect the exemption being retained; Section 9 is deleted because the period of exemption from tax is retained; and Sections 10, 11, and 12 are not changed and provide for transition language and effective dates.

[2:03:20 PM](#)

REPRESENTATIVE SEATON pointed out that his sectional only goes through Section 8.

MS. MORRIS offered to read the sectional that she has.

REPRESENTATIVE TARR noted that the actual bill of Version N only goes to Section 8.

MS. MORRIS explained that she put the actual bill into the sectional analysis, the changes are meant to reflect what happened. The sectional analysis is for Version N.

REPRESENTATIVE CHENAULT asked what version the committee is on.

MS. MORRIS responded that the committee is on the sectional analysis for Version N.

REPRESENTATIVE CHENAULT observed that Version A [the original bill], goes to Section 12 and Version N only goes to Section 8.

MS. MORRIS answered correct.

REPRESENTATIVE TARR noted Sections 9, 10, and 11 were deleted.

MS. MORRIS replied correct.

CO-CHAIR TALERICO pointed out that there are only eight sections in Version N.

[2:05:37 PM](#)

REPRESENTATIVE SEATON referred to Version N, page 2, lines 17-18, Applicability, and asked whether [AS 43.65.010(a)] only applies to those that begin production on or after that date and therefore if a mining operation was in operation before that it would not ever have to get a mining license.

MS. MORRIS responded that the uncodified law in Section 5 would add an applicability to that section that relates to the exemption period under [AS 43.65.101(a)]; [AS 43.65.010(c)] would be applicable to the net income of the taxpayer from the property in the state during the taxable year that begins on or after the effective date in Section 2.

REPRESENTATIVE SEATON referred to subsection (b) [page 2, lines 19-21], and agreed that it begins on or after the effective

date, which is every taxable year. He asked whether the applicability of "section (a)" applies only to the three and one-half years or does it apply to the mining license requirement, which is "section (a)."

CO-CHAIR TALERICO requested Mr. Jerry Burnett to answer the question.

JERRY BURNETT, Deputy Commissioner, Office of the Commissioner, Department of Revenue (DOR), stated DOR is reading this as being clear that the intent of Section 5 is to apply to the three and one-half year tax holiday on new production, which is changed to a three year holiday [in Version N], and the license applies to each year thereafter. He advised the department will review this carefully given DOR just saw it this morning.

[2:09:13 PM](#)

REPRESENTATIVE TARR posited it is an issue because Version N removes the three and one-half year exemption from the original bill and so it makes that section just about having to obtain a mining license. In Version N that section is about both obtaining a license and the three year exemption. She suggested that it be split into two sections to make it clear that every mining operation would have to obtain a license versus how long of an exemption period there would be for taxes. Otherwise, as questioned by Representative Seaton, it sounds like a mining operation would not have to get a mining license unless it was on or after the effective date and therefore there are two separate things in that one section.

MR. BURNETT answered that AS 43.65.010(c) is the second applicability, which is the new license fee every year. He reiterated that the department will have its attorneys look at this carefully before the next meeting, but in talking with the sponsor's staff this morning it is clear what the intent is.

REPRESENTATIVE JOSEPHSON stated he has concerns about the timing and impact, but surmised that Section 8 would make Section 5 applicable July 1, 2016. The question is whether it is existing mines or the license requirement is for future licensees, but that the effective date appears to be July 1, 2016.

MR. BURNETT replied yes, that is what it says.

[2:11:24 PM](#)

REPRESENTATIVE TARR inquired about any fiscal note changes between the original bill and Version N. She recalled that the fiscal note for the original bill was about \$6 million. She asked whether there are any estimates on the change from the 9 in the original bill to the 8 in Version N.

MR. BURNETT responded that in fiscal year (FY) 2018, since this would not be collected until a year after it starts, it looks like approximately \$3.6 million and then \$3.2 million, so it is about one-half of what it was, because it is now a 1 percent change instead of a 2 percent change. It varies based on DOR's current commodity price estimates and production estimates between \$2.8 million and \$3.6 million per year over the life of the fiscal note. The department will provide a new fiscal note at the next meeting as it was difficult to prepare a new fiscal note given the CS was only received this morning.

[2:12:42 PM](#)

REPRESENTATIVE JOSEPHSON understood that when the Donlin Gold Mine becomes operational it will become the largest gold mine in the world. He said he is still looking for comfort that when the gold is removed and severed from Alaska that Alaskans are getting their fair share. He asked how he should go about figuring this out.

MR. BURNETT recounted that DOR earlier provided the committee with a number of documents about comparative tax rates for Canada and states in the U.S. He agreed it is a dilemma to figure out because each mine is clearly unique, and obviously the governor felt that the 9 percent rate was appropriate. Donlin Gold Mine is the largest gold mine, Red Dog Mine is certainly one of the largest zinc mines anywhere, and Greens Creek Mine is the largest silver producing mine in North America. The discussion here is not about small mines but about large amounts of minerals being taken from the state.

[2:14:21 PM](#)

REPRESENTATIVE HERRON removed his objection to adopt Version N. There being no further objection, Version N was before the committee as its working document.

[2:15:14 PM](#)

REPRESENTATIVE TARR observed that Version N would remove the requirement for electronic submission. She posited that this

requirement did not seem troublesome for large-sized companies. She recalled that the state previously spent a large amount of money upgrading and implementing DOR's database to get everything in one place and understand it better. She asked what the reasoning was for removing this requirement. She related she does understand possibly delaying a penalty until a new program has been implemented and people given an opportunity to participate, but that [removing the electronic submission requirement] does not seem to be moving in the direction that the department wanted to go.

MS. MORRIS explained this provision was taken out of the bill at the recommendation of Legislative Legal and Research Services, because Sections 1 and 2 apply to any tax return or report to be submitted under AS 32, not just returns for mining taxes. However, the bill only amends filing requirements related to mining taxes and there are several other sections of the tax law that should be changed to accommodate the new electronic filing requirements. So, Legislative Legal and Research Services has advised that a separate bill is needed to address that issue. She offered to provide the legal memorandum to the committee.

REPRESENTATIVE OLSON asked whether a separate bill is forthcoming.

[Response to question unclear on audio.]

CO-CHAIR TALERICO advised that all members will receive a copy of the legal memorandum.

CO-CHAIR TALERICO held over HB 253.

[2:17:55 PM](#)

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 2:18 p.m.