

"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."

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."

Co-Chair MacKinnon discussed housekeeping.

9:07:01 AM

JIM SHINE, SPECIAL PROJECT ASSISTANT, OFFICE OF THE COMMISSIONER, DEPARTMENT OF NATURAL RESOURCES, discussed SB 205, and HB 373, which were identical bills that would ratify the contract that had been negotiated between the department and Tesoro for the sale of royalty oil.

9:08:07 AM

Mr. Shine discussed the presentation, "Proposed Sale of the State's Royalty Oil to Tesoro: SB 205/HB 373." (copy on file). He showed Slide 2, "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.

Mr. Shine noted that come of the contract negotiations dated back to 1979.

9:09:13 AM

Mr. Shine displayed Slide 3, "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.

Mr. Shine elaborated that British Petroleum and ConocoPhillips had topping plants on the North Slope for infield use, letters had also been sent to Flint Hills, Tesoro, and Petro Star. Response had been weak, which led to the determination to enter the contract with Tesoro.

[9:10:46 AM](#)

Mr. Shine discussed Slide 4, "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

[9:11:14 AM](#)

Mr. Shine spoke to Slide 5, "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).

9:12:22 AM

Mr. Shine showed Slide 6, "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.

9:13:08 AM

Mr. Shine discussed Slide 7, "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 patterns of investment.

Mr. Shine stated that after consideration of the criteria a report had been prepared that discussed the criteria and recommended approval, as well as a resolution that recommended the ratification of the contract (copy on file).

[9:13:38 AM](#)

Mr. Shine turned to Slide 8, "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.

[9:14:35 AM](#)

Senator Dunleavy understood that if the contract were terminated the state would revert back to RIV.

Mr. Shine answered in the affirmative.

[9:14:59 AM](#)

Mr. Shine continued discussing Slide 8:

- 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.

[9:16:02 AM](#)

Mr. Shine discussed Slide 9, "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 > 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).

[9:16:57 AM](#)

Mr. Shine spoke to Slide 10, "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:
 - o Tesoro employs approximately 210 Alaskans
 - o Tesoro produces 59,000 bpd refined products at its Nikiski refinery
 - o Tesoro refinery's estimated contribution to the local economy is \$127mm

[9:19:12 AM](#)

Mr. Shine displayed Slide 11, "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.

Mr. Shine confirmed that the provision had been added after the public comment period; the issues that had been raised were the length of the contract and the pro-rated preference that had been provided to Tesoro through commercial negotiations. He said that the pro-rated preference meant that if the state had a number of royalty purchasers, and less volumes available than the contractual obligation called for, companies would be prorated down according to their percentage of royalty purchase. He stated that in 2015, during the course of the negotiations, Petro Star had approached the department and had indicated a willingness to purchase on established price terms; in an effort to make more volumes available for Petro Star to purchase, Tesoro reduced their maximum volumes from 30,000 to 25,000/ barrels per day. He furthered that in exchange, the state had provided a pro-ration preference, which would have allowed them to be the last purchaser of royalties to be prorated in the event that the sale occurred. He said that after internal discussions the provision had been struck from the contract, leaving the status quo to remain.

[9:21:40 AM](#)

Co-Chair MacKinnon asked whether a Petro Star contract would necessitate a separate piece of legislation.

Mr. Shine answered in the affirmative. He explained that there were two separate contracts under discussion with Petro Star that would give the company 5 years of royalty purchases: a 1-year contract that would commence in middle to late August of 2016, and a 4-year contract that would commence after the 1-year terminated. Both the Petro Star and the Tesoro contracts would terminate in 2021.

[9:22:38 AM](#)

Senator Bishop asked about the \$45 million to \$55 million increase over the life of the project under the 5 year

contract. He understood that the number was the differential on the marine shipping between the RIK and the RIV.

Mr. Shine stated that was correct.

[9:23:12 AM](#)

Senator Dunleavy asked how extreme price differentials would impact the agreement.

Mr. Shine stated that the price differentials would bring more money to the state because the barrels would be valued higher, but the actual methodology would not change. He said that if the value of oil went up to \$100/bbl., the deductions would be taken from that value.

[9:24:07 AM](#)

Senator Dunleavy asked whether changes in the per barrel valuation adjustments could make the RIK equal to RIV at the same prices.

Mr. Shine was not aware of all the ramifications of the price changes, but detailed that the current contract had been negotiated to give the department the confidence that the contract would bring more for RIK than would have been received in RIV.

[9:25:20 AM](#)

Senator Hoffman asked whether the state knew the intended market that Tesoro had for the product under the contract.

Mr. Shine noted that Tesoro produced a significant amount of jet fuel, which was shipped via a common carrier pipeline to the Anchorage Airport; additionally, diesel and gasoline were sold to in-state markets.

[9:25:56 AM](#)

Senator Bishop commented that the five-year contract was the result of the amount of production on the North Slope.

Mr. Shine stated that the state had been selling royalty oil for several years. He added that; historically, the state had enjoyed the ability to have longer term contracts

because there had been more throughput in taps and more volumes available for sale. He said that when the 2013 contract was negotiated with Flint Hills, there had been some concern with having a long-term contract based on set-volumes and the state's inability to predict the future. He said that the production forecast and declines that the contract was based on was only for current production and did not incorporate projects that had yet to come online.

[9:27:45 AM](#)

Vice-Chair Micciche asked if the committee had a chance to review the document, "Final Best Interest Finding and Determination for the Sale of Alaska North Slope Royalty Oil to Tesoro Refining & Marketing Company, LLC, Division of Oil and Gas Alaska Department of Natural Resources March 17, 2016" (copy on file). He thought that it would be very difficult for RIV to bring more value to the state than RIK. He referred to the chart on Page 11 of the document, which showed the marine transportation costs, which he believed were unlikely to dramatically shift downward. He read the statement at the top of Page 5:

....the State sold approximately 95.14 million barrels of royalty oil in-kind under three different contracts: the Flint Hills Resources RIK contract from April 2004 to March 2014 (FHR 2004); the Flint Hills Resources RIK contract from April 2014 to May 2014 (FHR 2014); and the current Tesoro RIK contract from February 2014 to January 2016 (Tesoro 2014). The sale of those 95.14 million barrels in-kind generated about \$106.11 million of additional revenue to the State, which would not have been realized had this volume of royalty oil been taken in value.

Mr. Shine concurred. He noted that Page 11 reflected that marine transportation costs would increase over the next 5 years.

[9:29:10 AM](#)

Co-Chair MacKinnon asked how many barrels of royalty oil were available.

Mr. Shine thought the state had 52 to 55 thousand barrels per day, but considering the production decline, he thought

that it could be as low as 36 to 38 thousand barrels per day by 2021.

Co-Chair MacKinnon asked whether there was a formula used by the state to determine using the RIK versus the RIV.

Mr. Shine explained that when the state used RIK, it did not nominate more than 95 percent of the available volume. He said that by maintaining and selling some of the oil in-value, market indicators could help determined actual costs and insure that RIK prices met, or exceeded, RIK in future negotiations.

[9:30:57 AM](#)

Vice-Chair Micciche referred to the table on page 3 of the best interest finding document. He believed that the state was losing value by not increasing the amount of RIK oil. He wondered whether there was any way to increase the proportion of RIK volumes.

Mr. Shine reiterated that the state was currently negotiating contracts with Petro Star, which when used in combination with the Tesoro contract, would be approximately 95 percent of the available royalty volumes. He added that in an effort to increase and maximize the value of royalty oil for the state, the department would be nominating and selling up to 95 percent of the available volumes, over the next 5 years.

[9:32:22 AM](#)

Co-Chair MacKinnon OPENED public testimony for SB 205 and HB 373.

[9:33:15 AM](#)

MATT GILL, EXTERNAL AFFAIRS SENIOR MANAGER, TESORO ALASKA, urged the committee to support the legislation. He offered a background of the Tesoro Corporation. He shared that the company's refinery in Kenai had the operational capacity of up to 72,000 barrels per day of primarily jet and diesel production followed by gasoline and gasoline bland stocks, heating oil and heavy fuel oils, and propane and asphalt. He shared that the corporation operated a 68 mile, common carrier products pipeline, which transported jet fuel, gasoline, and diesel fuel to the Port of Anchorage and the

Anchorage International Airport. He stated that the wholesale delivery of products occurred through terminals in Kenai, Anchorage, Nikiski, and the Port of Anchorage. He relayed that in addition to being the largest tax payer in the Kenai Peninsula Borough, the corporation provided 225, family wage, in-state jobs at the refinery and terminals. He added that there were 30, full-time contractors working in and around the refinery year-round. He expounded on the many positive ways that the corporation impacted the state socially and economically. He relayed that the legislation was the product of over a year of dialogue and productive negotiations between the Department of Natural Resources (DNR) and Tesoro. He expressed appreciation with the state's ability to understand the corporation's issues and arrive at a mutually beneficial agreement that was a "win - win" for both parties. He added that DNR estimated that the state would continue to receive a price for its RIK oil that exceeded the price for RIV. He related that the estimated additional value to the state was between \$45 and \$56 million for the span of the contract. The five year contract would provide Tesoro with a stable supply of ANS crude, which giving the volumetric flexibility to help accommodate seasonal fluctuations in demand for refined products. He furthered that the availability, flexibility, and stability offered by the contract would have a positive impact on Tesoro's ability to maintain ongoing operations at the Nikiski refinery. He stated that in order to accommodate the needs of other in-state refiners, the contract had been modified to reduce the volumes, and eliminate a pro-ration clause and a 5 year extension period. He offered that Tesoro believed in the future of Alaska and was committed to being an active corporate citizen.

[9:37:20 AM](#)

Senator Hoffman referred to his previous question regarding Tesoro markets in the state.

Mr. Gill detailed that the refined jet fuel went primarily to the Anchorage International Airport, gasoline went into the Interior markets; Tesoro products generally fed Anchorage, up to Fairbanks, and along the highway system. He said that the communities in Southeast and Western Alaska were serviced by other imports from other companies.

[9:38:14 AM](#)

Co-Chair MacKinnon CLOSED public testimony.

[9:38:46 AM](#)

AT EASE

[9:39:32 AM](#)

RECONVENED

Co-Chair MacKinnon discussed the fiscal note. She referenced the second page of the note:

There will be an indeterminate increase in revenues; the increase is indeterminate due to the uncertainty in predicting the price of ANS crude.

Co-Chair MacKinnon wondered which forecast had been used when determining the potential economic benefit to the state.

Mr. Shine explained that the \$45 to \$56 million had been meant to represent the difference between the RIV marine transportation of \$3.50 per barrel, and the \$1.95 location differential in an RIK contract, over the life of the contract on 20 to 25 thousand barrels per day of oil. He said that the numbers reflected the volumes being sold, with the approximate \$1.50 delta between RIK and RIV, exclusive of the price of ANS.

[9:42:00 AM](#)

Vice-Chair Micciche wondered whether the fiscal note could reflect a more defensible and conservative number.

Mr. Shine stated that the amount on the fiscal note had been determined by DNR.

[9:42:33 AM](#)

Co-Chair MacKinnon commented that the committee was working to pass only the barest of fiscal notes out of committee. She thought that the indeterminate note did not reflect the positive position that the state would be in with the approval of the contract.

Mr. Shine added that there would be no negative fiscal impact, and the indeterminate note was not an effort to reflect any increases in cost to the department. He

stressed that if the committee wanted a positive fiscal note he was eager to have the conversation.

[9:43:58 AM](#)

Vice-Chair Micciche reiterated that the numbers could be conservatively estimated. He thought that indeterminate was less accurate than just using the lowest estimates.

Co-Chair MacKinnon said that the committee would work with Legislative Finance Division to determine historical reflections of the numbers, and whether something positive could be put forward.

[9:44:53 AM](#)

AT EASE

[9:45:13 AM](#)

RECONVENED

SB 205 was HEARD and HELD in committee for further consideration.

SB 373 was HEARD and HELD in committee for further consideration.

Co-Chair MacKinnon discussed housekeeping.

#

ADJOURNMENT

[9:46:07 AM](#)

The meeting was adjourned at 9:46 a.m.