

SENATE FINANCE COMMITTEE

April 5, 2022

1:02 p.m.

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CALL TO ORDER

Co-Chair Bishop called the Senate Finance Committee meeting to order at 1:02 p.m.

MEMBERS PRESENT

Senator Click Bishop, Co-Chair  
Senator Bert Stedman, Co-Chair  
Senator Lyman Hoffman  
Senator Donny Olson  
Senator Natasha von Imhof  
Senator Bill Wielechowski  
Senator David Wilson

MEMBERS ABSENT

None

ALSO PRESENT

Jhonny Meza, Commercial Analyst, Division of Oil and Gas, Department of Natural Resources.

PRESENT VIA TELECONFERENCE

Adi Chaobal, Commercial Analyst, Division of Oil and Gas, Department of Natural Resources; Chalinda Weerasinghe, Commercial Analyst, Division of Oil and Gas, Department of Natural Resources; Doug Chapados, President, Petro Star; Casey Sullivan, Government and Public Affairs Manager, Marathon Petroleum.

SUMMARY

SB 239 APPROVE PETRO STAR INC. ROYALTY OIL SALE

SB 239 was HEARD and HELD in committee for further consideration.

SB 240 APPROVE MARATHON PETRO ROYALTY OIL SALE

SB 240 was HEARD and HELD in committee for further consideration.

#sb239

#sb240

SENATE BILL NO. 239

"An Act approving and ratifying the sale of royalty oil by the State of Alaska to Petro Star Inc.; and providing for an effective date."

SENATE BILL NO. 240

"An Act approving and ratifying the sale of royalty oil by the State of Alaska to Marathon Petroleum Supply and Trading Company LLC; and providing for an effective date."

1:02:31 PM

Co-Chair Bishop relayed that it was the first hearing for SB 239 and SB 240. The committee would hear a bill introduction and a presentation.

1:03:47 PM

JHONNY MEZA, COMMERCIAL ANALYST, DIVISION OF OIL AND GAS, DEPARTMENT OF NATURAL RESOURCES, explained that the department had prepared a presentation summarizing the royalty in-kind contracts for the sale of royalty oil from the North Slope to in-state refineries Marathon and Petro Star. He noted that there had been close to an 8-month period that the department had carefully followed the language of the regulations and statutes governing the sale of royalty oil from the North Slope. Following the regulatory and statutory requirements, the department maintained the process open to the public, and also allowed for public comment through publication of a preliminary best-interest finding.

Mr. Meza discussed the presentation "The Process for the Sale of ANS Royalty Oil In-Kind and the Proposed Contractors with Marathon and Petro Star - SB 239 and SB 240," (copy on file).

Mr. Meza showed slide 2, "CONTRACT TERMS FOR MARATHON and PETRO STAR."

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Mr. Meza turned to slide 3, "CONTRACT TERMS FOR MARATHON AND PETRO STARb- OVERVIEW OF RECENT AND PROPOSED RIK CONTRACT TERMS," which showed a table listing the two currently proposed contracts at the bottom: Marathon for 2022 and Petro Star for 2022, and also the most recent contracts the state had entered since 2016. The second column showed duration of the contracts, with the most recent being for three and five years. He explained that the duration of the contracts was important because statutory language determined that for every long-term contract that the Department of Natural Resources (DNR) entered for the sale of royalty oil, it must look for the approval of the legislature before the commissioner can execute the contracts. He noted that there was an exception if the contracts lasted one year and were entered for the purpose of relieving storage or market conditions, which is what DNR did for the one-year contracts seen on the table.

Senator Wielechowski thought it looked as though the Tesoro royalty in-kind (RIK) contract expired the previous July and wondered where Tesoro was getting its oil currently.

Mr. Meza stated that the best interest findings published by DNR detailed how much oil the Kenai refinery obtained from the North Slope and Cook Inlet combined, which he thought was about 80 percent. He thought the remaining 20 percent of the oil was obtained from foreign sources and the Lower 48.

Senator Wielechowski asked if there was a reason Tesoro did not use 100 percent of its oil from Alaska. He asked if Mr. Meza knew the source of the foreign oil.

Mr. Meza detailed that the department, when offering its royalty oil, published a solicitation of interest in order to gauge the refineries demand for royalty oil. He noted that Alaska's oil was subject to competitive forces, and the refineries compared prices from different sources including foreign sources of crude. He thought the refinery sporadically obtained the foreign sources of crude rather

than on a long-term basis. He did not know the specific regions from which the foreign oil was obtained.

Co-Chair Bishop understood that the state did not know the source of the foreign oil and whether it was from offshore from the United States or other countries.

Mr. Meza relayed that the department had not asked for the information.

Senator Wielechowski asked if any of the oil was from Russia.

Mr. Meza did not know.

Co-Chair Bishop stated that the committee would find out.

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Mr. Meza continued to discuss slide 3. He pointed out that the third column showed royalty barrels that were for sale throughout the contracts, and observed that some of the older contracts had sold about 20,000 to 25,000 barrels per day, which had been declining and may be a reflection on the particular demand for royalty oil. The currently proposed contracts were for the sale 10,000 to 15,000 barrels per day for Marathon; and for Petro Star 12,500 barrels per day for the first three years, and between 10,000 and 12,500 barrels per day for the remaining three years.

Mr. Meza continued to address slide 3. He directed attention to the column that showed the way that DNR and the royalty oil buyers had agreed in determining the value of royalty oil in kind at the field. He continued that DNR sold the royalty oil at the field and explained that the valuation process needed to be done in a more transparent way. He discussed deductions and adjustments and mentioned the RIK differential. He described a "net back" methodology and noted that the price of oil was determined on the U.S. West Coast, and it was how both parties had agreed to arrive at the value of the oil. He noted that the final column gave information on the RIK differential. He noted that the contracts for 2016 were at \$1.95/bbl, which had increased to \$2.23/bbl for Marathon and \$2.25 for Petro Star.

Mr. Meza spoke to slide 4, "CONTRACT TERMS FOR MARATHON AND PETRO STAR - RIK DIFFERENTIAL IS THE SOURCE OF THE PREMIUM OF RIK OVER RIV," which showed two flow charts providing a graphical comparison of how the value of royalty oil was determined, whether the state chose to value the oil in-value or when it selected the oil to be in-kind. He highlighted that the left side of the slide showed royalty in-value. He noted that most of the Alaska North Slope (ANS) oil was sold on the U.S. West Coast. He discussed the state taking a share of the proceeds from lessees, after assessing the oil at the field and deduction of transportation casts and adjustments for differing quality. He made note of the numbers presented as an illustrative example.

Mr. Meza continued to address slide 4 and the graphic on the right which showed how the state priced royalty oil in-kind. There was a similar net-back methodology, but the oil was no longer physically transported to the U.S. West Coast. In substitution for the marine transportation allowance, DNR used the RIK differential. The example showed all elements were at the same value save for the RIK differential. He made note of the numbers presented in the example.

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Senator Wielechowski considered slide 3 and thought the total the state was putting out for RIK was between 20,000 to 30,000 barrels per day. He was curious about the total amount of barrels available.

Mr. Meza relayed that the total royalty that DNR expected to obtain from ANS production was a range between 40,000 barrels per day and 70,000 barrels per day. He reminded that the number was dependent upon the production forecast and different royalty rates in the leases.

Senator Wielechowski asked if there was a public bidding process for RIK oil.

Mr. Meza explained that DNR published a solicitation of interest, and mentioned that the statutory language stated that the default for the RIK oil sales should be on a competitive basis. He detailed that in the solicitation of interest the department invited responses by market

participants in royalty oil. In the current iteration there were only two interested responses.

Senator Wielechowski asked if Marathon and Petro Star were the only two companies that had requested a bid, and if the amount of oil requested was listed on the slide.

Mr. Meza relayed that the initial requirements had varied slightly. Through the negotiation process, DNR was able to obtain higher volume of sales of royalty oil for one of the buyers.

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Senator Wielechowski thought the state had anywhere from 20,000 to 40,000 additional barrels that would be sold down the pipeline.

Mr. Meza agreed, unless the state submitted a solicitation of interest for a second time.

Senator Wielechowski assumed that the amounts shown would be maximum amount of oil that would be needed by Marathon and Petro Star.

Mr. Meza stated that the amounts were the maximum that the companies would need from the state.

Senator Wielechowski asked if Tesoro was getting a better deal from producers directly to replace the oil it got from the state.

Mr. Meza explained that the Kenai refinery was operated by Marathon, which obtained 80 percent of its crude oil needs from a combination of ANS producers and Cook Inlet producers, private producers, including the royalty oil from the state.

Co-Chair Bishop thought that the committee could inquire directly to Marathon through invited testimony.

Mr. Meza addressed slide 5, "CONTRACT TERMS FOR MARATHON AND PETRO STAR - RIK DIFFERENTIAL IS THE SOURCE OF THE PREMIUM OF RIK OVER RIV":

- There is a consistent difference between the marine transportation allowance and the negotiated values of the RIK differential.
- Why, for the proposed RIK contracts, is the RIK differential higher?
  - When the in-state refineries buy ANS oil from North Slope producers, they use a similar netback methodology for arriving at the price of ANS oil at the field.
  - In doing so, they use a "location differential."
  - DOR publishes the weighted average of these location differentials for all contracts for the sale of ANS oil within Alaska.
  - From the perspective of the RIK buyer, the royalty oil in-kind needs to be as competitive as other sources of crude oil from the North Slope.

Mr. Meza explained that the graph on slide 5, entitled "Marine transportation, RIK differential, and location differential," provided historical information on the comparison highlighted on previous slides. The distance between the marine transportation cost (blue line) and the RIK differential (grey line) represented the premium that DNR obtained by selling its royalty oil in-kind versus receiving it in-value. He explained that the dotted line on the graph represented what the Department of Revenue published every year, known as the weighted average differential, which signified a deduction that third parties used when selling ANS oil within the state. At that point in the sale, the oil was not used outside Alaska and transportation deductions were not taken. He noted that the purpose of showing the dotted line in the graph was to have an indication of where the market for ANS oil sales within the state was going. He pointed out the upward trend.

Co-Chair Bishop summarized that Mr. Meza had communicated that regarding the weighted average on the DOR location differential, because of the increased production the state had more RIK oil to offer on the market.

Mr. Meza agreed.

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Senator Wielechowski asked if it would lower the tariff for everyone if there was more oil in the pipeline, which would bring the state more tax revenue. He was curious if the matter had been considered.

Mr. Meza answered "yes." He affirmed that the relationship that Senator Wielechowski highlighted was correct. He affirmed that the more through-put the state had in the Trans-Alaska Pipeline System (TAPS), the per-barrel transportation costs would be lower and the proceeds from the sale of royal oil in-kind would be greater. He noted that DNR focused on total proceeds as well as incremental revenue.

Co-Chair Stedman thought the topic came up every several years. He asked Mr. Meza to highlight the difference between the current proposal for RIK oil currently as compared to previous versions. He wondered if there was anything the legislature should be paying special attention to.

Mr. Meza went back to slide 3 and noted that one purpose of the table was to compare the current terms of the proposed contracts with the contracts seen in the past. One main difference that could be seen was the value of the RIK differential, which had increased from \$1.95 to \$2.23 and \$2.25, which signified a further reduction in the value of royalty oil by approximately \$.30. The slide that followed showed evidence of why DNR believed that increasing the deduction still corresponded to what the market was assessing, but also allowed DNR to obtain incremental revenue versus the other option of royalty-in-value. He noted that future slides would continue showing current contracts compared to previous contracts.

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Mr. Meza addressed slide 6, "CONTRACT TERMS FOR MARATHON AND PETRO STAR - FLEXIBILITY FOR BUYER AND SELLER," which showed a table showing a comparison of contract terms. He noted that throughout the contracts beginning in 2016, the RIK buyer (the refinery in Alaska) obtained significant flexibility that perhaps they might not be able to obtain through other contracts with third parties from private suppliers. One of the provisions was that the refinery could ask for no barrels for up to two consecutive months or for three months with using the "turnaround clause." The

clause was something to use if there was scheduled maintenance of facilities and no need to buy royalty oil in-kind. The refinery could also request a permanent reduction of the nominations of royalty oil, subject to the approval of the DNR commissioner.

Senator Wielechowski assumed that if there was a period of time in which no barrels were nominated, the oil got shipped down the pipeline and sold royalty in-value.

Mr. Meza answered in the affirmative.

Mr. Meza continued to address slide 6. He reiterated that the contracts provided flexibility for the buyer and the state. He added that if for some reason the producers had a lower expectation for production, there was less royalty oil for sale and the state would not be harmed by guaranteeing any amount. There was a provision by which the department could limit its delivery of royalty oil up to 95 percent. There was no guarantee related to the quality, quantity, or the source of royalty oil to the buyers, which would take whatever the state received. If there was excess royalty to be offered and the buyers had the demand, the contract would allow for incremental sale.

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Senator Wielechowski asked about the marketing for royalty in-value oil, and whether the state paid a fee.

Mr. Meza informed that the state did not pay a fee. He expanded that DNR looked at contracts and received proceeds subject to other provisions in the oil and gas lease contracts that allowed for the state to arrive at a fair market valuation of the royalty oil.

Senator Wielechowski asked if there had been any sort of look-back to see how the state's prices compared to those of major producers.

Mr. Meza affirmed that DNR did perform a look-back exercise and thought that in the final best interest finding there was a chart showing how much more revenue the state has obtained by selling its royalty oil in-kind versus the alternative. On average the state had received a premium of \$.93 for each barrel of royalty oil in-kind it sold.

Senator Wielechowski was curious how the state compared to producers.

Mr. Meza informed that the \$.93 was a comparison of the price of royalty oil that the state obtained by selling via its contracts for royalty oil in kind versus what the state would receive from lessees or producers as proceeds from contracts by the sale of their own equity oil.

Senator Wielechowski thought the amount was "really good." He wondered how it was possible that the state was getting such a high premium in the oil industry.

Mr. Meza relayed that the success was mainly due to the fact that the oil was not being transported to the U.S. West Coast, and there was no deduction for marine transportation. In place of the deduction, the state had a much lower negotiated deduction (RIK differential).

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Mr. Meza advanced to slide 7, "CONTRACT TERMS FOR MARATHON AND PETRO STAR - OTHER PROVISIONS," which showed a table of contract comparisons which focused on the financial assurance of contracts. He mentioned the risk of default by the buyer (the refinery or its parent company or guarantor), which was an area the state paid attention to. He described that in the provisions, the guarantor offered the state the options of a letter of credit, a surety bond, or an opinion letter by a financial analyst attesting to the quality of the guarantor. He discussed the calculation for a financial assurance amount, which had varied for different refineries and was an outcome of negotiations between DNR and the refineries.

Mr. Meza continued that there was also a retroactivity provision, because once the invoice was sent to the buyer calculating the value of royalty oil and the amount to be paid, there could be further changes to elements in the calculation. Both the buyer and seller had the ability to request a recalculation based on new information such as Federal Energy Regulatory Commission (FERC) mandated revisions or quality adjustments. There was an eight-year period that allowed for such readjustments, even if the contract was terminated before that time. Lastly there were other provisions encouraging the buyer to use commercially reasonable efforts to manufacture the refined product in

the state. As stated in the final best interest finding, the refineries primarily provided refined products to Alaska, and only a minor part of production went to Canada or the Pacific Northwest. He mentioned a provision encouraging the employment of Alaska residents.

Senator Wielechowski asked if Mr. Meza knew how many Alaska residents were hired by Marathon and Petro Star and what percentage the hires represented.

Mr. Meza thought his colleagues would have a precise number to answer Senator Wielechowski's question.

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ADI CHAOBAL, COMMERCIAL ANALYST, DIVISION OF OIL AND GAS, DEPARTMENT OF NATURAL RESOURCES (via teleconference), addressed Senator Wielechowski's question. He relayed that Marathon reported 220 full-time employees and 60 contractors hired from within Alaska for its Kenai refinery. Marathon also reported an additional 40 employees at terminals in Anchorage and North Pole.

Co-Chair Bishop asked about Marathon's percentage of Alaska hire.

Mr. Chaobal relayed that Marathon had not provided a percentage for its Alaska hire.

Co-Chair Bishop asked Mr. Chaobal to provide the percentage information at a later time.

Senator Wielechowski asked if Mr. Chaobal had the same information related to Petro Star.

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CHALINDA WEERASINGHE, COMMERCIAL ANALYST, DIVISION OF OIL AND GAS, DEPARTMENT OF NATURAL RESOURCES (via teleconference), relayed that Petro Star had reported 80 full-time high paying positions at both refineries, and employed 275 positions companywide. Petro Star reported that the refineries were 100 percent staffed by residents of Alaska, and 99 percent of the company was staffed by Alaskan residents.

Mr. Meza addressed slide 8, "CONTRACT TERMS FOR MARATHON AND PETRO STAR - CONTRACTS ARE IN THE BEST INTEREST OF THE STATE," which showed a table comparing contract terms and focusing on the addition of revenue that state would obtain. He highlighted that beginning with a contract in 2016, the state obtained an additional \$31 million in incremental revenue. Had the state received the barrels in-value, it would not have obtained the \$31 million. He listed revenue amounts from the contracts listed on table, which were in addition to what the state would have received if it had elected to take 100 percent of its royalty oil in-value. For contracts that had not expired there were estimates with a range of possible incremental revenues.

Senator Wielechowski referenced many disputes over the years related to tariff costs with producers. He wondered if the state had similar legal disputes or other disputes over what the RIK should be.

Mr. Meza had not seen any legal disputes with buyers of royalty oil in-kind.

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Senator Wielechowski requested copies of the bid packet, the best interest finding, and copies of the contracts the state had approved. He asked if there were any dissenting votes on the royalty board in approving the contracts.

Mr. Meza affirmed that the best interest findings, responses to solicitation of interest and the proposed contracts were all public, and the department would provide them to Senator Wielechowski directly. He informed that there were no dissenting votes and the board had given unanimous recommendations of approval of the contracts.

#sb239

SENATE BILL NO. 239

"An Act approving and ratifying the sale of royalty oil by the State of Alaska to Petro Star Inc.; and providing for an effective date."

^Public Testimony: SB 239

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Co-Chair Bishop OPENED public testimony on SB 239.

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DOUG CHAPADOS, PRESIDENT, PETRO STAR (via teleconference), testified in support of SB 239. He shared that he was in support of Petro Star's proposed five-year royalty oil contract. He shared that Petro Star was a wholly owned subsidiary of the Arctic Slope Regional Corporation and was the state's only Alaskan-owned refiner. In addition to fuel distribution terminals located in Anchorage, Valdez, Kodiak, Dutch Harbor, and Interior Alaska, Petro Star also operated two of the states three commercial refineries, both of which drew crude oil directly from TAPS. He emphasized that TAPS was Petro Star's only source of crude oil, which meant that the contracts such as the one being considered were crucial to operation.

Mr. Chapados continued his testimony. He described that Petro Star produced a variety of products from crude oil including jet fuel for commercial airlines, as well as over 90 percent of the jet fuel consumed at the United States Department of Defense and United States Coast Guard installations located across the state. He listed additional products including heating oil, diesel fuels, asphalt oil for road paving, and specialized fuel for two Alaskan electrical associations. He referenced the best interest finding, which concluded that the contract was good for the state in maximizing revenues from Alaska's royalty oil share and would help maintain the in-state petroleum refining industry while preserving competition within the state's fuels market. He encouraged the committee to approve the royalty oil contract.

Co-Chair Bishop commented that congratulations were in order regarding Petro Star's Alaska hire numbers.

Mr. Chapados cited that Petro Star had approximately 275 employees, and all but two were located in the state.

Co-Chair Bishop CLOSED public testimony for SB 239.

#sb240

SENATE BILL NO. 240

"An Act approving and ratifying the sale of royalty oil by the State of Alaska to Marathon Petroleum Supply and Trading Company LLC; and providing for an effective date."

[1:41:17 PM](#)

^Public Testimony: SB 240

Co-Chair Bishop OPENED public testimony for SB 240.

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CASEY SULLIVAN, GOVERNMENT AND PUBLIC AFFAIRS MANAGER, MARATHON PETROLEUM (via teleconference), testified in support of SB 240. He detailed that the bill would ratify the three-year contract between the state and Marathon Petroleum. He commented that the contract would have a positive impact and would optimize operations at the Kenai refinery. He described that Marathon was a leading, integrated downstream energy company that operated the nation's largest refining system. He noted that Marathon had a sister company, NPLX, that was a midstream company that operated gathering, processing, and other aspects. He reminded that Marathon had merged with Endeavor (formerly Tesoro) in October of 2018.

Mr. Sullivan recalled that the company had been operating the Kenai refinery since 1969 and was one of Alaska's longest in-state manufacturers that produced quality transportation fuels for the state. He cited that the Kenai refinery could produce about 868,000 barrels per calendar day, and the primary focus was on jet and diesel production, followed by gasoline, heavy fuel oil, propane, and asphalt. He cited that Marathon was one of the primary providers for jet fuel for the Anchorage airport. He added that Marathon had terminals in Nikiski, the Port of Anchorage, and in North Pole, via which it moved products to communities.

Mr. Sullivan continued his testimony. He relayed that Marathon was one of the largest taxpayers in the Kenai Peninsula Borough, it provided approximately 250 jobs at the refinery with an additional 50 full time contracts that

worked year-round. Marathon also employed an additional 37 Alaskan operators that worked at terminals. He reported that the company's Alaska hire was 100 percent for full-time employees. He commented on multi-generational employees.

Mr. Sullivan noted that he had provided written comments to the committee (copy on file). He summarized that the legislation was the result of constructive dialogue and productive negotiations between DNR and Marathon. He appreciated the professionalism of DNR at all stages of the process. He commented on the positive outcomes of the contract, including revenue for the state.

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Co-Chair Bishop asked if Mr. Sullivan had heard an earlier question about the source of 20 percent of oil obtained by Marathon.

Mr. Sullivan stated it was Marathon's general practice to not discuss its crude oil sourcing. He shared that the large majority of crude run by Marathon was Alaskan-produced crude. Over the five-year average, Alaska crude was close to accounting for 90 percent of what was run in Alaska. He acknowledged it was true that Marathon utilized a small portion of imported crude in order to optimize production, which could come from a wide variety of domestic or international markets.

Co-Chair Bishop asked if it was safe to say the portion of crude oil was not coming from Russia.

Mr. Sullivan affirmed that it was safe to say the crude was not coming from Russia.

Co-Chair Bishop CLOSED public testimony for SB 240.

SB 239 was HEARD and HELD in committee for further consideration.

SB 240 was HEARD and HELD in committee for further consideration.

Co-Chair Bishop discussed the agenda for the following day. He reminded that bills previously heard could come up on the agenda at any time.

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ADJOURNMENT

1:48:45 PM

The meeting was adjourned at 1:48 p.m.