HB
370

BILL SHEFFIELD
GOVERNOR

STATE OF ALASKA
OFFICE OF THE GOVERNOR
JUNEAU

May 5, 1983

The Honorable Joe Hayes
Speaker of the House
Pouch V
Juneau, AK 99811

Dear Mr. Speaker:

I am attaching the information that we discussed on our proposed royalty oil agreements. I have also attached a letter from Commissioner Wunnicke to Representative Ringstad that may be of interest to you.

If these contracts are approved, we will have met our responsibility under state law for satisfying in-state needs for royalty oil. This accomplished, the Administration will review other kinds of options for the sale of royalty oil in the coming months.

Please let me know if you have any questions or comments.

Sincerely,

Bill Sheffield
Governor

cc: The Honorable John Ringstad
The Honorable Richard Shultz
The Honorable Rick Uehling
The Honorable John Cowdery
The Honorable Charlie Bussell
The Honorable John Liska
The Honorable Tony Vaska
The Honorable Peter Goll
The Honorable Ronald Larson

AGO 786714

5/5/83

1983 Alaska Prudhoe Bay Royalty Oil Information

I. Pending Agreements:

Tesoro

- an 11-year contract for almost 14 percent of PBU production (about 26,000 b/d at current levels);
- for every barrel, a 30-cent premium over the in-value price;
- special provisions to avert control of Tesoro by Charter;
- enables $90 million expansion of Nikiski refinery by Tesoro; entire quantity must be processed in-state.

Chevron

- an 11-year contract for about 9 1/2 percent of PBU production (about 18,000 b/d at current levels);

AGO 786715

- as with Tesoro, a 30-cent premium for each barrel over the in-value price;

- will avert the closure of the Kenai refinery;

- will require the in-state production of specified petroleum products, including asphalt (which is in high demand).

II. Key points on the agreements:

A. In-state processing of more than 23 percent of Alaska's royalty oil promising:

- adequate and secure supplies of gasoline, asphalt, and other petroleum products for Alaskans;

- over $40 million above the amount that would have been received in-value:

  ° over $25 million for Tesoro;

  ° approximately $18 million for Chevron;

- continuation of Chevron's Kenai refinery; nearly $90 million expansion of Tesoro's Nikiski refinery;

- attendant tax base and employment benefits:

  - 250-300 construction jobs;

  - 20-30 direct permanent jobs;

  - increased state income tax collections;

  - approximately $500,000/year increased property tax revenues to Kenai Peninsula Borough;

B. Future options are still possible:

- contract is for fixed <u>percentage</u> of Prudhoe Bay Unit production; from 75,000 to 125,000 b/d of royalty oil will still be available from Prudhoe Bay, Kuparuk, and other North Slope fields that are expected to come into production during the next decade.

- if exports become a reality, the price term in these contracts will increase along with any increase in the sales price for Prudhoe Bay oil.

- The Shell offer of a $1 premium for 20,000 b/d for their Anacortes, Washington refinery is short-term only, and does not guarantee in-state processing. It can still be pursued if these contracts are approved.

- Several West Coast refiners are also interested in purchasing Alaska royalty oil. Large volume royalty oil sales on the West Coast can result in lower North Slope crude oil prices. The State must therefore look carefully at the effect of such sales on all royalty and severance tax revenues before consummating any agreement.

- State retains the option to purchase and re-sell residual produced under these contracts.

III. Existing Agreements

A. Cook Inlet - Tesoro takes all royalty oil under 1969 contract; expires in 1983; a ten-year renewal is now before the Legislature (HB 320).

B. Prudhoe Bay

1. Golden Valley Electric Association - may take up to 5,000 barrels a day (b/d) under their 1977 agreement which expires in 1984. Currently working with DNR on renewal.

2. North Pole Refining (Mapco) - entitled to 15 percent, or up to 35,000 b/d under their 1978 agreement, which expires in 2003.

3. Tesoro - entitled to 24.5 percent, or up to 46,000 b/d under their 1982 agreement, which expires in 1994.

All of these existing contracts were approved by the Alaska Legislature. Two other long-term agreements, with Alpetco and Doyon, were approved by the Legislature in 1978 and 1982, respectively, but have since been terminated.

In the opinion of the Commissioner of Natural Resources, the proposed Chevron and Tesoro contracts meet existing and projected needs for in-state refining. The Administration will provide other royalty oil options, as well as generally reviewing the statutes, before the next legislative session.

STATE OF ALASKA

BILL SHEFFIELD, GOVERNOR

DEPARTMENT OF NATURAL RESOURCES

POUCH M
JUNEAU, ALASKA 99811
PHONE: 907-465-2400

OFFICE OF THE COMMISSIONER

April 26, 1983

The Honorable John Ringstad
Co-Chairman, House Resources Committee
Pouch V
Juneau, Alaska 99811

Dear Representative Ringstad:

I very much appreciate the opportunity to present the House Resources Committee with some additional comments on our proposed royalty oil agreements with Tesoro and Chevron. During previous discussions, several questions were raised on specific aspects of the agreements. I thought it might be useful to you and the committee if I provided our response in writing, as well as in oral testimony before the committee.

The contract with Tesoro would commit the State to providing 13.867% of Prudhoe Bay Unit production, or approximately 26,000 barrels a day (b/d) at current production levels, if Tesoro expands the capacity of their refinery to process the oil by 1986. The agreement expires on January 1, 1995; at the same time Tesoro's existing royalty oil contract for 46,000 b/d terminates. The basic rationale for this contract is fairly straightforward - providing a long-term guaranteed crude supply enables Tesoro to make a significant, new in-state investment, with attendant employment, supply, and tax base benefits.

The Chevron contract would furnish their Kenai refinery with 9.6% of Prudhoe Bay production, currently 18,000 b/d, until 1995. The Kenai refinery is not an economic component of Chevron's West Coast refining system, and the company has threatened to close it without a long-term supply of oil from the State. Chevron has consistently requested a 38,000 b/d contract, and will continue to seek an additional 20,000 b/d for processing on the West Coast and return to Alaska in the form of products. The 18,000 b/d agreement will enable the company to operate the Kenai refinery for as long as possible; that volume of oil must be processed at the Kenai plant to maintain the effectiveness of the contract.

Several legislators have questioned the duration (eleven years) of the Chevron and Tesoro contracts. The reasons for the concern, to our knowledge, include a desire to leave royalty oil uncommitted so that it can later be offered as an incentive for economic development projects, or so that it can be sold in Japan or elsewhere at a higher price, or a general desire to retain flexibility in the face of ever-changing oil markets and the future decline in Prudhoe Bay production. We agree that these are valid points, but feel that they have been addressed in the following ways:

1. The contracts provide for a certain percentage of Prudhoe production, not a certain volume. As Prudhoe production declines, so will the contract volumes. At current levels, the contracts leave available 62,500 b/d of Prudhoe royalty production, as well as all Kuparuk royalty oil (currently 12,000 b/d). We expect additional production from Kuparuk and new production from North Slope fields now under development to add somewhere between 30,000 to 80,000 b/d to total of available royalty oil. Approximately 50,000 b/d of residual oil may also be available for sale by the State as a result of the option that the State retains for that oil in most of its royalty oil agreements.

Until 1995, the State will have sufficient royalty volumes (75,000 to 125,000 b/d) available to take advantage of other opportunities that may arise.

2. Mapco and Tesoro already have royalty contracts until 2005 and 1995, respectively, for their base volumes. Although those contracts were consummated by the previous Administration, we felt that Chevron's request for a contract at least as long deserved some consideration in the interest of preserving equity among competing refineries. As a general principle, to preserve fair competition among in-state refiners, we believe that the same term should be offered to all in-state refiners.

3. The term was a negotiated item; although the State originally sought a shorter term from Tesoro (nine years), the additional premium over the in-value price of $.30 was agreeable because the State was willing to offer the eleven-year term. Tesoro stated that the premium affected the amortization schedule of the expansion, and necessitated at least an additional two to three years.

4. The contract's price term is tied to the in-value price, based on producer sales. If Japanese exports become a reality, the price to royalty purchasers will

increase if sales to Japan result in higher average prices for North Slope oil.

5. We have reviewed the previous Administration's determination that the highest and best use for royalty oil is for in-state processing, all other things being equal, and concur with it, in light of the existing royalty oil statutes. These contracts are for that use. Since in-state refiners have sought long-term commitments to make in-state processing economic, we believe that we must seriously consider their requests, given current law.

Legislators have also understandably questioned the recent acquisition by two Charter Co. life insurance subsidiaries of 20% of Tesoro's stock, and the placing of Charter directors Raymond Mason and Gerald Ford on the Tesoro board. The involvement of a corporation with which the State has significant litigation was a cause of serious concern to us at the time of contract negotiations. In response to that concern, we took the following measures to protect the State from possible harm because of the involvement of Charter:

1. A "third-party control" provision in the royalty agreement allows the Commissioner to unilaterally terminate the contract if Charter gains a greater degree of influence over the management of Tesoro.

2. An agreement between Tesoro and Charter requires that Charter vote its shares in the same proportion as the shares held by all other Tesoro stockholders, and prevents Charter from seeking proxy votes.

3. Tesoro may not take the oil unless the Commissioner determines that the refinery will be capable of processing the additional crude; the contract terminates if the refinery expansion has not been completed by July 1986; and all oil taken under the contract must be run at the Tesoro Kenai refinery, and may not be traded, exchanged or otherwise disposed of.

4. The State retains the option to purchase and resell the substantial volumes of residual oil produced by the refinery.

5. Tesoro owns facilities worth over a hundred million dollars in Alaska.

We would hope that the concerns expressed do not stem from a desire to "punish" Charter by rejecting this agreement. We do not believe that Charter would be much affected by rejection of this contract. A vigorous legal effort to

collect the money owed the State by Alaska Oil Co. seems to us to be the proper course at this point. Tesoro is a long-standing Alaska business, and deserves to have its contract treated on the merits.

The effect of in-kind royalty oil sales on the State's production tax and royalty income is also a matter of concern. I have attached a short paper which discusses this issue for your consideration.

The provisions of the contract which specify in-state processing and supply are "sideboard" or minimum provisions which protect the State from abuses against the intent of the contract by the purchaser. The State insisted that the oil taken under the contracts be processed in an in-state refinery, that the refinery actually produce significant amounts of products, and that the purchaser otherwise excercise its best efforts to produce and market in Alaska some minimum quantity of oil products. The State left economic decisions on how best to meet the local demand for products to the individual refiner. We do not feel that anything other than these requirements are appropriate. Any further specificity would likely act against the interests of Alaskans in the long run, by reducing the flexibility to meet changing market conditions.

Thank you for your consideration of these important agreements. Please let me know if you have any comments or questions, or if we can provide additional information to the committee.

Sincerely,

Esther C. Wunnicke
Commissioner

Attachment

4/26/83
ADNR

EFFECT OF IN-KIND ROYALTY OIL TAKING ON STATE FINANCES

The price term for sales of royalty oil is founded on the average destination sales price (or internal transfer price) received by the Producers for all sales of Alaska North Slope (ANS) crude oil, netted back (i.e., with transportation and pipeline tariff charges subtracted) to Pump Station No. 1, the point of sale; this is referred to as the Producers' Weighted Average Field Price. Because ANS crude oil is marketed both on the West Coast and the Gulf Coast of the United States, the Weighted Average Field Price is necessarily a mixture of sales prices for both markets. Traditionally, the average netback price for West Coast sales has been higher than for Gulf Coast sales (as explained in Section IV-F, pp. 175-211, of the Department's January 1, 1983 Review of Alaska Royalty Oil). Since Prudhoe Bay began production, this differential has ranged from one to three dollars per barrel. The differential netback is often called the two-tier price structure; the State believes this structure is a valid indication of the value of ANS in the respective markets and will persist in the future.

The two-tier price structure creates two potential adverse financial consequences to the State for a royalty oil sale to a West Coast destination. First, since the Producers'

Weighted Average Field Price is used to calculate severance tax and royalty payments due the State, a State royalty sale to a West Coast destination may replace a higher netback West Coast producer sale. The State estimated that the effect of displacement in the proposed sales to Tesoro and Chevron would be in the neighborhood of two to five cents per barrel. That analysis partially provided the rationale for the required per barrel premium of $.30 in the 1983 Tesoro and Chevron contracts. (In the 1982 royalty sales to Tesoro and Doyon, as well as in the 1978 sale to North Pole Refining, the State had not asked for any premium, instead relying on the array of benefits provided by in-state processing of the oil.)

Second, if the State's mixed-market Producers' Weighted Average Field Price were substantially below the West Coast Commercial Price for ANS crude oil, large volume sales by the State on the West Coast could create a downward trend on the price of ANS generally with some major adverse effects on royalty and severance tax payments to the State. This apparently happened once previously when approximately 159,000 b/d of the State's royalty oil was on the market short term from several of the State's purchasers. The potential losses to the State from creating a downtrend in the market can be in the tens of millions of dollars annually.

AGO 786726

While economic and other benefits can generally be identified as an offset to the potential losses from in-state processing, the same is not necessarily true of royalty oil processed elsewhere. For this reason, the State has recently avoided entering into agreements with West Coast refiners.

The State believes that the $.30 per barrel premium established in the proposed Prudhoe Bay Unit agreements with Tesoro and Chevron more than offsets any proposed financial loss to the State which might occur as a result of the two-tier price structure for ANS crude oil. In addition, the employment, tax base, and general economic benefits also should be included in any judgement of the net cost to the State of in-kind royalty oil sales.

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

POUCH Y STATE CAPITOL
JUNEAU, ALASKA 99811
907 465 3800

M E M O R A N D U M May 5, 1983

SUBJECT: Royalty oil sales under AS 38.06.055 (Work Order No. 13-1361)

TO: Representative John Cowdery

FROM: Richard C. Folta
Legislative Counsel

You have asked if the legislature does not approve a royalty oil sale under the above statute, may the commissioner of natural resources sell the oil without legislative approval to the same company on a negotiated short term contract substantially different from the original sale.

The answer is yes, if the sale is determined by the commissioner to be needed to "relieve storage and market conditions". AS 38.06.055(b)(1) provides that legislative approval is not required when the sale, exchange, or other disposition of oil or gas for one year or less if the sale, exchange, or other disposition is entered into to relieve storage or market conditions. The commissioner may also forego competitive bidding if in the "best interest of the state" after notice to the Royalty Board (AS 38.05.183(a)).

The transaction may be viewed with suspicion by the legislature, who after disapproving a sale of royalty oil sees the commissioner finding a sudden storage and market crisis and proceeding with a sale under AS 38.06.055(b)(1). If there was litigation over the sale the standard of review by the courts would be as set out in National Bank of Alaska v. Department of Revenue, 642 p.2d 811 (1982).

The reasonable basis standard is used where the question at issue, i.e., determination of "relieve storage or market conditions" implicates special agency expertise or the determination of fundamental policies within the scope of the agency's statutory functions. The second test or independent judgment standard is when the court makes its own determination of the meaning of the statute and need not

AGO 786728

follow the agency's construction even if it is one of several reasonable readings. Very likely the court would invoke the former rule in coming to a decision.

RCF:ljb
17/031

Alaska State Legislature

Sen. Bettye Fahrenkamp,
Co-Chairman
Sen. Vic Fischer
Sen. Don Bennett

Rep. John J. Cowdery,
Co-Chairman
Rep. Mike Davis
Rep. Joe Hayes
Rep. John Ringstad
Rep. Mike Szymanski
Rep. Rick Uehling
Rep. Anthony N. Vaska

Joint Committee on Oil and Gas

May 6, 1983

TO: ALL LEGISLATORS

FROM: Rep. John J. Cowdery

RE: For Your Information

This report contains some good backround material on the dispute between the State of Alaska and Alaska Oil Company, more commonly recalled as the ALPETCO deal or the Charter sale.

I would call your attention to at least the last 4 pages of the report, pages 13 - 16.

Thank you.

Pouch V, Juneau, Alaska 99811

AGO 786730

MEMORANDUM REGARDING PRICE DISPUTE BETWEEN THE STATE OF ALASKA AND ALASKA OIL COMPANY

April 19, 1983

AGO 786731

TABLE OF CONTENTS

		Page
I.	INTRODUCTION	1
II.	ROYALTY OIL FROM PRUDHOE BAY LEASES.	1
III.	ALPETCO AOC CONTRACT	3
	A. Negotiations	3
	B. Amendments to APC Contract	4
	C. Contract Price Provisions.	5
IV.	THE PRICE DISPUTE.	9
	A. AOC Cancellation of Refinery Project . .	9
	B. AOC Withholding from Payments to State.	10
	C. AOC's Claimed Justification for Withholding	12
V.	LITIGATION BETWEEN THE STATE AND AOC	13

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1 I. INTRODUCTION

2 The litigation between the State of Alaska ("State")
3 and Alaska Oil Company ("AOC") arises from AOC"s failure to
4 pay approximately $62.6 million of the full invoiced price
5 for royalty oil purchased by AOC from the State in 1981 and
6 1982. The State has insisted from the beginning of the dis-
7 pute that the price invoiced by the State was calculated in
8 accordance with the contract between the State and AOC, and
9 that the full invoiced price must be paid. But AOC claims
10 that the price invoiced by the State exceeds the "market
11 price" which AOC asserts was agreed to in the contract, and
12 AOC has therefore paid the State a lower price in accordance
13 with AOC's unilateral calculations of the "market value" of
14 the oil.

15 Section II of this memorandum briefly discusses
16 the State's right to and its options for the disposition
17 of royalty oil from Prudhoe Bay. Then, in Section III, the
18 negotiation and amendment of the AOC contract will be con-
19 sidered, and the price terms will be examined. AOC's with-
20 holding from payments to the State, and AOC's claimed reasons
21 for such withholding, are described in Section IV. Finally,
22 in Section V, the ongoing litigation between the State and
23 AOC is reviewed.

24 II. ROYALTY OIL FROM PRUDHOE BAY LEASES

25 During the 1960s, the State sold leasehold interests
26 at Prudhoe Bay to various oil companies. Each lease reserves
27 for the State a one-eighth (12.5%) royalty share, to be taken
28

"in kind" or "in value," in any production which might occur after the leases are explored and developed.

Under the lease terms, if the State opts to take all or part of its royalty share "inkind," the State takes possession of the royalty oil at Pump Station No. 1 after giving the North Slope Producers six months notice of the volume of oil desired. Traditionally, the State does not take physical custody of the oil, but rather resells it at Pump Station No. 1.

Under the "in value" alternative in the Prudhoe Bay leases, the State can receive cash payments from the North Slope Producers for the value of some or all of the State's 12.5% of Prudhoe Bay oil. Although in this case the State has no control of how the oil is marketed, the State is empowered to audit the Producers to insure that proper value is received for the State's royalty oil.

Disposition of the royalty oil to which the State is entitled under the Prudhoe Bay leases is governed by AS 38.05.182-183. Section 182(a) requires the Commissioner of Natural Resources to take royalty oil "in-kind" unless the Commissioner finds that "in value" taking is in the best interest of the State. Section 183(e) requires the Commissioner to evaluate royalty oil purchase proposals (where sale is other than by competitive bid) in light of, among other things, the cash value offered, the benefits of refining or processing in the State, and the ability of the purchaser to supply refined products in-state with price or

AGO 786734

supply benefits. These statutory directives imply a preference for taking royalty oil "in kind" rather than "in value," and a preference for in-state processing over purely export sales.

In 1974 the Alaska Legislature established the Alaska Royalty Oil and Gas Development Advisory Board, and invested it with authority to approve or disapprove any royalty oil disposition contracts submitted by the Commissioner of Natural Resources. Under the 1974 legislation, proposals for the sale of royalty oil first had to be approved by the Royalty Board, and then submitted to the Alaska Legislature for its concurrence.

III. ALPETCO AOC CONTRACT

A. Negotiations

In the summer of 1977, the Department of Natural Resources formally solicited bids for the sale of the State's royalty oil from Prudhoe Bay. The solicitation required each bid to provide for the use in Alaska of "some or all" of the purchased royalty oil. Concurrently, the Royalty Board supplemented the existing statutory guidelines with several policies to guide the disposition of the State's royalty oil. Among the policies was the requirement that the price at which the State sold royalty oil should be no less than the amount the State would have received had the State opted for "in value" cash payments from the Producers instead of taking the oil "in kind."

Ten preliminary proposals responding to the State's solicitation were received by August 1, 1977. After the

AGO 786735

Commissioner of Natural Resources evaluated the proposals, the list of bidders was reduced to four companies who submitted final proposed contracts for large-volume purchases of royalty oil. Following intensive negotiations with the final four bidders, on February 22, 1978 the Commissioner signed, and the Royalty Board approved, an Agreement for the Sale and Purchase of State Royalty Oil (the "Contract") between the State and Alaska Petrochemical Company ("APC"). The initial Contract was for a term of 27 years and authorized the purchase of up to 150,000 barrels per day of royalty oil for processing in a world-scale petrochemical plant APC agreed to construct in Alaska.

B. Amendments to APC Contract

The APC Contract was amended twice. The first amendment occurred as a result of the legislative approval process for the initial Contract; changes were mandated by the Legislature in some of the terms of the Contract relating to required expenditures and construction obligations. The amended Contract required Alpetco to expend certain amounts in furtherance of the project at specified intervals, to enter into arrangements for construction and financing by December of 1979. The amended Contract was approved by the Legislature on June 13, 1978.

The second amendment stemmed from three events. First, the project sponsors indicated that the petrochemical portion of the project was not immediately feasible, and that the facility constructed would in fact be a refinery (although a highly sophisticated refinery using state of the art technology).

AGO 786736

1 Second, the State's determination in December 1979 that Alpetco
2 had met required conditions regarding construction and financing
3 arrangements, entitling them to interim taking of royalty
4 oil, met with substantial public criticism. Third, the owner-
5 ship of the project changed substantially in 1979 when APC
6 assigned its interest in the Contract to the Alpetco Company,
7 which later changed it name to Alaska Oil Company ("AOC").
8 AOC is a general partnership presently consisting of Charter
9 Oil (Alaska) Inc. (85.31%), Valdez Oil, Inc. (8.04%) and
10 Barbour Oil Company (6.65%). Charter Oil (Alaska), Inc. and
11 Valdez Oil, Inc. are both wholly owned subsidiaries of The
12 Charter Company, which therefore has an indirect 93.35% inter-
13 est in AOC.

14 The second amendment, entered into in May 1980,
15 reduced the volume of oil to be purchased by AOC beginning in
16 July 1980 from 150,000 to 75,000 barrels per day. Only when
17 the promised refinery was operational would AOC be permitted
18 to purchase up to 100,000 barrels per day. To ensure that
19 AOC constructed the refinery in an expeditious manner, the
20 amended Contract also required AOC to meet specific project
21 development criteria by December 31, 1981, before the
22 Commissioner would approve further sales of North Slope
23 crude to AOC.

24 C. Contract Price Provisions

25 The price provisions of the Contract were not
26 altered by either amendment. Since price is at the center of
27 the State's dispute with AOC, the price provisions are des-
28 cribed below in some detail.

AGO 786737

The State had insisted from the outset that the minimum acceptable price for its royalty oil would be the equivalent of the "in value" price the State would have received from the Producers had the State not opted to take its oil "in kind." In keeping with the State's unwavering position on price, the Contract expressly provides that the final price to be paid by APC/AOC "shall be equal to the sum the [State] would have received from the [Producers] had [the State] received its royalty in value instead of . . . in kind." (Article 8.1.1.) This provision reflects the simple fact that the State had no intention of diminishing its royalty income as a result of taking its royalty oil "in kind" (for sale to AOC) instead of "in value" (i.e., cash).

At the time the Contract was signed, the method of determining the "in-value" price of royalty oil was the subject of a still unresolved lawsuit entitled State of Alaska, et al. vs. Amerada Hess Corporation, et al. Since the "in value" price had yet to be determined in the Amerada Hess litigation, the Contract provided for two prices: a final price to be paid once Amerada Hess establishes the "in value" price, and an interim price to charged pending the resolution of Amerada Hess.

Article 8.1.1 of the Contract provides that the final price under the Contract will equal the "in value" price to be judicially determined in Amerada Hess.

> After such time as [Amerada Hess] shall be resolved among Seller and [the Producers], the parties hereto will be bound by the terms of such resolution, judicial or otherwise. Seller and Buyer expressly

AGO 786738

> recognize that adjustments in prices previously paid may be necessary following said resolution . . .

Article 8.1.1 of the Contract also specifies the interim price to be used until Amerada Hess is decided:

> Pending resolution of said dispute among Seller and [Producers], by judicial decision or settlement in the [Amerada Hess] case, the in value royalty under the Leases, and therefore the price hereunder, shall be computed in accordance with Exhibit "B", attached [to the Contract.]

Exhibit B was designed to yield a price akin to what the State believes the Court in Amerada Hess will eventually determine is the proper "in value" price. The Exhibit B price is calculated each month in two steps. First, a per barrel royalty oil "value" is determined for each Producer, by taking the higher of the weighted average of the actual prices received by that Producer or the weighted average of the actual prices received by all other Producers. The "values" for each Producer are then used in the second step of the Exhibit B calculation, which computes the weighted average of the "values" of all the Producers. The effect of this method of price calculation is to disregard, for purposes of the final weighted average, the lower prices received by some Producers, and unless all Producers report exactly the same prices, the Exhibit B price will always exceed the weighted average of all Producers' prices for that month.

The fact that neither the final price nor the Exhibit B price under Contract would necessarily equal "market"

value was repeatedly recognized during negotiation of the Contract, and on at least three occasions the parties rejected use of "market price" as a price standard. APC's original contract proposal called for a "market price" tied to the price of Saudi crude oil. But the State insisted on receiving an "in value" price pegged to the price the Producers would have paid the State had the State's royalty been taken "in value" rather than "in kind," and Alpetco eventually agreed.

Later in the negotiations, discussion turned to the interim price to be paid by APC pending resolution of Amerada Hess. Until Amerada Hess is decided, royalty payments by the Producers are based on a weighted average of all Producers' actual sales, a formula which yields a price lower than the "in value" price which the State in Amerada Hess claims is appropriate, and which Exhibit B approximates. APC objected to paying a higher interim price than the interim price the Producers were paying, and sought to base its interim price on the weighted average of the prices reported to the State by all the Producers. The State, however, was unwilling to allow APC to follow the Producers in paying less than the price the State expects Amerada Hess to establish since APC had no security in Alaska comparable to the Producers' leases. APC eventually agreed to base the interim price (Exhibit B) on the State's position in Amerada Hess, and thus agreed to a price higher than the weighted average of the Producers' prices.

AGO 786740

Thereafter, during the detailed negotiation on using the State's position in Amerada Hess as a basis for the interim price, market price was once again rejected, this time by APC. In Amerada Hess, the State asserts that each Producer should pay the highest of three price standards, one of them being "market price." The State proposed using the same three-part standard for APC's interim price, but APC objected that "market price" is too subjective to use in computing price. The parties then agreed to exclude "market price" from Exhibit B calculations, a decision reflected in Footnote 5 to Exhibit B:

> "Market" . . . value shall not be used in calculating the "In Value Price to Buyer" unless and until the methodology of determining same is judicially decided.

Thus, during negotiation of the Contract, the subject of using "market price" as a standard arose three times. On each occasion, its use was rejected.

IV. THE PRICE DISPUTE

A. AOC Cancellation of Refinery Project

By meeting certain "benchmark" requirements of the Contract pertaining to progress on the refinery project, AOC became entitled to and began receiving 75,000 barrels per day of royalty oil in July 1980. Each month thereafter, the State tendered an invoice to AOC for the oil purchased the previous month. The price used in each invoice was computed by applying the formula in Exhibit B of the Contract to data reported by Producers for royalty purposes The State also provided AOC with certain data from the Producers' royalty

AGO 786741

reports which were used to calculate the Exhibit B price. For almost one year, AOC paid each monthly invoice, based on the interim Exhibit B price, in full.

On May 21, 1981, AOC announced the cancellation of the refinery project, claiming that they had determined that they would be unable to obtain adequate project financing before the Contract deadline of December 31, 1981. The State and AOC thereafter mutually agreed to terminate the Contract. But because of the notice requirement in the Prudhoe Bay Unit Agreement for denominating royalty oil, the Contract provided that AOC had to continue taking royalty oil for seven months after notice of termination unless the State could make alternate sales arrangements. The State was unable to place the oil elsewhere under satisfactory terms, and AOC therefore continued to take 75,000 barrels per day until January 12, 1982, when the Contract was officially terminated.

B. AOC Witholding from Payments to State

In mid-1981, shortly after AOC's cancellation of the refinery project, AOC became dissatisfied with the interim Exhibit B price established by the Contract and decided to set the price unilaterally. Thereafter, during the remaining months of the Contract, AOC paid about $62.6 million less for the State's royalty oil than the amount invoiced by the State pursuant to Exhibit B.

In underpaying the State for oil delivered from June 1981 to January 1982, AOC not only unilaterally "adjusted" the Exhibit B price to a lower price arbitrarily set

by AOC; it also subtracted a portion of its payments previously made at the Exhibit B price for the months of February through May 1981. For example, for the month of November 1981, AOC underpaid the State approximately $3 million on the basis of its unilateral price adjustment for the month of November, and withheld an additional $7.5 million as a "retroactive adjustment" for February 1981 -- even though AOC had previously paid the February 1981 invoice in full.

By this device of "retroactive adjustment," AOC attempted to disguise the magnitude of its unilateral price revisions. For example, AOC purported to reduce the price it paid for oil in November 1981 by $1.92 per barrel and attributed the remainder of its November underpayment to a "retroactive adjustment" of $3.53 per barrel for the month of February, 1981; the combined effect of these "adjustments," however, was a price reduction of more than $6 a barrel below the $22.91 invoiced price calculated pursuant to Exhibit B for oil delivered in November.

The oil for which AOC had underpaid the State was re-sold by AOC, through an affiliate, for a profit which has been estimated at between $32 million and $38 million. The disposition of this profit by AOC is difficult to trace with precision, but it is clear that AOC itself retained virtually none of the profit. Instead, the profit was transferred to AOC's partners and to other affiliates of The Charter Company (which indirectly owns 93.35% of AOC).

AGO 786743

1 C. AOC's Claimed Justification for Withholding

2 AOC claims that the Contract price for the oil
3 should represent a "market price," and that AOC does not have
4 to pay any price higher than the "market price" calculated by
5 AOC. The basis for AOC's claim that it should pay only a
6 "market price" (rather than the invoice price computed pur-
7 suant to Exhibit B of the Contract) has never been thoroughly
8 explained. But AOC argues that the invoiced Exhibit B price
9 was too high because the prices reported by the Producers, on
10 which the Exhibit B calculation is based, were too high.
11 Despite repeated requests from the State for evidence support-
12 ing AOC's claim that the Producer reported prices were too
13 high, AOC's only evidence to date consists of theoretical
14 calculations by AOC of what the true "market price" for
15 Prudhoe Bay oil should be. AOC's claim of inflated price
16 reports from the Producers is especially implausible since
17 the severance tax paid to the State by the Producers is based
18 on the prices they report. In other words, if, as AOC claims,
19 the Producers are reporting prices which are too high, then
20 the Producers are thereby deliberately increasing the amount
21 of severance tax they must pay to the State.

22 Although the factual basis for AOC's withholding
23 remains murky, the claimed legal basis for that withholding
24 is more focused. Article 9.3 of the Contract provides in its
25 entirety:

26 > Billing Disputes. Should any portion of
27 > the account furnished to Buyer by Seller be disputed in good faith, Buyer and
28 > Seller agree to mutually arrive at a fair and equitable resolution of such dispute,

AGO 786744

1 if possible, and Buyer agrees to pay the amount so determined to be due to Seller
2 within fifteen (15) days after such resolution. Buyer shall pay for such amounts
3 as it does not in good faith dispute in accordance with the provisions of this
4 Article IX.

5 The State's position is that this Contract provision is designed
6 to cover routine and relatively minor billing disputes, and
7 that, in any event, AOC's price dispute is not in "good faith."
8 But AOC interprets the provision much more broadly, arguing
9 that it covers matters as fundamental as the method of calcula-
10 ting the price, and that AOC has no obligation to pay amounts
11 it unilaterally disputes until fifteen days after the resolu-
12 tion of such dispute.

13 V. LITIGATION BETWEEN THE STATE AND AOC

14 The State met on numerous occasions with AOC and
15 its lawyers in an attempt to determine if AOC had any valid
16 grounds for claiming the existence of a pricing dispute within
17 the meaning of the Contract, and to hear various presentations
18 made by AOC in support of their claim. On December 14, 1981,
19 a letter was sent by the State to AOC setting forth the State's
20 determination that no cause for a price dispute existed, and
21 demanding payment of the full amount due to the State under
22 the Contract. The day following receipt of this letter, AOC
23 filed a Complaint for declaratory judgment against the State
24 in Fairbanks Superior Court. The State answered, alleging
25 that the Contract price term controls, and that AOC had en-
26 gaged in various fraudulent conveyances and other transactions
27 which had depleted its assets. That case is currently pending,
28 but has been stayed by the petition filed by the State in the

AGO 786745

United States Bankruptcy Court in Anchorage seeking to have AOC declared an involuntary bankrupt.

The decision to proceed against AOC in the Bankruptcy Court rather than in Fairbanks Superior Court reflected the fact that AOC itself has virtually no assets, having transferred them to its affiliates. In order to recover any substantial portion of the money owed to the State by AOC, it will be necessary for the State to collect from AOC's parent (The Charter Company) and its affiliates -- a process which is far easier in the Bankruptcy Court than in State Court. Moreover, the Bankruptcy Court has broader jurisdiction over witnesses and documents outside of Alaska, and Bankruptcy proceedings tend to be resolved more quickly than State Court actions.

The bankruptcy proceeding was commenced by the State in February 1982 and the matter was tried in January 1983. During the intervening months, nine separate hearings were held, dozens of briefs and memoranda were filed by both sides, thirty-one depositions were taken in four states, and tens of thousands of pages of documents were exchanged and reviewed.

Trial commenced in Anchorage on January 17, 1983, and continued for five very full trial days. At the conclusion of the trial, the Bankruptcy Judge denied the State's petition to have AOC placed in involuntary bankruptcy. This ruling does not, however, prevent the State from now proceeding against AOC in the Alaska State Courts.

The Findings of Fact and Conclusions of Law which the Bankruptcy Judge must issue to conclude the bankruptcy

AGO 786746

proceedings are still the subject of memoranda and argument before the Court, and are not expected to be issued before the end of April. But even in the absence of a definitive statement from the Court, the oral ruling by the Judge at the close of the trial in Anchorage gives a fair indication of the basis for his ruling.

The Bankruptcy Judge stated that, based solely on the price provisions of the Contract, AOC has a debt to the State for at least some portion of the amount withheld from AOC's payments for royalty oil. But the Judge also concluded that AOC's price dispute is in good faith within the meaning of Article 9.3, and that Article 9.3 of the Contract gives AOC the right to withhold payment of any amounts disputed in good faith until such time as the dispute is resolved. Therefore, the Court concluded, AOC's debt to the State is not yet "due" to be paid because of the good faith price dispute, and AOC could not be judged to be bankrupt for failing to pay that debt. Counsel for the State believe that the Court's ruling is not consistent with existing law, and the prospects for an appeal of the Bankruptcy Court's decision are now being evaluated.

The State is also considering the extent to which it will be fruitful to pursue the State Court action against AOC to recover the $62.6 million withheld by AOC from its payments for royalty oil. Among the factors to be considered in connection with that decision is the fact that Article 9.3, which proved to be the major stumbling block in the Bankruptcy Court proceeding, would have little bearing on an action in Alaskan Courts. AOC was able to avoid involuntary

AGO 786747

bankruptcy by convincing the Bankruptcy Court that its dispute with the State was in good faith, and that (because of Article 9.3) AOC's debt was not yet "due" to be paid. But in State Court, the central issue would be simply whether or not AOC has paid the price called for by the Contract, and AOC's good faith (or lack thereof) would not control whether AOC must pay the State the amount withheld. Another important consideration bearing on the decision whether to pursue the State Court case is the fact that much of the research and discovery already conducted in the bankruptcy proceeding could be used in a State Court action.

AGO 786748

BILL SHEFFIELD
GOVERNOR

Ce

1HB370

STATE OF ALASKA
OFFICE OF THE GOVERNOR
JUNEAU

April 19, 1983

The Honorable Joe L. Hayes
Speaker of the House
Alaska State Legislature
Pouch V
Juneau, Alaska 99811

Dear Mr. Speaker:

Under the authority of art. III, sec. 18, of the Alaska Constitution, I am transmitting a bill which provides for legislative approval of a royalty oil contract between the state and Chevron, U.S.A., Inc. for the sale of Prudhoe Bay royalty oil.

This contract is described in the findings entitled "Proposed Disposition of Royalty Oil, Chevron, U.S.A." issued by the Department of Natural Resources on March 16, 1983. Copies of these findings have been made available to the legislature and the public for review.

This contract is being submitted for legislative approval for two reasons. First, although this and the previous administration have consistently taken the position that the statutory requirement of legislative approval of royalty oil contracts is unconstitutional (AS 38.06.055), as a matter of comity I respect the legislature's desire to have a direct voice in major disposals of royalty oil. Therefore, this contract contains provisions requiring approval by the legislature before it becomes effective. Second, this bill would ratify the agreement for the sale of oil. This ratification would cure any procedural defect that may have occurred in the process of entering into this contract.

Although we believe that all necessary steps have been taken, the statutes and regulations governing the disposal of royalty oil represent often conflicting desires and goals, both procedural and substantive. For example, even if statutoril requiring legislative approval were constitutional, the present statutes provide, on the one hand, that the legislature is to approve the contract by enacting legislation (AS 38.06.055(a)), but, on the other

AGO 786749

hand, they also provide that a report of the Royalty Board "shall be submitted for legislative review at the time of [sic] resolution for legislative approval of a proposed disposition of royalty oil and gas is introduced in the legislature" (AS 38.06.070(c)). Since legislative approval is required anyway as a matter of contract, I believe it only prudent to present this contract for legislative approval and ratification at this time.

Sincerely,

Bill Sheffield
Governor

AGO 786750

STATE OF ALASKA
FISCAL NOTE

Revision Date , 1983

I. REQUEST
Bill/Resolution No.: HB 370
Title: Chevron Prudhoe Bay Unit Royalty Oil Agreement
Sponsor: Governor
Requestor: Governor

II. FISCAL DETAIL
Agency Affected: Natural Resource Mgmt.
Program Category Affected: Mgmt. of Energy
BRU, Program of Subprogram(s) Affected: Res Oil and Gas Management

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 83	FY 84	FY 85	FY 86	FY 87	FY 88
100 PERSONAL SERVICES						
200 TRAVEL						
300 CONTRACTUAL						
400 COMMODITIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC						
TOTAL OPERATING	0	0	0	0		

CAPITAL						

REVENUE						

FUNDING: (Thousands of Dollars)

GENERAL FUND						
FEDERAL FUNDS						
OTHER (Specify Source)	0	0	0	0		

POSITIONS:

FULL-TIME						
PART-TIME						
TEMPORARY						
	0	0	0	0		

III. SOURCE OF FUNDS TO OFFSET FISCAL IMPACT OF BILL:

IV. ANALYSIS: Attach a separate page for any Analysis

Prepared By: Mark Wittow Phone: 465-2400
Division: Commissioner's Office, DNR Date: 4/8/83

Approved for Commissioner: Date: 4/8/83
Department: Natural Resources

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ACO 786751 3/8/83