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STATE OF ALASKA
OFFICE OF THE GOVERNOR
JUNEAU

April 19, 1983

The Honorable Jalmar Kerttula
President of the Senate
Alaska State Legislature
Pouch V
Juneau, Alaska 99811

Dear Mr. President:

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 Tesoro Alaska Petroleum Company for the sale of Prudhoe Bay royalty oil.

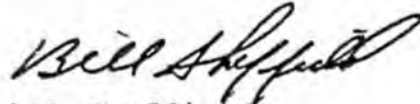
This contract is described in the findings entitled "Proposed Disposition of Royalty Oil, Tesoro Alaska Petroleum Company" issued by the Department of Natural Resources on March 16, 1983. Copies of these findings have been made available to the legislature and the public for review.

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 statutorily 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

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,

A handwritten signature in cursive script that reads "Bill Sheffield". The signature is written in dark ink and is positioned above the typed name.

Bill Sheffield
Governor

REQUEST

Bill/Resolution No.: SB268
 Title: Tesoro 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)

	FY 83	FY 84	FY 85	FY 86	FY 87	FY 88
OPERATING						
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 by Commissioner: Maughal Loren Date: 4/8/83
 Department: Natural Resources

Distribution:

- Original to Legislative Finance
- Copy to Office of Management and Budget (for Legislature introduced bills)
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- Copy to Sponsor
- Copy to Requestor (if different from Sponsor)

Alaska State Legislature

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Senate Committee on Resources

MEMORANDUM

TO: SENATE RESOURCES COMMITTEE MEMBERS

FROM: SENATE RESOURCES COMMITTEE STAFF

RE: ROYALTY OIL CONTRACTS

DATE: MAY 3, 1983

Attached is a copy of a letter from the Commissioner of Natural Resources to the Chairman. The letter discusses the proposed royalty oil contracts and the Department's position on their approval.

DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

POUCH M
JUNEAU, ALASKA 99811
PHONE:

May 2, 1983

The Honorable Bettye Fahrenkamp
Chairman, Senate Resources Committee
Pouch V
Juneau, Alaska 99811

Dear Senator Fahrenkamp:

On Wednesday, May 4, the Senate Resources Committee will be taking testimony on our proposed royalty oil agreements with Tesoro and Chevron. Since several questions have consistently been raised in hearings before the Legislature, I thought it might be useful to you and the Committee if I provided the Committee with a discussion of some of the key areas in writing, prior to our 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 agreements. 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 any other opportunities that may arise.

2. North Pole Refining 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. However, we are supporting a vigorous legal effort to collect the money owed the State by

Alaska Oil Co. Tesoro is a long-standing Alaska business, and deserves to have its contract treated on the merits.

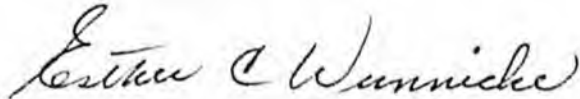
To the best of our knowledge, the purchase of stock by the Charter subsidiaries in Tesoro is in no way tied to the refiner's proposed Alaska expansion. If the contracts were to be rejected by the Legislature, Tesoro would still be able to utilize the capital funds realized as a result of the stock sale. If we believed that Charter in any way controlled Tesoro, or that the oil sold under this contract could in any way end up in the control of Charter, this contract would not be before you.

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 exercise 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.

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.