

SB

164

SFIN

FILE

SENATE FINANCE COMMITTEE REPORT

DATE: 4/27/95

FURTHER:

DATE TURNED INTO OFFICE: 4-29-95

The Finance Committee considered **SENATE BILL NO. 164**

Approving the sale of Prudhoe Bay Unit royalty oil by the State of Alaska to Tesoro Alaska Petroleum Company; etd.

and recommends:

- be replaced with _____ CS _____ (_____)
- adopt previous _____ CS _____ (_____)
- attached amendment(s)
- adopt Letter of Intent by _____ Committee
- further referral to the _____ Committee

Senate Bill:

same title
new title

House Bill:

same title
technical change
new: SCR*

SIGNING DO PASS	DP	OTHER RECOMMENDATIONS	NR	D&P	AM
<i>[Signature]</i>	✓				
<i>[Signature]</i>	✓				
<i>[Signature]</i>	✓				
<i>[Signature]</i>	✓				
Co-Chair: <i>[Signature]</i>	✓				
Co-Chair: <i>[Signature]</i>	✓				

NEW FISCAL NOTE(S):

Department Date Zero Fiscal

PREVIOUS FISCAL NOTE(S):*

Department Date Zero Fiscal

#2	DOR	4/19/95	e	
#1	DNR	4/19/95	e	

APPROPRIATION -- no fiscal note

*include fiscal notes accompanying Governor's bill

FISCAL NOTE

No. 1

Bill Version: SB 164

(S) Publish Date: 4/22/95

**STATE OF ALASKA
1995 LEGISLATIVE SESSION**

BILL

Revision Date: _____ Dept Affected: Natural Resources
 Title: An act approving the sale of Prudhoe Bay Unit BRU: Resource Development
royalty oil by the State to Tesoro Alaska Petroleum Co. Component: Oil & Gas Development
 Sponsor: Rules Committee
 Requestor: Governor Component Serial No. 439

Expenditures/Revenues

(Thousands of Dollars)

OPERATING EXPENDITURES	FY96	FY97	FY98	FY99	FY00	FY01
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0
CAPITAL EXPENDITURES	0.0	0.0	0.0	0.0	0.0	0.0
CHANGE IN REVENUES ()	0.0	0.0	0.0	0.0	0.0	0.0

FUND SOURCE

(Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1006 GF/MHTIA						
Other						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY95) cost: \$ 0.0

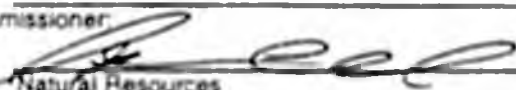
POSITIONS

FULL-TIME	0	0	0	0	0	0
PART-TIME	0	0	0	0	0	0
TEMPORARY	0	0	0	0	0	0

ANALYSIS:

(Attach a separate page if necessary)

The State will sell royalty oil to Tesoro Alaska Petroleum Co. at a price based on the royalty value of Prudhoe Bay Unit (PBU) royalty oil sold by Exxon. In 1994, the value averaged \$ 15 per barrel more than the volume-weighted average royalty value of royalty oil sold by all of the PBU producers. This difference will decline over the life of the contract as the surplus of Alaska North Slope oil shipped to the Gulf Coast declines. It is expected that this difference will just offset potential revenue losses of royalties and severance taxes which may result from the sale. These losses are caused when, in selling royalty oil, the State reduces the volume of oil sold by the producers in Alaska. The proportion of oil sold by the producers in the higher value West Coast (including Alaska) is reduced and the average royalty value and value of severance tax oil is also reduced.

Prepared by: Kevin Banks Phone: 762-2589
 Division: Oil & Gas Date: 19-Apr-95
 Approved by Commissioner:  Date: 4/20/95
 Agency: Natural Resources

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FISCAL NOTE

No. 2

Bill Version: SB 164

(S) Publish Date: 4/22/95

STATE OF ALASKA
1995 LEGISLATIVE SESSION

BILL NO. LA

Revision Date: _____ Dept. Affected: Revenue
 Title: Royalty Oil Sale to Tesoro by the State BRU: Revenue Operations
 Component: Oil and Gas Audit
 Sponsor: Governor
 Requester: _____ COMPONENT SERIAL NO. 115

Expenditures/Revenues (Thousands of Dollars)

OPERATING EXPENDITURES	FY 96	FY 97	FY 98	FY 99	FY 00	FY 01
PERSONAL SERVICES	0.0	0.0	0.0	0.0	0.0	0.0
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES	0.0	0.0	0.0	0.0	0.0	0.0
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CHANGE IN REVENUES ()	0.0	0.0	0.0	0.0	0.0	0.0
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FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1006 GF/MHTIA						
Other						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY95) cost: \$ 0.0

POSITIONS

FULL-TIME						
PART-TIME						
TEMPORARY						

ANALYSIS: (Attach a separate page if necessary)

Passage of the Bill reflecting LAWLOG: 95-0052 will not impact the Department of Revenue. Any change in royalty receipts should be reflected by the Department of Natural Resources.

Prepared by: Bob Barako Phone: 465-2312
 Division: Administrative Services Date: 4/18/95
 Approved by Commissioner: Deborah Vogt Date: 4/18/95
 Agency: Department of Revenue

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STATE OF ALASKA
OFFICE OF THE GOVERNOR
JUNEAU

April 22, 1995

The Honorable Drue Pearce
President of the Senate
Alaska State Legislature
State Capitol
Juneau, AK 99801-1182

Dear President Pearce:

Under the authority of art. III, sec. 18. of the Alaska Constitution, I am transmitting a bill that provides for legislative approval of a royalty oil contract between the state and Tesoro Alaska Petroleum Company for the sale of Prudhoe Bay Unit royalty oil. Also transmitted with this bill are copies of the resolution of the Alaska Royalty Oil and Gas Development Advisory Board recommending approval of that contract in accordance with AS 38.06.040(a)(3) and 38.06.050(a), and the report required by AS 38.06.070(c).

The contract is described in a final finding issued by the commissioner of the Department of Natural Resources on April 21, 1995. A copy of the commissioner's final finding and the signed contract are attached. Copies of the commissioner's preliminary finding and the draft contract previously were sent to the legislature and made available to the public for review.

A bill approving the contract is being introduced for legislative approval for two reasons. First, as a matter of comity, I respect the legislature's desire to have a direct voice in major disposals of royalty oil. Therefore, although this and previous Administrations have consistently taken the position that the statutory requirement of legislative approval of royalty oil contracts (AS 38.06.055) is unconstitutional, the contract itself contains provisions requiring approval by the legislature before it can take effect.

Second, this legislation would ratify the royalty oil contract. This ratification would cure any procedural defect that might have occurred in the process of entering into this contract.

I urge your prompt consideration and passage of this bill.

Sincerely,

A handwritten signature in dark ink, appearing to read "Tony Knowles".
Tony Knowles
Governor

The Alaska Royalty Oil and Gas Development Advisory Board

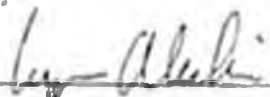
Resolution 95-1

On March 21, 1995, the acting director of the division of oil and gas ("director") provided the Alaska Royalty Oil and Gas Development Advisory Board ("Board") with preliminary findings and proposed contract for a three-year sale of approximately 40,000 barrels per day of Prudhoe Bay Unit royalty oil to Tesoro Alaska Petroleum Company ("Tesoro"). Tesoro will process the oil in its refinery in Nikiski, Alaska.

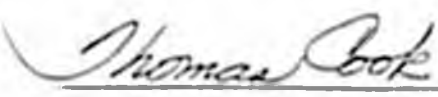
The proposed contract was discussed between representatives of the division of oil and gas and Tesoro over the past four months culminating in a draft contract. On March 21, 1995, the director made public the proposed contract and the Preliminary Finding and Determination of the Commissioner of the Department of Natural Resources. The director notified the public that the proposed sale would be discussed at the Board's meeting on April 6, 1995 and invited them to attend.

On April 6, 1995, the Board met to discuss the sale and to take public comment on it. The meeting was attended by representatives of the division of oil and gas, representatives of Tesoro, and members of the public. The Board received a presentation from the division staff regarding the proposed sale and contract, questioned the staff about them, and made several suggestions. The staff will implement those suggestions. At the conclusion of the discussion, the voting members of the Board, who attended the meeting, unanimously approved the proposed sale and recommended that the proposed contract be approved by the legislature.

Based on the Board's review of the contract for the sale and purchase of royalty oil between the state of Alaska and Tesoro, the Commissioner's finding and determination regarding the proposed sale, and the information presented at a public meeting of the Board, the Board is of the opinion that the proposed disposition of Prudhoe Bay Unit royalty oil to Tesoro meets the requirements of AS 32.06 and 11 AAC 26. The Board adopts the Commissioner's finding and determination, and recommends that the Nineteenth Legislature approve the agreement for the sale and purchase of royalty oil from the Prudhoe Bay Unit to Tesoro Alaska Petroleum Company.



Lynn Aleshire

 04-06-95

Tom Cook



Wilson Condon



Becky Galt

Willie Hensley



John Shively

APR 10 1995

The Alaska Royalty Oil and Gas Development Advisory Board

Resolution 95-1

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Lynn Alekhue

Tom Cook

Wilson Condon

Becky Gay

Willie Hensley 4/6/95

Willie Hensley

John Shively

Final Finding and Determination
to Sell Royalty Oil
to
Tesoro Alaska Petroleum Company



Alaska Department of
**NATURAL
RESOURCES**

Division of Oil and Gas
3601 "C" Street, Suite 1380
Anchorage, Alaska 99503-5948

April 21, 1995

Final Finding and Determination to Sell Royalty Oil
to
Tesoro Alaska Petroleum Company

I. Summary

The commissioner of the Department of Natural Resources, on behalf of the State of Alaska, proposes a three-year sale of approximately 40,000 barrels per day of the state's royalty oil to Tesoro Alaska Petroleum Company (Tesoro). Tesoro operates a refinery in Nikiski on the Kenai Peninsula and is one of the state's largest retailers of petroleum products. This document provides the final finding and recommendation required under AS 38.05.183 for the proposed sale.

The department distributed the preliminary finding and draft contract on March 21, 1995. The public comment period ended one month later on April 21, 1995. The department notified the public about the preliminary finding and draft contract and written comments were solicited by sending a notice of the sale or copies of the preliminary finding and draft contract to 388 citizens, special interest groups, industry and government representatives, and the media. The department also advertised through legal notices and display advertisements in newspapers throughout Alaska. At the close of the public comment period only two letters were received by the department both of which supported the sale. (See Appendix B.)

The mailing and advertisements also notified the public of a meeting of the Alaska Royalty Oil and Gas Development Advisory Board (Royalty Board) that was held on April 6, 1995 at which the proposed sale was discussed and public comment solicited. Comments made by the public (there were two people who testified) are addressed in this final finding. The Royalty Board subsequently unanimously approved the sale and signed a resolution recommending approval of the proposed sale by the Alaska Legislature. (See Appendix B.) The Alaska Legislature was also afforded an opportunity to be briefed by the commissioner of the Department of Natural Resources in informal meetings of the House Oil and Gas Committee and the Senate Resources Committee held on April 11-12, 1995.

II. Background

The State of Alaska receives a royalty of approximately 12.5 percent of the oil and gas produced from the Prudhoe Bay Unit. The state may take its share of oil production "in-kind or "in-value." When the state takes its royalty share of the oil in-kind (RIK), it assumes ownership of the oil, and the commissioner disposes oil through either competitive or non-competitive sales. When oil is taken in-value (RIV), the state's lessees, who produce the oil, market the state's share along with the lessees' own share. The lessees are obligated to pay the state the value of its royalty share.

On September 9, 1995 the state agreed to sell to Tesoro a volume of royalty oil equal to 27.2 percent of the daily royalty oil production of the Prudhoe Bay Unit. Deliveries under this contract began on January 1, 1995 and will continue through December 31, 1995. By statute this contract may not be renewed without a specific recommendation of the Royalty Board to the legislature and the legislature's subsequent approval. Last December, Tesoro initiated negotiations with the

royalty value reported by the largest PBU producers, ARCO, BP, and Exxon. The proposed contract price is compared with the current contract and the value of RIV in Table 2.²

Table 1: North Slope Royalty Crude Oil Production Forecast (MBO)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Prudhoe Bay Unit	143	135	127	116	105	95	85	75	69
Kuparuk River Unit	29	38	38	38	27	27	35	32	29
Mine Point	5	7	7	8	7	8	7	5	5
Exxon ¹	13	12	10	7	8	7	5	5	4
Total Royalty:	200	192	182	171	149	147	133	118	108
minus RIV Deduct for Field Cost Allowance									
Prudhoe Bay Unit	18	14	13	12	11	10	9	8	7
Kuparuk River Unit	3	3	3	3	3	3	3	3	2
Mine Point	2	2	2	2	2	2	2	2	2
Exxon ¹	1	1	1	1	1	1	2	2	2
	18	18	17	15	14	13	12	10	10
minus Current RIK Contracts									
Modco	35	35	35	35	35	35	35	35	35
Tesoro	29	-	-	-	-	-	-	-	-
Total Current RIK Obligation	64	35	35	35	35	35	35	35	35
ANS Royalty Oil Available to Supply New RIK Contracts:									
	108	140	130	121	110	99	96	73	63
Less Tesoro @ 30.0%	-	41	38	35	-	-	-	-	-
ANS Royalty Oil Remaining:	108	99	92	86	110	99	96	73	63

The Exxon West Coast royalty value further simplifies the calculation of the price for Tesoro's RIK purchase. In the calculation of royalty value in the current contract, the West Coast price reported by BP must be held confidential by mutual agreement with BP and the state. Since this information is proprietary, a mechanism was devised so that this value is first estimated with a provision to later revise it when the data are no longer restricted. The BP royalty value is subject to a six-monthly true-up of its actual marine transportation deduction which is also subject to review and audit by the state. This means that an RIK price value based on a BP royalty value would be subject to subsequent re-adjustments that could occur over several years.

² If the commissioner elects to sell Tesoro RIK from the Prudhoe Bay IPA, then the price will be calculated on the basis of Exxon's Royalty Value from just the IPA. See Table 2.

Tesoro opted for a RIK price based on the Exxon West Coast royalty value to avoid this uncertainty. The Exxon formula is strictly a West Coast price and no Gulf Coast pricing enters into its rather straightforward calculation of the PBU royalty value. Confidentiality provisions also apply in the intermediate calculations of the Exxon royalty value, but the value is determined by a formula that can be readily calculated independently.

The use of the Exxon royalty value explicitly recognizes that the sale of RIV to Tesoro is a West Coast placement. While Table 2 suggests that this price is about \$.19 per barrel higher than the volume-weighted average royalty value, this difference would have averaged about \$.15 per barrel in 1994 had this contract been in place then.

Previous RIK Findings have described the so-called "displacement effect" and "competitive effect" that may occur with a state sale of RIK. The "displacement effect" theorizes that any RIK sale by the state replaces ANS sales by North Slope producers to refineries on the West Coast (including Alaska). Although the total volume of ANS sold on the West Coast is the same without a RIK sale, the state's RIK volume displaces the volume that North Slope producers may sell on the West Coast. The producers must then show in their royalty reports that a larger percentage of their oil is placed on the U.S. Gulf Coast with higher transportation costs and a lower netback value. The result is a calculation of the lessees' average royalty value for RIV that reflects a new ratio of West Coast-to-Gulf Coast sales. This proportion of deliveries to the West Coast and Gulf Coast is also reflected in the netback value reported for severance tax purposes. In this way, selling RIK may decrease the states revenues from both RIV royalties and severance taxes.

The "competitive effect" relies on an assumption that the price of ANS on the West Coast as reported in the producers' royalty value is higher than the price that would result from a purely competitive market. The ANS spot market is dominated by one North Slope producer who may be able to influence the price by its decision to transport oil to the Gulf Coast. When the state was selling most of its royalty oil in-kind (nearly 210,000 barrels per day in 1986), there was concern that the state, as another seller in the market, could contribute to a lower West Coast price.

The "displacement effect" will diminish insofar as the proportion of total ANS sold on the Gulf Coast will continue to decline over the next few years. As above, the effect appears both in RIV royalty value and severance taxes. Now at less than 15 percent of total ANS production, Gulf Coast deliveries may cease in 1996.¹ The "competitive effect" is minimized insofar as the volumes of royalty crude considered for nomination under this proposed contract are so small (less than 3 percent) when compared to the total ANS production. Since the state may benefit from the continued operation of the Tesoro facility and, since the consumers of Alaska, may be better off with a more competitive refining industry, these benefits will likely outweigh the impact of these effects.

¹ Alaska Department of Revenue, 1994 Fall 1994 Revenue Sources Book, Anchorage, Alaska, p 16. In 1990, ANS movements to destinations in the Eastern U.S. represented 22 percent of total ANS production. Personal Communication with Roger Marks, Alaska Department of Revenue.

Tesoro or the state may reopen the proposed RIK contract if the ban on ANS exports is lifted. This would also be cause for the state to reopen the ANS Royalty Settlement Agreement with Exxon. Though Tesoro may not intervene between the state and Exxon, the RIK contract reopener provides a mechanism for the state and Tesoro to develop a new price term through prompt and good faith negotiations between each other. If the state and Tesoro fail to agree on a new price then, by notice to the other, either the state or Tesoro may terminate the contract.

Payments Like the current contract, the proposed contract has specified the timing and due dates associated with the Initial Billing, Initial Adjustments, and Subsequent Adjustments. The timing of these invoice and due dates has been shortened somewhat to reduce the state's exposure to default risk as described below.

Unlike the current contract, the state has agreed that any subsequent adjustment rendered more than six years after the date of delivery will bear interest for only six years from the due date of the initial billing. However, this six-year interest limitation does not apply to adjustments that result from regulatory decisions, reopeners, court proceedings, or audits of Exxon's royalty reports that are commenced during the six year period.

Termination Notice The state requires at least a six-month plus ten-day notice of early termination of the contract or any reduction in the maximum quantity taken by Tesoro. This timing is based on the ANS Royalty Settlement Agreements and the Prudhoe Bay Unit Agreement. Under the original Prudhoe Bay Unit Agreement, the state has a right to "denominate" RIK deliveries with a six month notice. Under each of the royalty settlement agreements, the timing requirement was reduced to 90 days. However, the settlements also provide that the lessees may claim *force majeure* if transportation is unavailable to transport any additional RIV for the first 90 days that the RIK has reverted back to the producers. During this up-to-90-day period that lessees could claim *force majeure*, the state must take full possession of its RIK and find customers to buy it and tankers to transport it. For this reason Tesoro is obliged to provide sufficient notice to terminate the contract or reduce its maximum quantity.

Security Supplies of RIK under the current contract are secured by an irrevocable letter of credit equal to 60 days worth of oil deliveries. The proposed contract will require a letter of credit equivalent to the value of 75 days worth of RIK to secure the state in the event that Tesoro, for any reason, fails to pay its bills or to take delivery. The increase in the value of the letter of credit is required to protect the state from its exposure to "denomination risk."¹ As described above, in addition to the risk assumed by the state should Tesoro fail to pay, the state also runs a risk of losing full value of its RIK when it "denominates" the RIK volumes as RIV. This 90 day denomination notice period under the ANS Royalty Settlement Agreements is effectively increased to 180 days should a lessee declare *force majeure* in obtaining sufficient marine transportation to haul the additional RIV volume. During this period, the state either has to find a new RIK purchaser or negotiate with the lessees to take back the RIK. In either event, the state is in a distress sale situation and the letter of credit instrument is intended to protect the state from this event.

¹ Denomination risk and default risk were fully described in the Final Finding and Determination in Sell Royalty Oil to Petro Star Valdez Refinery Joint Venture, March 4, 1992.

operation and expansion of Tesoro's Nikiski refinery. The state can offer a somewhat unique crude oil supply contract whose terms might not be available from any other seller. Presumably, Tesoro would continue their operations without this contract, but there are direct benefits to Tesoro that may be derived in their dealings with the state. To the extent that these benefits are translated into jobs, taxes, and more vigorous refined-products competition, the state will also benefit. By the same token, the degree to which the sale may contribute to the ongoing operation of the refinery also must be taken into account when describing the environmental effects of the refinery's operation.

Economic Impacts Tesoro reports that it currently employs 189 people in the Kenai Peninsula Borough.⁵ This translates as one-in-ten of the manufacturing jobs in the Borough (competing largely with fish processing and timber). Tesoro is, according to the Alaska Department of Labor, number six of the top-ten private sector employers in the Borough. For the most part these are also high-wage jobs with a payroll in the Borough of over \$11 million per year.

Tesoro's statewide marketing and distribution of petroleum products also contributes to the diversity of the Alaskan economy. Tesoro employs 552 people statewide with a payroll of over \$20 million.

Social Impacts Tesoro is one of the largest property taxpayers in the Kenai Peninsula Borough. It contributed \$1.3 million in ad valorem taxes in 1994 and the state received another \$7.6 million in various income, payroll, and excise taxes. No incremental effects on land use, impacts on the local social infrastructure, i.e., schools, public safety, roads, and other government services, are anticipated as a result of this sale.

Consumption Benefits In 1993, the Corps of Engineers reported "coastwise receipts" of 626,000 tons of petroleum products (185 million gallons). These are domestic shipments originating outside of Alaska. Furthermore, another 152,000 tons (45 million gallons) of petroleum products were imported to Alaska from Canada and elsewhere. Together these volumes amount to about 15 percent of the state's consumption. Presumably, some of these volumes can be displaced by a growth in local production of refined petroleum products and there may be a benefit to Alaskan consumers if competition from local supplies contribute to lower prices for the consumer.⁶

Tesoro estimates that its throughput in 1995 will 50,000 barrels per day. It produces a wide-range of products and contributes to a 30 percent share of the local market for diesel fuel, jet fuels, gasoline, and is a major supplier of propane and butane.

⁵ Tesoro Alaska Petroleum Company, March 14, 1995. Letter to Kevin Banks from Bernie Smith.

⁶ Scott Sellemeyer, February 1995. "A Diversified Economy--The Kenai Peninsula" Alaska Economic Trends, Alaska Department of Labor, pp. 1-7.

⁷ U.S. Department of the Army, Corps of Engineers, November 1994. Waterborne Commerce of the United States, Calendar Year 1993, Part 4--Waterways and Harbors Pacific Coast, Alaska and Hawaii, WRXC-WCUS-93-4. New Orleans, Louisiana and Alaska Department of Natural Resources, March 1995. Historical and Projected Oil and Gas Consumption, Anchorage, Alaska.

Under compliance orders with both ADEC and the U.S. Environmental Protection Agency, Tesoro is undertaking a long term clean-up of historical groundwater and soil contamination at the refinery.

V. Findings and Determination

The commissioner must conclude that in any disposition of RIK, first, under AS 38.05.183(a) the best interests of the state will be served by a non-competitive sale, and second, under AS 38.05.183(e), the non-competitive sale of RIK will be awarded to the prospective buyer whose proposal offers maximum benefits to the citizens of the state. The commissioner is specifically directed to consider the cash value offered for the RIK, the economic effects of the sale, the benefits of in-state processing of the RIK, and the ability of the prospective buyer to supply the state with refined products. In addition to these considerations, commissioner is obligated to analyze the sale using the same criteria that are to be considered by the Royalty Board in its review of the sale. These criteria are listed in AS 38.06.070 and include: the revenue needs and fiscal condition of the state; the local and regional requirements for petroleum products; the desirability of localized capital investment, increased payroll, and secondary development effects; the social impacts of the sale; the additional costs to the state and local governments caused by the development related to the transaction; the local and regional labor market; environmental effects; and the impact on existing private commercial enterprises and investment patterns.

Competitive Bidding is Waived As commissioner of the Department of Natural Resources, I have determined in accordance with AS 38.05.183(a) and 11 AAC 03.030 that the best interest of the state may be achieved in this sale without competitive bidding. The State is currently selling 37 percent of its North Slope royalty oil under the Mapco contract and Tesoro's one-year contract. There are other refineries that have requested RIK from the State. At the time of the publication of this finding, Petro Star Inc. and Petro Star Valdez Refinery together have requested 62,000 barrels per day and Tosco Refining Co., an independent West Coast refinery, has indicated an interest in a one-year supply contract. So, while competition for RIK may be said to exist, the state will retain enough royalty oil to meet the needs of these other RIK purchasers even with the proposed contract.

By this Preliminary Finding and Determination, the Alaska Royalty Oil and Gas Development Board has been notified that competitive bidding is waived as required under 11 AAC 03.040.

Contract Prices are Acceptable Under 11 AAC 03.010(b), I find that in establishing the price of this royalty oil contract, the department has obtained a price applicable to the oil that is being sold that is at least equal to, and probably will exceed, the volume-weighted average of the royalty value for all the RIV oil lifted in the Prudhoe Bay Unit.


The Sale is in the Best Interest of the State In accordance with AS 38.05.183(a), (c), and (e), I find that taking RIK and selling by non-competitive bid to Tesoro for use at the Nikiski refinery is in the best interests of the state. Furthermore, the sale as described above will maximize benefits to the citizens of Alaska. I find the following:

1. The state is now highly dependent on oil revenue and will continue to depend on oil

Legislative Approval According to AS 38.06.055(c) the commissioner may not renew the current one-year contract with Tesoro without the prior approval of the legislature. By statute, The Royalty Board must review the sale and submit a written recommendation to accompany a resolution introduced in the legislature to approve the sale.

Conclusion Under the terms of the proposed contract, the state would receive a fair royalty value for the royalty oil, while fostering in-state processing, potentially lowering product prices, and providing attendant benefits. The satisfactory price terms, coupled with the associated economic benefits for Alaska citizens, supports the decision to waive competitive bidding.

The foregoing facts and analysis support the finding that this disposal is in the best interest of the state and that it maximizes the benefits to Alaska citizens.



John T. Shavey, Commissioner

4/21/95

Date

Appendix A: AS 38.05.183(e), AS 38.06.055, and AS 38.06.070(a)

AS 38.05.183(e). When a sale, exchange or other disposal of oil or gas taken in kind by the state as its royalty share, or a sale, exchange or other disposal in whole or in part of a right to receive future royalty oil or gas, under a state lease under this chapter is made other than by competitive bid, the sale, exchange or other disposal shall be awarded by the commissioner to the prospective buyer whose proposal offers the maximum benefits to citizens of the state. The commissioner shall consider:

- (1) the cash value offered;
- (2) the projected effects of the sale, exchange or other disposal on the economy of the state;
- (3) the projected benefits of refining or processing the oil or gas in the state;
- (4) the ability of the prospective buyer to provide refined products or by-products for distribution and sale in the state with price or supply benefits to the citizens of the state; and
- (5) the criteria listed in AS 38.06.070(a).

AS 38.06.055. Legislative approval. (a) In addition to the recommendation by the board required under AS 38.06.050, the commissioner of natural resources may not enter into a sale, exchange, or other disposition of oil or gas or of the rights or waiver of the rights to receive future production of royalty oil or gas under AS 38.05.183 without the prior approval of the legislature. The legislature may approve a sale, exchange, or other disposition of oil or gas or of the rights or of a waiver of the rights to receive future production of royalty oil or gas only by enacting legislation. (b) The provisions of (a) of this section do not apply to

- (1) 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;
- (2) contracts for the sale of state-owned royalty gas or oil that specify the sale and delivery of not more than
 - (A) 400 barrels of crude oil per day;
 - (B) 460 barrels of natural gas liquids per day; and
 - (C) 2,400 Mcf of natural gas per day.

(c) A sale, exchange, or other disposition of oil or gas under (b)(1) of this section may not be continued after the end of one year or renewed with the same party without the prior approval of the legislature under (a) of this section. This subsection does not apply to a sequential competitively bid sale of oil or gas made with the same party under (b)(1) of this section.

Appendix B: Comments and Responses on the Preliminary Findings and Draft Contract

The department sent either a copy of the preliminary finding and draft contract, or a notice announcing its availability to a 388-person mailing list. In addition, legal notices and display advertisements were published in the Anchorage Daily News, Juneau Empire, Fairbanks Daily News-Miner, Kenai Peninsula Clarion, Homer News, Homer Tribune, and the Frontiersman.

The department received two letters commenting on the proposed sale. These letters appear below. Also, attached is Resolution 95-1 of the Alaska Royalty Oil and Gas Development Advisory Board signed by the Board members April 6, 1995.

Kevin Banks
Division of Oil and Gas
3601 C Street, Suite 1398
Anchorage, Alaska 99503-5948

April 18, 1995

APR 20 1995

Dear Mr. Banks,

This is in response to a publicly advertised request for comments concerning the sale of royalty oil to Tesoro Alaska Petroleum Company. The exploration for, production of, and shipment of oil in Cook Inlet continue to be emotionally charged issues in which I have been involved over the past 6+ years. This sale though should remain unrelated to those discussions.

As a commercial fisherman since the late 1960's in Cook Inlet waters ("semi-retired" in 1991), I have seen fishing overtaken by oil as the premier "industry" in Alaska. Unfortunately for all Alaskans, the oil industry merely increased resource *extraction* rather than expand resource *development*. Tesoro Alaska operations represent the pinnacle of resource development for the oil industry in Alaska. This sale needs to be supported wholeheartedly to continue at least this small effort of resource development in our state. The reasons I see of supporting this sale are, in general, split in two major areas.

On a local economic level innumerable opportunities have been provided to the Kenai Peninsula by the Tesoro operations. A stable economic base provided by the Tesoro plant and the related industry it helped spawn has made the Kenai region one of steady growth and excellent services. The continued sale of royalty oil to Tesoro will assure this region of its immediate future. In long-range economic terms this is an immeasurable benefit, yet there is no doubt of the positive effect. Providing a three year contract maintains security for Tesoro and the local economy.

A more thought-provoking reason concerns my belief the Tesoro plant and its responsible development plan should be the model for resource development in this state. While limiting or eliminating the royalty oil sale would have an economic effect largely confined to the central peninsula, the ramifications of such a detrimental action would be felt dramatically in the conceptual design of resource development for Alaska. The effect to future responsible development planning in the timber, fishing and oil industries would be to continue as merely a resource extraction site. This would be devastating to Alaska, especially as we attempt to rely less on oil extraction revenue and develop a broader economic base. Indeed, the continued sale of royalty oil to Tesoro Alaska Petroleum Company should be embraced by all Alaskans as the most positive and prominent step in responsible resource development in this state.

I enthusiastically endorse this royalty oil sale under a three year contract. Thank you for this opportunity to comment.

Yours truly,


Karl Pulliam

Sea Breeze Inn & Charters

Karl & Nancy Pulliam, Box 31, Sedrovia, Alaska 99663
PH/AX 907-234-7641/7699

The Alaska Royalty Oil and Gas Development Advisory Board

Resolution 95-1

APR 10 1995

On March 21, 1995, the acting director of the division of oil and gas ("director") provided the Alaska Royalty Oil and Gas Development Advisory Board ("Board") with preliminary findings and proposed contract for a three-year sale of approximately 40,000 barrels per day of Prudhoe Bay Unit royalty oil to Tesoro Alaska Petroleum Company ("Tesoro"). Tesoro will process the oil in its refinery in Nikiski, Alaska.

The propose contract was discussed between representatives of the division of oil and gas and Tesoro over the past four months culminating in a draft contract. On March 21, 1995, the director made public the proposed contract and the Preliminary Finding and Determination of the Commissioner of the Department of Natural Resources. The director notified the public that the proposed sale would be discussed at the Board's meeting on April 6, 1995 and invited them to attend.

On April 6, 1995, the Board met to discuss the sale and to take public comment on it. The meeting was attended by representatives of the division of oil and gas, representatives of Tesoro, and members of the public. The Board received a presentation from the division staff regarding the proposed sale and contract, questioned the staff about them, and made several suggestions. The staff will implement those suggestions. At the conclusion of the discussion, the voting members of the Board, who attended the meeting, unanimously approved the proposed sale and recommended that the proposed contract be approved by the legislature.

Based on the Board's review of the contract for the sale and purchase of royalty oil between the state of Alaska and Tesoro, the Commissioner's finding and determination regarding the proposed sale, and the information presented at a public meeting of the Board, the Board is of the opinion that the proposed disposition of Prudhoe Bay Unit royalty oil to Tesoro meets the requirements of AS 32.06 and 11 AAC 26. The Board adopts the Commissioner's finding and determination, and recommends that the Nineteenth Legislature approve the agreement for the sale and purchase of royalty oil from the Prudhoe Bay Unit to Tesoro Alaska Petroleum Company.

Lynn Alestue

Tom Cook

Wilson Condon

Becky Gay

Wilbur Hensley 4/6/95

Wilbur Hensley

John Slavely

*An Analysis of the Department of Natural Resources'
Proposed Three-Year Contract for the Sale of
Prudhoe Bay Royalty Oil to Tesoro Alaska
Petroleum Company*

Tesoro Alaska Petroleum Company
March 29, 1995

*An Analysis of the Department of Natural Resources'
Proposed Three-Year Contract for the Sale of
Prudhoe Bay Royalty Oil to Tesoro*

I. Summary

The Department of Natural Resources ("DNR") is proposing to sell 30% of the state's royalty oil entitlement from the Prudhoe Bay Unit--or about 27% of all North Slope royalty oil--to Tesoro Alaska Petroleum Company ("Tesoro"). Roughly 40,000 barrels per day of royalty oil would be available to Tesoro under the contract.

The contract term would be only three years, and would require that at least 80% of the oil purchased be processed at Tesoro's Nikiski refinery.

The contract requires legislative approval under AS 38.06.055. Royalty oil has been, and remains, the principal feedstock for Tesoro's refinery; indeed, deliveries under the proposed contract would represent about 80% of the refinery's crude supply. There are no other stable, long-term sources of crude for that refinery, and Tesoro's current one-year contract for state royalty oil expires on December 31, 1995.

As a result, if the legislature is unable to act on the proposed contract before it adjourns its 1995 session, Tesoro would lose about 80% of its crude oil supply, and continued operation of the Nikiski refinery would be in peril.^{1/}

Because the proposed contract must be reviewed by the Alaska Royalty Oil and Gas Development Advisory Board ("Royalty Board") before being presented to the

^{1/} By statute, DNR could not even renew Tesoro's one-year purchase contract without the legislature's approval. AS 38.06.055(c)

legislature,^{2/} legislation approving the contract should be ripe for introduction about April 24, 1995. However, and given that time is short, the legislature ought to begin evaluating the proposed contract now.

The legislature will review the proposed contract from two distinct perspectives: (1) as steward of Alaska's economy; and (2) as a seller of oil intent on receiving full value, and adequate security, for its product. This paper looks at the contract from both points of view:

1. *The Alaska Economy.* Alaska has a longstanding policy of employing a portion of its royalty oil entitlement to promote the growth of, and competition among, in-state oil refiners. As a result, Alaska has become virtually self-sufficient in refined petroleum products, and the resultant competition between the state's three in-state refiners has saved Alaska consumers hundreds of millions of dollars in retail gasoline prices alone.

Alaska's royalty oil policy has succeeded in large measure through royalty oil sales to Tesoro. This despite the fact that, among in-state refiners, Tesoro suffers a considerable competitive disadvantage, principally because its refinery is not directly linked to the Trans Alaska Pipeline. While Tesoro has never asked the state to help level this playing field, future competition can be assured only if the state, through its royalty oil dispositions, does nothing to aggravate the competitive disparity between Tesoro and other in-state refiners.

^{2/} AS 38.06.050(a).

2. *The State's Interest in Full Value.* Tesoro has never asked for, nor has it ever received, any subsidy or special allowance in purchasing royalty oil. Certainly the proposed contract grants none. Indeed, DNR has taken considerable advantage of its virtual monopoly position as Tesoro's only realistic principal source of supply.

Among the document's more rigorous requirements are these:

a. *Price.* Tesoro would be obligated, under the proposed contract, to pay a substantial "premium" above the price that the state receives from either: (1) the North Slope producers, in the aggregate, for royalty oil taken in value; or (2) other in-state refiners. In the month of January, 1995, that premium would have been \$.19/bbl.--or, on an annualized basis, about \$2.77 million;

b. *Security.* DNR has always been rightly concerned with the prospect of purchaser default--an event that could force the state to sell royalty oil under distress conditions. The proposed contract affords DNR an extraordinary series of safeguards in this respect. For example: in the past, Tesoro has posted a 60-day letter of credit to guarantee payment of oil delivered under the contract. (MAPCO Petroleum, conversely, posts no letter of credit at all.) The proposed contract lengthens that letter of credit to 75 days, unless Tesoro is able to assign its long-term tanker charter agreement to the state itself, so that DNR would have immediate access to an oil tanker if it found itself holding royalty oil; and

c. *Special Flexibility to Respond to a Lifting of the North Slope Export Ban.* Even if Tesoro takes every barrel allowed under the proposed contract, about 57%

of the state's ANS royalty oil would remain uncommitted, and available for whatever opportunities a lifting of the ban might create. Moreover, under a special reopener clause in the contract, the state can renegotiate the price term if and when the ban is lifted, and then terminate the contract if reopener negotiations don't yield a price commensurate with a changed ANS market. This clause affords DNR ample discretion to manage both uncommitted royalty oil, and Tesoro's royalty oil, if and when the ban is lifted.

In short, at virtually every turn DNR has exploited its considerable bargaining advantage. This will be the most favorable contract--from the state's perspective--under which any royalty oil has ever been delivered.

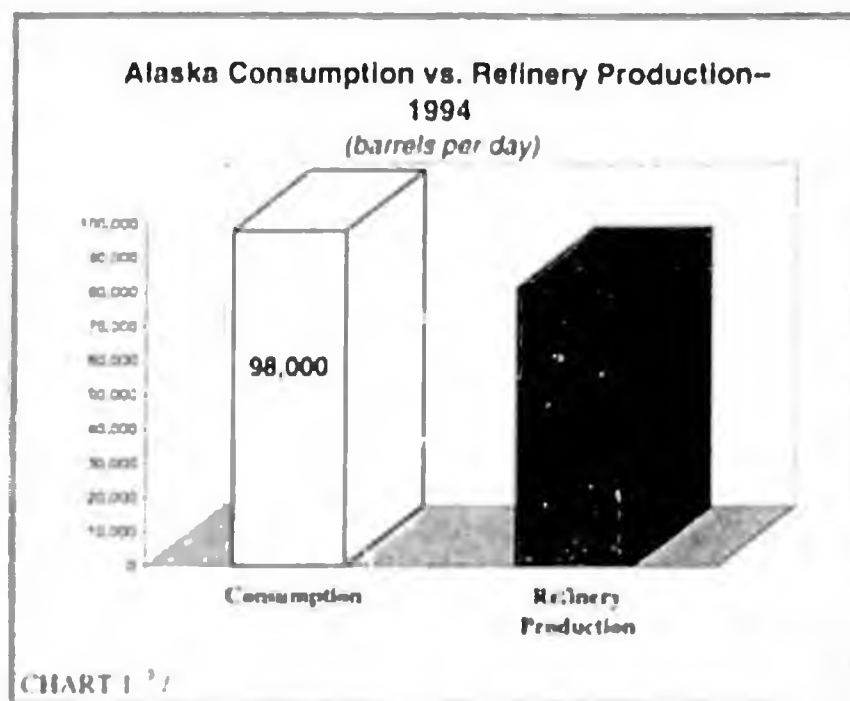
Nonetheless, the contract does meet Tesoro's need for a stable source of crude--albeit for only three years. As a result, the contract deserves legislative approval.

II. The Proposed Contract's Contribution to Alaska's Economy and Energy Self-Sufficiency

A. The Proposed Contract is a Continuation of an Alaska Success Story

Alaska has always used a portion of its royalty oil as more than a source of revenue. Since the 1970's, it has employed that oil to make Alaska virtually self-sufficient in gasoline and other refined products. Alaska's refineries actually have the capacity to meet all of the state's refined product needs. While Alaska still imports about 15% of its refined products,

those imports reflect shipments to Southeast Alaska and the Arctic-- which are beyond the effective distribution reach of in-state refiners.⁴⁷ As Chart



1 illustrates, except

for those remote-market imports, Alaska's refinery production virtually equals in-state demand.

⁴⁷ Source: (1) Consumption: DNR, "Historical and Projected Oil and Gas Consumption," Feb 1994 at 23; (2) Production: Tesoro internal production estimates.

⁴⁸ DNR, "Preliminary Finding and Determination to Sell Royalty Oil to Tesoro Alaska Petroleum Company," March 21, 1995 ("1995 Tesoro Findings") at 9.

The impact on Alaska consumers has been considerable. A 1992 MAPCO Petroleum study, for example, documented a \$.30/gallon difference in gasoline prices between Anchorage and Southeast Alaska--the higher prices in the Panhandle being attributable, in material part, to the lack of refiner competition in that region.^{3/} As that study explains, even if only 1/3 of that price differential were attributable to the keen competition encouraged by state royalty oil policy, that policy would still be responsible for a \$450 million savings to Alaska consumers in the 1980's. *Id.* at 1.

Apart from direct consumer benefits, Alaska's refining industry directly employs about 850 people, and pays about \$11 million annually in local and state taxes. For its part, Tesoro employs 552 Alaskans, and it recently completed a \$25 million vacuum unit designed to convert currently-unprofitable residual fuel into more valuable product. This is in addition to the \$236 million in capital improvements that Tesoro has made in Alaska over the past two decades.

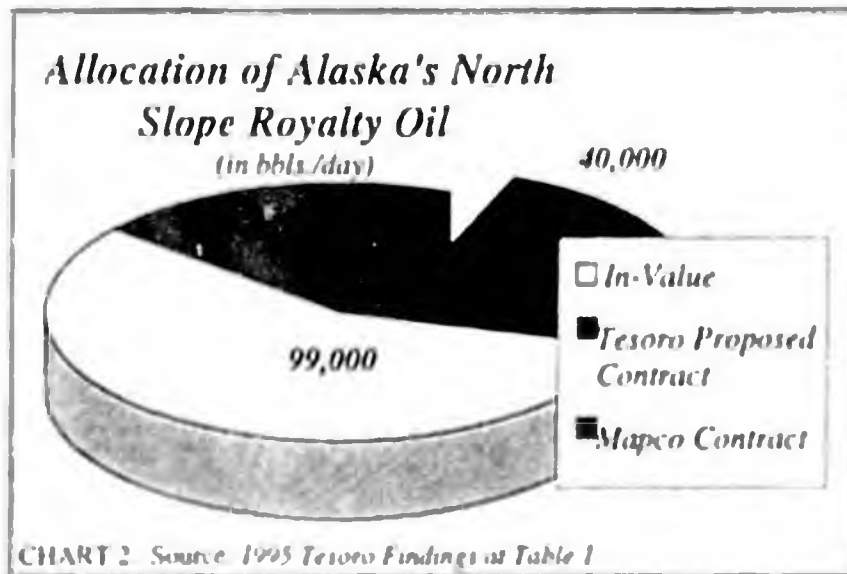
All these benefits flow directly from the Alaska Legislature's clear direction to manage Alaska's royalty oil and gas in a way that encourages in-state energy self-sufficiency. For example, royalty oil can't be exported unless it's surplus to in-state needs,^{4/} and non-competitive sales must always be made to the buyer that "offers the maximum benefits to citizens of the state"--including the "benefits of refining or processing the oil or gas in the state." AS 38.05.183(c).^{5/}

^{3/} Purvin & Gertz Study, prepared for MAPCO Petroleum (1992) at 4.

^{4/} AS 38.05.183(d).

^{5/} The statutes governing the Alaska Royalty Oil and Gas Development Advisory Board likewise create a pronounced bias towards in-state use of royalty oil. AS 38.06.070(a) and (b).

Given that policy, and the considerable benefits that have flowed from it, it's surprising how small a fraction of state royalty oil is actually committed to in-state



refiners. As Chart 2 shows, even if the legislature approves the proposed Tesoro contract, only 43% of the state's ANS royalty oil would be sold to in-state refiners. The rest would still be taken in value.⁹⁷

B. Royalty Oil Sales to Tesoro Are Largely Responsible for the Success of the State's Royalty Oil Policy.

The state has profited considerably from its modest investment of royalty oil. Nowhere is this more true than with respect to DNR's royalty oil sales to Tesoro. The Nikiski refinery began operations in the 1960's, supplied in part by Cook Inlet royalty oil. Tesoro began receiving ANS royalty oil in July, 1980, and, by 1987, Tesoro had invested over \$200 million to modify the refinery to process ANS royalty crude. ANS royalty oil has been the principal source of its feedstock ever since.

From that feedstock, Tesoro supplies virtually all of the gasoline sold in Southcentral Alaska, through (1) its own service stations, and (2) sales to other retailers.

⁹⁷ A 1992 contract to sell approximately 30,000 bbls./day of royalty oil to Petro Star IV over a 10-year period was terminated by DNR when Petro Star declined to take oil under the contract.

In addition, Tesoro's gasoline is sold by MAPCO in Anchorage, and MAPCO's gasoline is sold by Tesoro in Fairbanks. In this way, consumers at both ends of the Alaska Railbelt benefit from the presence of both refineries through the resultant savings in transportation costs.

Tesoro, to be sure, is not the only player in the Alaska trade, but it is equally plain that Tesoro plays a vital role in the delicate balance of competition and cooperation that, quite remarkably, has made a state as massive and underdeveloped as Alaska virtually self-sufficient in refined petroleum products.

C. Tesoro's Continued Contribution to In-State Refiner Competition Depends on the Continued Availability of Royalty Oil Under Fair Terms

1. The Absence of Any Alternative Source of Supply

As a practical matter, Tesoro has no reliable, long-term source of crude other than ANS royalty oil. Having modified its refinery to accommodate ANS crude, Tesoro now finds itself without any significant private supply source. This because:

- (1) ARCO refines its entire production itself;
- (2) British Petroleum has declined to sell oil to third parties at Valdez because of perceived potential environmental liability; and
- (3) Exxon is interested only in occasional, short-term sales.

Indeed, in 1994 Tesoro lost one of the few private sources of ANS crude heretofore available to it. In 1995, Tesoro purchased about 3,500 bbl/day of Milne Point production from Conoco. However, Conoco sold its Milne Point interest to British

Petroleum at the end of 1993, and BP, for the reasons discussed above, is unwilling to sell Milne Point oil to Tesoro.

2. It's Important to Make Royalty Oil Available to Tesoro Under Competitive Terms, Lest the State Aggravate Tesoro's Competitive Disadvantage

Tesoro's dependency on ANS royalty oil makes it rather tempting for the state to exploit its resultant bargaining advantage. As we'll see in the next section, that's what happened here.

To an extent, DNR has always been strict with its in-state purchasers--a policy of restraint borne in large part of the Alpetco Refinery fiasco. There are, however, prudent limits to that policy. The state hopes to use its royalty oil to enhance in-state refinery competition. When one of those refineries bears an underlying market disadvantage, DNR must take special care to assure that the terms under which royalty oil is made available to that company are no more burdensome than those offered the company's more fortunate competitors.

In Alaska, Tesoro is the disadvantaged company. Tesoro's principal competitors--MAPCO Petroleum and Petro Star--both take ANS crude directly from the Trans Alaska Pipeline ("TAPS"). As a result, neither MAPCO nor Petro Star have to inventory any crude oil at their refineries.

Tesoro, on the other hand, must ship its oil first over the entire length of the TAPS line, and then by tanker from the TAPS terminal at Valdez to the Nikiski refinery. Tesoro resultantly must: (1) always keep about one million barrels of crude oil in inventory, and (2) pay about \$2/bbl more for its feedstock than either of its competitors. And, the principal component of that additional cost--the cost of tanker transportation from Valdez

to Nikiski--is increasing because of new safety requirements imposed through the federal Oil Pollution Act of 1990.

MAPCO's and Petro Star's proximity to the pipeline not only affords them cheaper crude; it also enables them to dispose of unmarketable refinery product at only a nominal charge--while Tesoro, conversely, must pay dearly to ship that same product south. In particular, Tesoro and MAPCO both produce substantial quantities of heavy "residual" oil, which has no market in Alaska. MAPCO is able to return that product to the TAPS line, paying only a \$1.25-\$1.30/bbl. "quality bank" penalty. Tesoro, conversely, must ship its residual oil to the West Coast at a transportation cost of \$3.40/bbl. All tolled, Tesoro receives a much lower value for that product than does MAPCO.

Moreover, in recent years Tesoro has been forced to deal with yet another unwanted element of ANS crude--a product that, once again, MAPCO simply returns to the pipeline. ANS producers have been significantly increasing the LPG component to the crude stream, and Tesoro has been required to spend several million dollars to dispose of the LPG at the refinery. Again, however, MAPCO can reinject this product into the pipeline--which, ironically, even further increases the LPG content of ANS crude oil that Tesoro receives at Valdez.

Yet another example of MAPCO's competitive advantage relates to the recent installation of a benzene stripper at MAPCO's North Pole refinery. This unit reduces or extracts benzene, which MAPCO also reinjects into TAPS. This, in turn, has complicated Tesoro's ability to continue to meet gasoline specifications.

3. *Despite Its Disadvantaged Position, Tesoro Has Never Asked for More than Competitive Access to State Royalty Oil.*

Tesoro has always paid full value for its royalty oil. Indeed, after DNR settled with the ANS producers in the *Amerada Hess* litigation, Tesoro agreed to pay roughly \$95 million in retroactive price increases to bring its past royalty oil payments in line with the theory of "value" won by the agency in *Amerada Hess* negotiations. Tesoro has paid its bills on time--indeed, in recent years it has unfailingly paid its DNR invoices within 10 days of receipt. And it has posted a costly letter of credit to guarantee future payments, even though its chief competitor posted none.

• • •

In light of what we've learned from this section, the proposed contract's pronounced tilt towards DNR will seem rather surprising. This is not a case where the state bends some rule, or grants some favor, to encourage some economic enterprise. It is much the opposite--an experiment in brinkmanship undertaken *despite* the consumer interests at stake, and the disadvantaged position of the purchaser.

III. The Proposed Contract Vigorously Protects the State's Interest as Owner of the Royalty Oil

From the perspective of royalty owner, the state's principal interests in the proposed Tesoro contract are three-fold: (1) price; (2) security; and (3) flexibility in managing royalty oil. In all three respects, the Tesoro contract is uniquely favorable to the state.

A. Price

Until now, DNR has been satisfied, in its sales of royalty oil to in-state refiners, to receive a price commensurate with the amount it would have received had it left the oil with the ANS producers and taken its royalty share in value. As DNR recently said:

Since the first royalty oil sale, the state's policy has been that it would not necessarily maximize revenues from royalty in-kind sales, but that it would not receive less for the people's royalty when taken in-kind and sold than the state would otherwise have received had it left the oil with the lessees and taken its royalty in-value.

*DNR, Final Finding and Determination to Sell Royalty Oil to Petro Star Valdez Refinery Joint Venture ("Petro Star Findings"), March 4, 1992 at 6.*⁷ Moreover, DNR has declined to ask for any "premium," above the in-value price, from in-state refiners. In the past, DNR considered charging "premiums" for in-state sales out of its concern that its royalty oil, when taken and sold in-kind anywhere on the West Coast (including Alaska), tended to "displace" other ANS crude from the Pacific Coast, forcing it to the Gulf Coast

⁷ As noted previously, the Petro Star JV sale was terminated when Petro Star declined to take oil under the contract.

where it would yield a lower price. A "premium" charged the royalty oil buyer, DNR surmised, could offset the revenue loss caused by the "displacement."¹⁰

However, DNR has more recently concluded that the "displacement effect" is no longer a cause for concern, given the "small and decreasing proportion of gulf sales," and the relatively small amount of oil involved.¹¹ With respect to Tesoro's one-year 1995 contract, DNR said:

The proposed sale to Tesoro is unlikely to generate these effects which were a larger concern when so much of the ANS crude oil was shipped to the Gulf Coast...Since the state will clearly benefit from the continued operation of the Tesoro facility and, since the consumers of Alaska are likely to be better off in a more competitive industry, the state does not propose a price premium in this contract.

1994 Tesoro Findings at 14. The same conclusion was reached with respect to the long-term Petro Star sale, *Petro Star Findings* at 11 ("For these reasons, and to encourage the jobs, income, tax, and consumption benefits from in-state refining, the proposed contract does not include a premium.")

In its *Amerada Hess* settlements with the principal ANS producers, DNR defined "value" as a volume-weighted average of the values of ANS oil in different markets. ANS crude is sold along both the West and Gulf coasts, and, of late, Gulf Coast prices have generally been \$90-\$100/bbl, less than West Coast prices. By pegging "value" to a volume-weighted average of these sales, the aggregate "value" is thus lower than if "value" were defined solely with reference to West Coast sales.

¹⁰ See, e.g., *Petro Star Findings* at 10-11. As discussed in the following text, no premium was charged Petro Star.

¹¹ *Id.* at 11; see also DNR, "Preliminary Finding and Determination to Sell Royalty Oil to Tesoro Alaska Petroleum Company," August 16, 1994 ("*1994 Tesoro Findings*") at 14.

British Petroleum, for example, sells ANS oil in four different markets, and its settlement agreement provides that:

The Average Valdez Netback shall be a per barrel amount calculated by volume weighted averaging the Valdez Netbacks for each of the four market destinations to which production was delivered: West Coast, Gulf Coast, Hess and Mid-Continent.

ANS Royalty Settlement Agreement between BP Exploration (Alaska) Inc. and State of Alaska, ("BP Settlement") December 31, 1991, Art. 3.2(d).¹²⁷

This is also the deal that DNR struck with other in-state refiners. The State's contract with Petro Star JV incorporated the BP settlement methodology for valuing Petro Star's oil--with Petro Star paying the "average" royalty value from sales to all destination markets, rather than only the West Coast royalty value. *Id.* at Art. 2.3.

The same is true under MAPCO Petroleum's long-term contract.

One would expect, then, that the proposed Tesoro contract would allow the purchaser to pay on the basis of this same volume-weighted average of West and Gulf Coast prices. That, however, isn't what happened. Intent on charging Tesoro, and Tesoro alone, a "premium" for its royalty oil, DNR set Tesoro's price with reference to the value reported under the agency's *Amerada Hess* settlement with Exxon. But Exxon sells its oil only on the West Coast. As a result, and as Chart 3 illustrates, had the contract been in effect in January, 1995, Tesoro would have paid a \$19/bbl. premium over the

¹²⁷ While "market baskets" of oil are used to calculate BP's royalty obligations, there is a separate market basket for Gulf Coast placements, so the volume-weighted influence of Gulf Coast prices remains unaffected.

value received from other in-state refiners, and from the ANS producers in the aggregate-- a premium, which, over the course of a year, would have approximated \$2.77 million.



CHART 3. Source: 1995 Tesoro Findings at Table 2.¹⁷

Finally, not only is Tesoro charged a significant "premium."

Moreover, the

proposed contract also provides that the State can continue to "adjust" that price upwards as it obtains "more accurate information"--the adjustment period running for the full period permissible under the applicable statute of limitations, Art. 5.3.

B. Security

1. The Letter of Credit

DNR has always faced two risks in selling its royalty oil:

¹⁷ Table 2 of the 1995 Tesoro Findings mistakenly lists the January, 1995 volume-weighted average of all producer prices as \$11.027. This is due to an inadvertent failure to include British Petroleum Gulf Coast sales, and the correct figure of \$10.91/bbl. was agreed to in a phone conversation with DNR Division of Oil and Gas' Kevin Banks on March 24, 1995.

Further, had Petro Star actually taken delivery of royalty oil under its now-terminated 1992 contract, its actual volume-weighted average price would have been about \$ 21/bbl. less than the \$10.91 price depicted in the chart--or, about \$10.70/bbl. This is because Petro Star had contracted for Kuperuk River Unit production, which is subject to an approximately \$ 21/bbl. Kuperuk Pipeline tariff. However, since Petro Star would have paid that tariff to the pipeline company, the net cost of that royalty oil to Petro Star would have been the same as if it had taken Prudhoe Bay oil. Therefore, the price term of the Petro Star contract is more fairly depicted as the same volume-weighted average price paid by MAPCO.

(1) A certain quantity of oil might be delivered before the state discovered that the buyer would be in default. The state wants to be paid for that oil; and

(2) The state is obligated to give the ANS producers a certain amount of advance notice before it can require those producers to take the royalty oil back, and pay the state in-value. This is the so-called "denomination" period; and, while the state could sell its royalty oil to someone else during that waiting period, it fears receiving a lower price because it would be a distress sale.

Taking Risk (2) first, prior to 1992 the applicable ANS leases and unit agreements generally provided for six months' "denomination" notice--that is, the state could find itself holding six months of oil if the buyer defaulted. Nonetheless, prior to 1992 the state either: (1) required no letter of credit at all, as with MAPCO Petroleum's long-term contract, or (2) asked for only a 60-day letter of credit, as it did with every Tesoro royalty oil contract.

The 60-day letter of credit (or "LOC") was used because it was the commercial norm. In the private sector, longer-term oil purchases are usually secured, at most, by a 60-day LOC.

Thus, the risk posed by a "distress sale" during the "denomination" period was never the determining factor in DNR's security requirements. DNR never went beyond the bounds of commercial reason, because in doing so it would have risked placing in-state refiners at a further disadvantage--which, of course, would have offended Alaska's royalty oil policy.

Moreover, every *Amerada Hess* settlement reduced the "denomination" period to 90 days--unless, as in BP's case, the producer notified the state that, "after making documented good faith efforts,...it is unable to obtain acceptable vessel transportation" for the oil. *BP Settlement* at Art. 2.1(b). Given today's depressed market among independent U.S. flag oil tankers, it's doubtful that such a claim of "force majeure" could be made. And, in any event, the declaration of "force majeure" is intended as the exception, rather than the rule.

The point being, of course: if an across-the-board six-month "denomination" period wasn't enough to warrant more than a 60-day letter of credit, the general lessening of that period by half would hardly seem to warrant a more lengthy LOC.

Nor would Risk (1) seem to warrant anything more than the traditionally acceptable 60-day LOC. Nonetheless, DNR did require a 90-day LOC in its 1992 royalty oil sale to Petro Star JV.¹⁴⁷ In justifying that requirement, DNR imagined that 70 days of unpaid-for oil might be delivered before the state could declare a default. A 90-day LOC, DNR reasoned, was necessary to secure payment for that oil--the remaining 20 days' value in the LOC being in the nature of liquidated damages for Risk (2).¹⁴⁸

¹⁴⁷ This is the only royalty oil contract to contain the 90-day LOC requirement, and the Petro Star contract was a special case. The contract was intended to aid Petro Star's plan to build a then-nonexistent Valdez refinery. It was thus a speculative endeavor that presented the State with some of the same risks that it faced with the Alpetco contract years previous.

Tesoro, by contrast, has been a buyer in good standing for a quarter century, and in recent years has unfailingly paid its royalty oil bills within about 10 days of receipt.

Moreover, it should be noted that Petro Star JV never purchased any royalty oil under that contract. One can reasonably surmise that it didn't do so, in part, because the security requirements extended beyond the bounds of commercial reasonableness and availability.

¹⁴⁸ *Petro Star Findings* at 14.

DNR's 70-day timeline, however, wouldn't apply to the proposed Tesoro contract. Under that contract, DNR would bill Tesoro within 10 business days after the end of each month of delivery, and Tesoro would be required to remit payment *within 3 business days* of billing. *Id.* at Arts. 5.1 and 5.4. Since DNR can declare a default, and cease deliveries of oil, as soon as "Tesoro does not pay in full any sum owed under this Agreement at the time when payment is due,"^{16/} DNR risks, at most, about 47 days of unpaid-for deliveries under the contract--a risk more than amply covered by a 60-day letter of credit.^{17/}

Nevertheless, the proposed contract requires a 75-day letter of credit. *Id.* at Art. 15.1. And the difference is no small matter to Tesoro. Tesoro's current 60-day letter of credit with DNR consumes over 25% of Tesoro's total credit capacity. A 75-day LOC would reduce the company's available credit capacity by an additional \$8-9 million. And, based on current Pump Station 1 crude prices, a 75-day letter of credit would increase the banking charges associated with the LOC by about \$156,000 per year--to a total annual cost of about \$780,000.

The increase is apparently motivated by DNR's newly-heightened concern over the availability of tanker capacity to ship any royalty oil that it, or the ANS producers, might find themselves holding in the event of Tesoro's default. In that respect, the contract does allow Tesoro to reduce the term of the LOC to the traditional 60 days--but only if Tesoro can obtain a long-term charter with a tanker company for deliveries anywhere on the West Coast (rather than simply the Nikiski refinery), and then assign that charter to DNR so that

^{16/} *Id.* at Art. 7.1(ii)

^{17/} The 47 days is inclusive of: (1) a month's delivery of oil, (2) 10 days to render the bill, (3) 3 days' payment grace period, and (4) 4 intervening non-business days.

the agency could directly employ the tanker (or further assign the charter to an ANS producer) in the event of Tesoro's default. *Id.* at Art. 15.2.

Through this remarkable clause, DNR would have a ready answer to BP, or any other ANS producer, should that producer attempt to decline royalty oil on 90 days' notice under the *Amerada Hess* settlements' "force majeure" provisions.

DNR thus finds itself doubly protected with: (1) a more-than-sufficient 75-day LOC; or (2) a 60-day LOC, coupled with an ironclad charter, in-hand, with rates acceptable to DNR, to assure prompt transport of any oil--by itself or an ANS producer--should a default occur.

But while DNR is amply protected under the security clause, Tesoro isn't protected at all. The LOC can be reduced to 60 days only "if Tesoro and the State can reach an agreement" on a mutually-acceptable tanker charter--a rather gossamer contingency, from Tesoro's perspective. If DNR doesn't like the price term of the charter, for example, or is displeased with the charter in any respect, Tesoro will have to retain the 75-day LOC.

2. *Tesoro's Solvency*

As with other royalty oil contracts, the proposed Tesoro contract allows DNR to terminate the agreement: (1) "[i]f Tesoro becomes unable to pay any of its debts when due, or should otherwise become insolvent"; or (2) "[t]here is a material adverse change in Tesoro's condition, business, or property which may appreciably affect its ability to perform." *Id.* at Arts. 7.1(v) and 7.2.

More importantly, DNR is aware that its royalty oil is being purchased by a company with decades of good standing with the agency. With respect to the future, DNR has recently said:

Tesoro Alaska's parent company in February 1994 implemented a dramatic recapitalization plan which should provide the company with an immediate improvement in cash flow....Following resolution of Tesoro's dispute with the State of Alaska, implementation of the recapitalization plan, and issuance of additional common stock, the value of Tesoro's common stock has approximately doubled.

1994 Tesoro Findings at 9-10.

3. The Absolute Nature of Tesoro's Obligation to Accept Delivery of Royalty Oil

Although the contract rigorously protects DNR should the state ever be required to dispose of royalty oil after a default, DNR's overriding goal is to assure that this never happens. Here again, the contractual safeguards are extraordinary. Tesoro's obligations to take royalty oil "are absolute, and will not be excused or discharged by the operation of any disability of Tesoro, force majeure, or any other reason or cause." *Id.* at Art. 29.

The document continues:

(1) Tesoro may be required to periodically provide DNR with "satisfactory evidence or reasonable assurance" of Tesoro's continued ability to arrange transportation for the oil from Valdez. Art. 2.8:

(2) While, on six months' notice, Tesoro may take less than the maximum quantity of oil made available under the contract, to do so it must pay a penalty equal to

.75% of the difference in price between what it actually takes, and what it is entitled to take. Art 2.11;

(3) Tesoro remains obligated to immediately inform DNR of "any material adverse change" in its financial condition. Art. 3.2;

(4) Even if the agreement is entered into by consent, or through no fault of Tesoro's, Tesoro agrees to "continue to take and purchase the State's royalty oil...for up to six Months following termination if the State, in its sole discretion, so requires." Art. 8.1; and

(5) "If for any reason, Tesoro is unable or refuses to accept or receive any Oil" tendered under the contract, "Tesoro shall nevertheless be and remain responsible for the disposal of that Oil and for paying the State for the Oil as though it had been received..." Art 8.2.

It is, in sum, hard to envision a contract more protective of the seller's interest.

C. DNR's Retained Flexibility to Manage Royalty Oil

With renewed optimism over the possible lifting of the ANS oil export ban, DNR has paid special attention to retaining its flexibility to deal with market changes that may occur within the Tesoro contract period. Of course, we've seen that, even with the Tesoro contract, the state retains about 99,000 bbl/day of North Slope royalty oil--or about 57% its total--to use as it sees fit if the ban is lifted.

DNR, however, wanted more. It insisted on a special clause in the Tesoro contract giving it broad discretion to renegotiate the contract's price term if and when the ban is lifted. In pertinent part, the clause provides:

Neither the State nor Tesoro shall have the right to reopen this Agreement, unless the United States Congress lifts the export ban on ANS crude now in effect. Anytime after the export ban is lifted, either Tesoro or the State may reopen this Agreement for purchase price only...Upon issuance and receipt of a notice to reopen, Tesoro and the State will promptly commence good faith negotiations in an attempt to establish a new purchase price. If a new purchase price is not agreed to by Tesoro and the State within three months after giving the notice to reopen, either Tesoro or the State may terminate this Agreement upon nine months written notice to the other.

Art. 2.4(a). Of course, from Tesoro's perspective this clause injects a worrisome element of uncertainty, and a three-year contract doesn't bind the state for such a lengthy period of time that a price reopener clause of any kind would ordinarily seem warranted. Thus, the special benefit afforded DNR by this clause is simply another example of the unusually high price that Tesoro will pay to keep the Nikiski refinery open.

IV. Conclusion

Because DNR used every bit of its bargaining leverage in forging the contract's terms, the proposed Tesoro contract raises no controversies from the state's perspective as an oil seller. As a policy matter, the contract is simply a continuation of Alaska's successful program of promoting in-state refiner competition. As a technical matter, the contract gives the state a price premium, secures the state's interest as surely as any contract could do; and provides the state with ample flexibility to respond to changes in the ANS market.

True, the contract is quite tough on Tesoro. Tesoro should have access to royalty oil under the same terms as its competitors, and the proposed contract doesn't meet that goal. But there isn't time to have that debate. The proposed contract needs to be approved by the legislature before this May's adjournment, and it is rather apparent that the legislature can do that with the absolute assurance that the State of Alaska is getting a very good deal.

AGREEMENT FOR THE SALE AND PURCHASE

OF

STATE ROYALTY OIL

to

TESORO ALASKA PETROLEUM COMPANY

THE STATE OF ALASKA
Department of Natural Resources

Dated as of April 21, 1995

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1 1.7 "Lessee" means any person owning a working interest in any of the Leases.

2 1.8 "Month" means the period beginning at 12:01 a.m., Alaska Standard Time,
3 on the first Day of the calendar Month and ending at the same time on the first Day of the next
4 succeeding calendar Month.

5 1.9 "Oil" means the same as the word "oil" under the Leases and the Unit
6 Agreement, except where inconsistent with Articles 2.1(b) and 2.2 of this Agreement, in which case
7 Articles 2.1(b) and 2.2 shall control. For purposes of this Agreement, "Oil" shall also include natural
8 gas liquids ("NGLs").

9 1.10 "Point of Delivery" shall have the meaning set out in Article 2.6.

10 1.11 "Royalty Oil" means the Oil which the State may take in-kind (in amount) as
11 its royalty under the Leases whether or not the State has elected to take or is taking that royalty in-
12 kind except as provided in Article 2.1(b).

13 1.12 "Royalty Settlement Agreement" means the written royalty settlement
14 agreements between the State and Exxon Corporation ("Exxon") dated December 31, 1991.

15 1.13 "Royalty Value" means the royalty value of all liquid hydrocarbons from the
16 Prudhoe Bay Unit or the Prudhoe Bay Unit initial Participating Areas as provided in Article 2.1(b)
17 calculated in accordance with the Royalty Settlement Agreement for West Coast placements as
18 explained in Article 2.3.

19 1.14 "TAPS" means the Trans Alaska Pipeline System.

20 1.15 "Unit Agreement" means the Prudhoe Bay Unit Agreement effective April 1,
21 1977, by and between the Lessees and the State, as amended from time to time.

1 ARTICLE II

2 SALE OF ROYALTY OIL

3 2.1 Quantity

4 2.1(a) Prudhoe Bay Unit Quantity. The State agrees to sell to Tesoro and
5 Tesoro agrees to buy from the State that amount of Oil equal to 30.0 percent of the Daily Royalty Oil
6 (Maximum Quantity). At any time upon six months and ten days written notice, Tesoro may: (1)
7 decrease the Maximum Quantity; or (2) terminate this Agreement, in which case Tesoro shall not
8 make any payments as described in Article 2.11.

9 Subject to the limitations in this article, Tesoro may temporarily decrease or increase
10 the amount of Oil to be tendered, but not the Maximum Quantity provided in this article. To increase
11 or decrease the amount of Oil to be tendered, Tesoro must give the State at least six Months and ten
12 Days written notice. If, however, the increase or decrease is less than ten percent of Tesoro's then
13 current in-kind nomination, Tesoro must give at least one hundred Days written notice. In addition,
14 the new tendering will take effect on the first Day of the Month after the applicable notice period
15 expires.

16 The volume of Daily Royalty Oil available to the State will vary and may be
17 interrupted from time to time, and depends upon a variety of factors, including the rate of production
18 from the Leases. The State disclaims and Tesoro waives any representation, covenant or warranty,
19 expressed or implied, that a specific quantity or the total or daily, monthly, average, or aggregate
20 volume of Royalty Oil will be sold or tendered under this Agreement. The State warrants that it has
21 good title to the Oil tendered under this Agreement.

1 If the State underlifts or stores Royalty Oil at the Prudhoe Bay Unit, or if the State
2 recovers underlifted or stored Royalty Oil, the quantity of Oil tendered under this Agreement shall be
3 calculated as if no Royalty Oil were underlifted or stored or recovered.

4 2.1(b) Initial Participating Areas Quantity. The State may choose, in its sole
5 discretion, to sell to Tesoro, and Tesoro agrees to buy from the state, oil that is produced solely from
6 the initial Participating Areas of the Prudhoe Bay Unit, as defined in the Unit Agreement, rather than
7 from all participating areas and Leases within the Prudhoe Bay Unit. If the State so elects, the
8 Maximum Quantity of Oil shall equal 35.2 percent of the Royalty Oil produced from the initial
9 Participating Areas in a Day. If the State so elects, the terms Daily Royalty Oil, Oil, and Royalty Oil
10 shall have the same meaning set forth in Article I as limited in this article.

11 2.2 Quality. The Oil sold shall be the same quality as the Royalty Oil delivered
12 by the Lessees to the State at the Point of Delivery from the Prudhoe Bay Unit Area. The quality of
13 the Oil sold may vary from time to time. The State disclaims, and Tesoro waives, any guarantee,
14 representation, or warranty, either expressed or implied, of merchantability, fitness for use, or
15 suitability for any particular use or purpose, or otherwise, of any of the Oil delivered under this
16 Agreement or as to any specific, average, or overall quality or characteristic of Oil to be sold or
17 tendered under this Agreement. Tesoro expressly waives any claim that any liquid hydrocarbons
18 made available to the State by the Lessees, including such substances as crude oil, condensate, natural
19 gas liquids, or return oil from the Prudhoe Bay Unit Crude Oil Topping Plant, that may be blended
20 with crude by the Lessees before the Point of Delivery and tendered as a common stream by the
21 Lessees to the State as Royalty Oil are not Oil, for purposes of this Agreement.

1 2.3 Price of the Royalty Oil. The price each Month for Oil purchased under this
2 Agreement shall be the Royalty Value for that Month of Oil delivered to the West Coast by Exxon
3 from the Prudhoe Bay Unit production. The Royalty Value shall be determined according to the
4 Royalty Value calculation stated in Article 3.2 c) of its Royalty Settlement Agreement, except that the
5 Average Valdez Netback shall be the West Coast Valdez Netback. Exhibit A is an illustrative
6 calculation of the price if Tesoro had purchased Oil during the Month of January, 1995.

7 If any applicable law of the United States of America or any rule or regulation
8 promulgated by a federal agency will, in the sole judgment of the State, operate to prohibit or prevent
9 the State from receiving the full amount due under the above provision, Tesoro's obligation to pay the
10 amount of the purchase price in excess of the amount permitted will be suspended or adjusted to the
11 minimum extent required for the State to comply with that law, rule or regulation.

12 2.4 Reopeners.

13 2.4(a) Export Ban Reopener. Neither Tesoro nor the State shall have the
14 right to reopen this Agreement, unless the export ban on Alaska North Slope crude now in effect is
15 lifted. Anytime after the export ban is lifted, either Tesoro or the State may reopen this Agreement
16 for purchase price only, by giving the other party one month's prior written notice. Upon issuance
17 and receipt of a notice to reopen, Tesoro and the State will promptly commence good faith
18 negotiations in an attempt to establish a new purchase price. If Tesoro and the State cannot agree on a
19 price within three months after the written notice to reopen, either Tesoro or the State may terminate
20 this Agreement upon nine months written notice to the other. The purchase price for Oil tendered
21 during any period pending termination shall be the price in effect immediately before giving the

1 notice of intent to reopen. If a new purchase price is agreed to by Tesoro and the State, the new price
2 shall be effective for Oil delivered in the month following the Agreement.

3 2.4(b) Royalty Settlement Agreement Reopener. Tesoro shall not intervene
4 or otherwise participate in any way regarding litigation, styled ANS Royalty Litigation, Case No. J-
5 JU-77-847, any future royalty settlement agreements with the Lessees, or reopeners or other
6 discussions under or pertaining to royalty settlement agreements. Any judgment resulting from the
7 ANS Royalty Litigation, any future royalty settlement agreements, or any reopener under the Royalty
8 Settlement Agreement shall be conclusively binding upon Tesoro whether or not Tesoro agrees with
9 or consents to the terms of any such judgment, settlement, or reopener. Furthermore, Tesoro has no
10 independent right to invoke any of the provisions of the Royalty Settlement Agreement. If the
11 Royalty Value is modified in the future as a result of a modification of the Royalty Settlement
12 Agreement, a corresponding retroactive modification will be made to the price term of this
13 Agreement and interest will apply to the modification, whether resulting in an overpayment or
14 underpayment, as set forth in Article 5.6. Tesoro agrees to be conclusively bound by any such
15 modification agreed to by the State and Exxon.

16 Nevertheless, due to potential unpredictable increased costs to Tesoro posed by any
17 changes to Article III of the Royalty Settlement Agreement and/or any changes made under the
18 reopener procedures of Article IV of the Royalty Settlement Agreement, the State shall give Tesoro
19 notice of such changes or a Notice of Reopener initiated by Exxon or the State. Such notice shall
20 include information on the nature of such changes and/or the reopener, the requested effective date of
21 any such changes or proposed changes, and the position taken by Exxon and the State. Any changes

1 and/or Reopener action under the Royalty Settlement Agreement will give Tesoro the right to
2 terminate this contract upon six Months and ten Days written notice to the State.

3 2.5 Point and Time of Delivery. Simultaneously with receipt of its Royalty Oil
4 from its Lessees, the State shall tender the Oil to Tesoro where the State receives the Royalty Oil
5 from its Lessees. That point presently agreed to by the State and its Lessees in Article 2.3 of the Field
6 Cost Agreement is the TAPS Pump Station No. 1 Prudhoe Bay Custody Transfer meter ("Transfer
7 Meter").

8 2.6 Passage of Title and Risk of Loss. Title and risk of loss to the Oil sold under
9 this Agreement shall pass from the State to Tesoro for all purposes when the State tenders the Oil at
10 the Point of Delivery.

11 2.7 Tesoro's Responsibility. Tesoro shall be responsible for the Oil after passage
12 of title. Tesoro will indemnify and hold the State harmless from and against any and all claims, costs,
13 damages (including reasonably foreseeable consequential damages), expenses, or causes of action
14 arising from or in connection with any transaction or event which relates to the Oil after title has
15 passed to Tesoro.

16 2.8 Transportation Arrangements. Tesoro shall make all necessary arrangements
17 for transporting the Oil sold under this Agreement from the Point of Delivery, including satisfaction
18 of line fill obligations and storage tank bottom requirements of the TAPS, if any. If requested by the
19 State, Tesoro shall submit specific information concerning its arrangement for transportation of the
20 Oil sold under this Agreement through and away from the TAPS and for the resale or other disposal
21 of the Oil. Such information may include the specific tenders of Oil made to the TAPS and
22 identification of tankers, if any, which will transport the Oil. In addition, Tesoro will provide the

1 State, if requested by the State, with satisfactory evidence or reasonable assurance of the existence
2 and continuing validity of adequate arrangements for the transportation or disposal of the Oil subject
3 to this Agreement. Failure to provide information, evidence, or assurances requested will, at the
4 State's election by notice to Tesoro, be a material default under this Agreement.

5 2.9 Absolute Obligations. The obligations of Tesoro to accept, pay for, and
6 arrange for the transportation of the Oil tendered or sold under this Agreement are absolute and will
7 not be excused or discharged by the operation of any disability of Tesoro, event of force majeure,
8 impracticability or performance, change in conditions, or any other reason or cause.

9 2.10 Date of First Delivery. The date of First Delivery will be the first Day of
10 January 1, 1996.

11 2.11 Performance Guaranty and Reservation Fee. If Tesoro does not take the
12 Maximum Quantity, Tesoro shall pay to the State, in addition to the purchase price on the actual
13 quantity taken, an amount equal to .75 percent of the purchase price per barrel per Day on the
14 difference between the Maximum Quantity and the actual quantity tendered to and accepted by
15 Tesoro for each Day Tesoro does not take the Maximum Quantity.

16 2.12 In-State Processing. Tesoro agrees to use best efforts to insure that any and all
17 of the Royalty Oil tendered under this Agreement will be processed through Tesoro's refinery near
18 Nikiski, Alaska, or will be exchanged for other crude oil which shall be processed at that refinery.

19 "Process" means the manufacture of refined petroleum products. In no event, however, shall the
20 quantity of Royalty Oil, which must be processed, be less than 80 percent of the volume of Royalty
21 Oil tendered under this Agreement. "Exchange" means: (1) direct trades of equal volumes of crude
22 oil; (2) trades of crude oil involving either cash or volume adjustments, or both, provided that those

1 adjustments relate solely to quality or location differences; (3) sequential transactions in which Tesoro
2 receives back crude oil from a party other than the party which receives the Royalty Oil in a trade
3 from Tesoro; or (4) matching purchases and sales of crude oil. The terms under which Tesoro
4 receives crude oil in any exchange shall not differ in any significant term from the terms under which
5 Tesoro delivered Royalty Oil except for terms which adjust for differences in quality and location.
6 Tesoro agrees that any trade or exchange shall not reduce the price to be paid to the State and that
7 trades or exchanges shall be at no cost or expense to the State.

8 Tesoro's obligation to process Royalty Oil or exchanged oil in-State may only be
9 suspended or excused under the provisions of Articles VIII and XI.

10 The State may, in its sole discretion, waive the in-State processing requirement in
11 whole or in part, if State is satisfied that Tesoro is using its best efforts to process the Royalty Oil
12 tendered or the oil exchanged for Royalty Oil tendered under this Agreement at Tesoro's Alaska
13 refinery and that the waiver would not be contrary to the underlying intent of the other provisions of
14 this Agreement.

16 ARTICLE III

17 REPRESENTATION AND OBLIGATIONS OF TESORO

18 Tesoro warrants, represents, and agrees:

19 3.1 Good Standing and Due Authorization. Tesoro is, and at all times during the
20 operation of this Agreement shall remain, a corporation organized and existing under and by virtue of
21 the laws of the United States or of any State, territory or the District of Columbia, and qualified to do
22 business in, and in good standing with, the State of Alaska. Tesoro has all necessary corporate power

1 to enter into this Agreement and to perform the covenants and obligation under this Agreement. All
2 necessary corporate action has been taken to authorize Tesoro to enter into this Agreement and
3 perform its covenants and obligations under this Agreement.

4 3.2 Financial Condition. The financial information submitted to the State is
5 complete and correct and fairly presents Tesoro's financial condition when the information was
6 submitted to the State. The financial information was prepared in accordance with generally accepted
7 accounting principles consistently applied. Since the date the information was submitted, the
8 condition, business, and properties of Tesoro have not been materially adversely affected in any way.
9 Tesoro agrees to inform the State immediately if there is any material adverse change in its condition,
10 business, or properties which may have an appreciable adverse effect on its ability to perform under
11 this Agreement. Tesoro, in addition, will immediately inform the State of any significant change in
12 ownership of Tesoro, affiliates, parent company, and of any change in Tesoro's operations or
13 Agreements, which may appreciably affect Tesoro's performance under this Agreement.

14 3.3 Financial Statements. As soon as possible after the end of the fiscal year of
15 Tesoro, and in any event within one hundred twenty Days thereafter, Tesoro will furnish to the State,
16 at Tesoro's sole cost and expense, a report or a complete copy of a report in a form to be prescribed
17 from time to time by the State which will include Tesoro's balance sheet as of the close of the fiscal
18 year and the income statement for that year, prepared in each case in accordance with generally
19 accepted accounting principles consistently applied by certified public accountants of recognized
20 standing. For purposes of complying with this article, Tesoro may submit, and the State will accept,
21 the annual report of Tesoro Petroleum Corporation filed with the United States Securities and
22 Exchange Commission pursuant to Sec. 13 or 15 (d) of the Security Exchange Act of 1934.

1 ARTICLE IV

2 MEASUREMENTS AND TESTS

3 The quantity and quality of Oil sold under this Agreement shall be determined at the
4 Point of Delivery. Procedures and methods for measuring and metering the Oil sold under this
5 Agreement shall be in accordance with the practices then in effect in the Prudhoe Bay Unit.

6
7 ARTICLE V

8 PAYMENTS AND ACCOUNTING

9 5.1 Initial Billing. The State will send to Tesoro, on or before the tenth business
10 Day of each Month after delivery of Oil, an invoice statement of account of all Oil estimated to have
11 been measured at the Transfer Meter and tendered to Tesoro under this Agreement during the
12 immediately preceding Month according to the best information available to the State, the estimated
13 purchase price applicable to those deliveries, and the total amount due (Initial Billing Invoice). The
14 estimates will be made by the State according to the best information reasonably available to the
15 State. The State may render its Initial Billing Invoice to Tesoro based in part upon information
16 reported by the Lessees to the State, information published by the U.S. Government, and information
17 published in Platt's Oilgram Price Report or any other publicly available report. The State shall
18 thereafter adjust its Initial Billing Invoice under this article as soon as more accurate information
19 concerning the quantity and purchase price of Oil delivered each Month is available. The State,
20 however, shall not be required to adjust the Initial Billing Invoice before the sending of the next
21 Month's invoice statement of account.

1 5.2 Initial Adjustment. After the Initial Billing Invoice under Article 5.1, the next
2 Monthly invoice will also state the State's initial adjustments, plus interest, to be made, if any, to the
3 Initial Billing Invoice rendered in the immediately preceding Month, in accordance with any
4 additional or more accurate information which may have become available to the State ("Initial
5 Adjustment Invoice"). Whether or not initial adjustments are made, however, subsequent adjustments
6 may be made under Article 5.5.

7 5.3 Subsequent Adjustments. Tesoro acknowledges that after the Initial Billing
8 and Initial Adjustment Invoices, more accurate information concerning the quantity of or purchase
9 price for Royalty Oil tendered may become available to the State. If any such information should
10 later become available to the State, it shall furnish a corrected invoice statement of account to Tesoro
11 ("Subsequent Adjustment Invoice") and the State will adjust the amount previously billed; and Tesoro
12 will pay, or the State will credit or refund, the amount of any Subsequent Adjustment Invoice plus
13 interest. If the State should render a Subsequent Adjustment Invoice to Tesoro, any amount to be
14 credited or refunded from the State to Tesoro or paid by Tesoro to the State will be refunded or paid
15 within thirty Days after the date of the Subsequent Adjustment Invoice.

16 The parties recognize that subsequent adjustments may be necessary after December
17 31, 1998, and, accordingly, the provisions of Article V will survive any termination of this
18 Agreement. Any Subsequent Adjustment Invoice rendered more than six years after the date of
19 delivery will bear interest for only six years from the date accrued as defined in Article 5.5. This
20 limitation on interest does not apply to Subsequent Adjustment Invoices resulting from: (1)
21 regulatory, reopener or court proceeding (including appeals) commenced during the six year period

1 whether or not the Tesoro or the State is a party and (2) bona fide audits by the State of Exxon
2 commenced during the six year period.

3 5.4 Payment. Tesoro will pay the Initial Billing Invoice on the third business Day
4 of the month following delivery or within three business Days after the date of the invoice whichever
5 is later; and the Initial Adjustment Invoice within three business Days of the date of the invoice and
6 on any Subsequent Adjustment Invoice within 30 Days of the date of the invoice. Payment shall be
7 made without any deduction, set off, or withholding, by wire transfer of immediately available funds
8 to the State's account at the following address:

9 State Street Bank & Trust Company
10 Boston, Massachusetts
11 ABA #011000028
12 For credit to the State of Alaska
13 General Investment Fund, AY01
14 Account #00657189
15 Attn: Kim Chan, Public Funds
16

17 Payment may be made in such other manner or to such other address as the State may
18 specify in the invoice statement of account or by other written notice. All other payments to be made
19 under this Agreement shall be paid in the same manner. If payment is due on a Saturday, Sunday, or
20 legal holiday of the place where payment is to be received, payment shall be made on the next
21 following business Day. It is recognized that the State may bill, and that Tesoro will pay, amounts
22 that are based upon confidential information held or received by the State. If confidential information
23 is used as the basis for a billing, then the State will furnish Tesoro, upon its request, with the certified
24 statement of the Commissioner that the amounts billed are correct based upon the best information
25 available to the State. If a dispute concerning a bill arises, Tesoro agrees to pay the full amount billed
26 by the State, except for obvious clerical mistakes, pending final resolution of the dispute.

1 5.5 Interest. The Amount of all sums, which are not paid when due under this
2 Agreement or which are later determined to be due as an adjustment, shall bear interest from the date
3 accrued until paid in full at the rate as provided in AS 38.05.135(d) or as that statutory provision may
4 later be amended. Currently, that interest rate in a calendar quarter is at the rate of five percentage
5 points above the annual rate charged member banks for advances by the 12th Federal Reserve District
6 as of the first Day of that calendar quarter, or at the annual rate of 11 percent, whichever is greater,
7 compounded quarterly as of the last Day of that quarter. The term "date accrued" means the date of
8 the "Initial Billing plus three business Days." Interest shall apply to both adjustments for
9 overpayments and underpayments.

10 The following illustrates from what date interest will run:

11 January 1 - 31, 1996 -- Tesoro takes 1996 January production:

12 February 9, 1996 -- State sends Tesoro the Initial Billing Invoice for 1996 January
13 production:

14 February 14, 1996 (Initial Billing plus three business Days) -- Tesoro must pay the
15 Initial Billing Invoice for January 1996 production. If Tesoro does not pay on
16 this day, the Initial Billing Invoice bears interest from this date plus a late
17 payment penalty.

18 March 8, 1996 -- State sends Tesoro the Initial Adjustment Invoice for January 1996
19 production. Tesoro owes the State an additional sum.

20 March 13, 1996 -- Tesoro must pay the Initial Adjustment Invoice plus interest from
21 February 14, 1996 through the payment date.

1 January 10, 1997 -- State sends Tesoro a Subsequent Adjustment Invoice for January
2 1996 production. Tesoro is entitled to a credit. State pays interest from
3 February 14, 1996 through January 10, 1997.

4 April 10, 2006 -- The State is notified by Exxon that, due to a clerical error, it has
5 revised the Royalty Value for January 1996.

6 April 17, 2006 -- State sends Tesoro another Subsequent Adjustment Invoice for
7 January 1996 production after Exxon reports a clerical error in its
8 calculation of the Royalty Value. Tesoro owes the State an additional sum.

9 May 17, 2006 -- Tesoro must pay the Subsequent Adjustment Invoice for January
10 1996 production plus interest from calculated February 14, 1996 through
11 February 14, 2002. If Tesoro does not pay the Subsequent Adjustment
12 Invoice on this date, interest will accrue from February 14, 1996 through the
13 date the payment is made and Tesoro must also pay a late payment penalty.

14 November 10, 2006 -- Court settles dispute between the TAPS carriers and shippers.
15 Carriers are awarded a higher tariff for January 1996.

16 November 30, 2006 -- State sends Tesoro a Subsequent Adjustment Invoice. Tesoro
17 is entitled to a refund which includes interest calculated from February 14,
18 1996 through November 30, 2006.

19 5.6 Late Payment Penalty If Tesoro fails to make a full payment within three
20 business days of the date of either an Initial Billing Invoice or Initial Adjustment Invoice, or within
21 thirty Days of the date of any Subsequent Adjustment Invoice, then in addition to the amount due

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ARTICLE VII

DEFAULT OR TERMINATION

7.1 Default. If any one or more of the following events ("Events of Default") occur, then the State, at the its sole option, may terminate or suspend its obligation to tender and sell Oil and exercise any one or more of the rights and remedies provided in this Agreement:

- (i) At any time, Tesoro (a) repudiates any of its covenants or obligations under this Agreement, or (b) fails, within five Days, after written request from the State to provide the State with written affirmation of this Agreement and of Tesoro's intention to perform under this Agreement (together with evidence or assurances of transportation arrangement pursuant to Article 2.8 reasonably satisfactory to the State);
- (ii) Tesoro does not pay in full any sum owed under this Agreement at the time when payment is due;
- (iii) Tesoro fails to observe or perform any of its other covenants and obligations under Article II;
- (iv) Tesoro does not perform any act required or contemplated under this Agreement and: (a) the non-performance cannot be cured; (b) the nonperformance continues for more than thirty Days after the State has notified Tesoro of its nonperformance; or (c) Tesoro has failed to perform the same or any other act required or contemplated under this Agreement.

1 (v) There is a material adverse change in Tesoro's condition, business, or
2 property which may appreciably affect its ability to perform any of its
3 obligations under this Agreement and Tesoro is unable or unwilling to
4 give the State adequate assurance of continued performance either
5 within five Days of a request for such an assurance or within such
6 other shorter time period as the State may request under the
7 circumstances;

8 (vi) Any representation or warranty made by Tesoro in this Agreement
9 was materially false or incorrect when made; or

10 (vii) Tesoro's failure or inability for any reason (including reasons beyond
11 Tesoro's control) to maintain the Security described in Article XV,
12 notwithstanding Tesoro's continuing willingness and ability to
13 perform its other obligations and covenants under the Agreement.

14 7.2 Failure to Pay Debts. If Tesoro becomes unable to pay any of its debts when
15 due, or should otherwise become insolvent (regardless how that insolvency may be evidenced),
16 Tesoro will immediately give written notice of that fact to the State. Whether that notice is given, if
17 Tesoro becomes unable to pay any of its debts when due or should otherwise become insolvent, the
18 State's obligation to tender and sell Oil will automatically and immediately terminate without any
19 requirement of notice or other action by the State; however, Tesoro will nevertheless be and remain
20 liable for payment and performance of all of its obligations and covenants under this Agreement
21 regarding Oil actually tendered by the State to and after any such termination. Within thirty Days
22 after receipt of Tesoro's notice or, if no notice is given, after the State otherwise becomes aware (as

1 determined in the State's sole discretion) of Tesoro's insolvency, the State will have the right, upon
2 written notice to Tesoro, to reinstate all of the State's and Tesoro's obligations under this Agreement
3 retroactively to the date of termination.

4 7.3 State's Remedies. If any Event of Default occurs or if the State's obligation to
5 tender and sell Oil under this Agreement is terminated or suspended, all of Tesoro's obligations
6 accrued but not otherwise due and payable under this Agreement will immediately be due and
7 payable in full. In addition, Tesoro will indemnify and hold the State harmless from and against all
8 other liability, damages (including reasonably foreseeable consequential damages), costs, losses and
9 expenses (including reasonable attorney's fees and disbursements) incurred by the State and arising
10 out of the Event of Default, termination, or suspension. The State shall have the right cumulatively to
11 exercise any and all other rights and remedies and to obtain all other relief available under applicable
12 law or at equity, including mandatory injunction and specific performance.

13 Additionally, in its sole discretion, the State, upon occurrence of any Event of
14 Default: (1) may dispose to third parties any or all Royalty Oil to be tendered and sold under this
15 Agreement and (2) may release Tesoro from the in-state processing obligations set forth in Article
16 2.12 until the Event of Default no longer exists or the obligation of Tesoro to take Oil under this
17 Agreement expires. If the State disposes of Oil to third parties, or if Tesoro is released from Article
18 2.12, whether or not this Agreement is terminated, Tesoro will nevertheless remain liable for the
19 difference between the purchase price for that Oil under this Agreement and the price received by the
20 State by disposition, including all of the expenses (including reasonable attorneys' fees and costs), and
21 losses incurred by the State arising out of the Event of Default or disposition.

1 of Tesoro under any nominations, Leases, agreements, contracts, charter parties and other
2 arrangements for the transportation of the Oil sold under this Agreement through and away from the
3 TAPS; provided, that the State shall not have any liability or obligations under any such nominations,
4 Leases, agreements, contracts, charter parties or other arrangement unless, and to the extent that, the
5 State shall actually exercise its rights to succeed to Tesoro's interest under them and shall obtain the
6 benefits of them.

7 8.3 No Right to Storage or Underlift. Tesoro waives and disclaims any interest or
8 right that it may assert to storage of Royalty Oil, including by underlift or other means, to which the
9 State is or may become to be entitled under the Leases or any other agreement.

10
11 **ARTICLE IX**

12 **WAIVER**

13 The failure of either party to insist upon strict performance of any provision of this
14 Agreement shall not constitute a waiver of, or estoppel against, asserting the right to require that
15 performance in the future. A waiver or estoppel in any one instance shall not constitute a waiver or
16 estoppel with respect to a later breach of a similar nature or otherwise. A course of performance
17 established by a party shall also not estop the other party from complaining of a later breach similar in
18 nature.

1 obligations to pay for Oil tendered and to accept and dispose of Oil, the disabled party's obligations to
2 perform that are affected by the force majeure shall be suspended from the time that notification
3 occurs until the disability should have been remedied with reasonable diligence, and for no longer.
4

5 ARTICLE XII

6 NOTICES

7 12.1 Method. All notices, requests, demands or statements shall be in writing, and
8 may be delivered personally, telecopied, or sent by registered or certified United States mail, postage
9 prepaid, with a return receipt requested, to the party to be notified. Notice deposited in the mail in
10 this manner shall be effective upon the expiration of seven Days after it is so deposited or upon the
11 date of receipt, whichever is earlier. Notice given in any other manner shall be effective only if and
12 when received by the addressee. For the purposes of notice, the address of the parties shall be as
13 follows:

14 If to the State: State of Alaska
15 Commissioner of Natural Resources
16 400 Willoughby Avenue
17 Juneau, Alaska 99801
18

19 and

20 Director, Division of Oil and Gas
21 P. O. Box 107034
22 Anchorage, Alaska 99510-0734
23 Telecopy Number: (907) 562-3852
24

25 If to Tesoro:

26 Gaylon H. Simmons
27 Tesoro Alaska Petroleum Company
28 8700 Tesoro Drive
29 San Antonio, Texas 78217
30 Telecopy Number: (210) 253-2031
31

1 national banking institution of the United States ("Issuer"), which is insured by the Federal Deposit
2 Insurance Corporation and has an aggregate capital and surplus of not less than One Hundred Million
3 Dollars (\$100,000,000), or other banking institution acceptable to the State in its sole discretion. The
4 principal face amount of such letter of credit shall be a sum estimated by the Commissioner, in his
5 sole discretion, to be equal to the aggregate purchase price for the approximate total amount of Oil to
6 be tendered by the State to Tesoro during the first seventy five Days following the Date of First
7 Delivery. The letter of credit shall be in a form satisfactory to the Commissioner, but in any event
8 shall not require any documents to be submitted in support of drafts drawn against this letter of credit
9 other than the certified statement of the Commissioner or his designee and the Attorney General of
10 the State of Alaska or his designee that Tesoro is liable to the State for a sum equal to the amount of
11 such draft, and that sum is due and payable in full and has not been timely paid. The letter of credit
12 must be renewed seventy five Days before its expiration so that a letter of credit is continuously valid
13 for seventy five Days after the date of the last delivery of Royalty Oil. If a replacement letter of
14 credit, in a form satisfactory to the Commissioner in his sole discretion, is not received seventy five
15 Days before the expiration of the existing letter of credit, then Tesoro shall be deemed to have
16 materially breached this Agreement, there shall have occurred an event of default under Article 7.1,
17 and all obligations of Tesoro accrued, but not otherwise due and payable under this Agreement, will
18 immediately become due and payable in full.

19 If the State has reasonable grounds for asserting any claims against Tesoro and does
20 assert those claims in an aggregate amount in excess of the aggregate principal face amount of the
21 letter of credit then in effect, Tesoro shall, upon the State's request (whether or not Tesoro may deny,
22 reject or otherwise resist such claims), cause the principal face amount to be increased by an amount

1 equal to the excess. Tesoro shall also automatically increase the principal face amount, without
2 request from the State, whenever the face amount is less than the expected purchase price of seventy
3 five Days of Oil tenders, to an amount equal to the expected purchase price of seventy five Days of
4 Oil tenders. Upon approval of the State in its sole discretion, Tesoro may decrease the principal face
5 amount if the face amount is more than the expected purchase price of seventy five Days of Oil
6 tenders to an amount equal to the expected purchase price of seventy five Days of Oil tenders.

7 The letter of credit must allow drafts to be drawn and presented to the Issuer up to and
8 including the 75th Day after the last delivery of Royalty Oil to Tesoro under this Agreement. The
9 Commissioner may accept such other or additional security as he, in his sole discretion, considers
10 adequate to protect the State.

11 15.2 Reduction of Term. The term of the letter of credit required under Article XV
12 shall be reduced from seventy five Days to sixty Days, if Tesoro and the State can reach an agreement
13 regarding the transportation of Oil if Tesoro defaults under this Agreement. If the parties cannot
14 reach an agreement, then the letter of credit shall remain at seventy five Days or Tesoro shall have the
15 right, in its sole discretion, to terminate this Agreement as provided in Article 2.1.

16 17 ARTICLE XVI

18 PREFERENTIAL HIRING AND NON-DISCRIMINATION

19 Tesoro agrees to employ Alaska residents and Alaska companies to the extent they are
20 available, willing and qualified for all work performed in Alaska in connection with the Agreement.

21 "Alaska resident" means an individual who has resided in Alaska for one year at the time of

1 employment and "Alaska companies" means companies incorporated in Alaska or whose principal
2 place of business is in Alaska.

3 If this provision is determined to be unconstitutional, then Tesoro agrees to employ
4 Alaska residents and Alaska companies to the extent such preferential hiring is determined to be
5 constitutional.

6
7 **ARTICLE XVII**

8 **APPLICABLE LAW**

9 17.1 Alaska Law. This Agreement shall be governed by and construed in
10 accordance with the laws of the State of Alaska.

11 17.2 Submission to Jurisdiction. Any legal action or proceeding arising out of or
12 relating to this Agreement or for the enforcement of the covenants or obligations of either party must
13 be instituted in a State court of general jurisdiction sitting in the State of Alaska, and Tesoro hereby
14 irrevocably submits to the jurisdiction of that court in any such action or proceeding.

15
16 **ARTICLE XVIII**

17 **WARRANTIES**

18 The purchase and sale of Royalty Oil are subject only to the warranties of the State
19 expressly set forth in this Agreement and the State disclaims and Tesoro waives all other warranties,
20 express or implied in law, whatsoever.

1 not limited to, the purchase or sale of Royalty Oil and its refined products, for a period of no less than
2 six years from the date of transaction or last adjustment relating to the transaction. Tesoro will also
3 maintain and preserve all similar books, accounts, and records of which it has possession belonging to
4 those third parties with whom it contracts for the performance of various parts of this Agreement.
5 Neither Tesoro nor the State shall be required to retain any records for more than six years unless
6 retention of such records is specifically required by applicable law or regulation, or this Agreement.
7 Tesoro shall either maintain its records within the State of Alaska or make such records available to
8 the State at Tesoro's principal office in the State of Alaska within thirty Days after written request by
9 the State.

10 22.2 Inspection of Records of Parties. Tesoro and the State will accord to each
11 other and to their authorized agents, attorneys, and auditors during reasonable business hours access
12 to any and all property, records, books, documents, and indices directly related to Tesoro's or the
13 State's performance of this Agreement and which are under the control of the party from which access
14 is desired so that the other party may inspect, photograph and make copies of that property, records,
15 books, documents and indices. The State shall not be required to disclose any information, data, or
16 records which are required to be held confidential by State or federal law or regulation, or by
17 agreement. If the information obtained by the State may be held confidential under State or federal
18 law or regulation, Tesoro may request that information be held confidential by the State and the State
19 will keep this information confidential.

SIGNATURES

1
2 the State

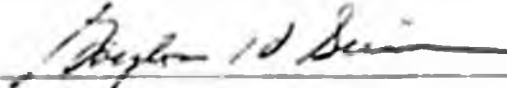
THE STATE OF ALASKA

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5 
Commissioner
Department of Natural Resources

6 Date 4/21/95

7
8 Tesoro Alaska Petroleum Company

TESORO ALASKA PETROLEUM COMPANY

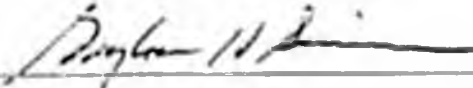
9 By 

10 Its Executive Vice President

11 Date April 20, 1995

12
13 Tesoro Petroleum Corporation

TESORO PETROLEUM CORPORATION

14 By 

15 Its Executive Vice President

16 Date April 20, 1995

ACKNOWLEDGEMENT

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State of Alaska)
) ss.
Third Judicial District)

THIS IS TO CERTIFY that on the 21 day of April, 1995, before me, appeared John T. Shively, the commissioner, Department of Natural Resources, State of Alaska; that John T. Shively executed that document under legal authority and with knowledge of its contents; and that this act was performed freely and voluntarily upon the premises and for the purposes stated in the document.

Witness my hand and official seal the day and year in this agreement first above written.

Sharon Fanning
Notary Public in and for Alaska
My commission expires: 5-24-95

ACKNOWLEDGEMENT

State of Texas

County of Bexar

SS

THIS IS TO CERTIFY that on the 20th day of April 1995 before me appeared Gaylon H. Simons of Tesoro Alaska Petroleum Company San Antonio Texas that Gaylon H. Simons executed that document under legal authority and with knowledge of its contents and that this act was performed freely and voluntarily upon the premises and for the purposes stated in the document

Witness my hand and official seal the day and year in this agreement first above written

Linda Iden

My commission expires _____

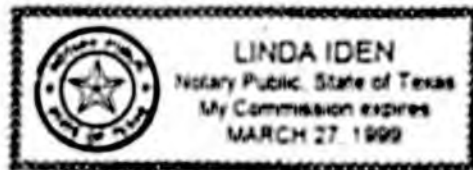


EXHIBIT A

CALCULATION OF ROYALTY VALUE

This exhibit shows the mechanics of the price calculation and data sources. Exxon's Royalty Value for the Prudhoe Bay Unit lessees are taken from its Royalty Report. Royalty Value currently is taken from Column H of these reports. An example calculation using the information for January 1995 and a hypothetical RIK volume sold to Tesoro is shown below. Attached are the Royalty Report Summaries for the Prudhoe Bay Unit.

	Exxon's Production from the Prudhoe Bay Unit		Royalty Value from Column H of the Oil Royalty Report Summary		Product of Volume Times Royalty Value
Lisburne Production Center	1,762,900.13	x	\$11.050	=	\$19,480,406.44
Prudhoe Bay IPA	8,807,215.20	x	\$11.110	=	\$97,848,160.87
Total	<u>10,570,115.33</u>				<u>\$117,328,207.31</u>

$$\text{Exxon's Royalty Value} = \$117,328,207.31 - 10,570,115.33 = \$111,099,999$$

Should Article 2.1(b) apply, the Royalty Value will be calculated using the Royalty Value and production volumes for only the initial Participating Areas

CALCULATION OF INTEREST

Numbers in these examples are illustrative. They do not represent accurate values that may have existed in the past or are forecasted for any time in the future.

Mechanics of the calculations include:

1. The annual interest rate specified in legislation is converted to a daily rate for calculations.
2. Credits are applied to the next monthly payment. Payment for an underpayment is due (a) within 3 business days of the date the bill is sent for Initial Billings and initial adjustment or (b) within 30 days of the time the bill is sent for subsequent adjustments. Interest on overpayments stops accruing on the date of the invoice.

Example 1: Initial Billing

Assumptions:

1. Month is February.
2. Royalty Oil delivered to Tesoro in January = 1,240,000 barrels.
3. Royalty Value for January, from Column H of Exxon's Oil Royalty Report Summaries (attached) = \$11.09999.
4. Bill sent to Tesoro on February 1st; Payment due to State by February 6th (Initial Billing date plus three business days).

Method for calculating Tesoro's initial invoice for January deliveries:

Volume	x	Price	=	Initial Billing
1,240,000	x	\$11.09999	=	\$13,763,987.60

Note:

The lessees are required to submit their royalty reports to the State for January's production by the last day in February. For this reason the State will bill Tesoro for January production based on the December Royalty Value. This is an interim value and is subject to revision, since the Agreement requires that Tesoro pay the Monthly Price for the same production month. The revised price is incorporated in the invoice submitted the following month (March).

Example 2: Initial Adjustment

Assumptions:

1. Month is March.
2. Royalty Oil delivered to Tesoro in January = 1,240,000 barrels.
3. Revised Monthly Price for January = \$11.00000.
4. Annual interest rate charged member banks for advances by 12th Federal Reserve District as of January 1st is three percent. Annual rate for contract = 11 percent.
5. Date of Initial Adjustment is March 1st.

Method for calculating Tesoro's revised invoice for January deliveries:

Volume	x	Price	=	Revised Billing
1,240,000	x	\$11.00000	=	\$13,640,000.00

Amount Paid by Tesoro for January deliveries (calculated in Example 1):

\$13,763,987.60

Overpayment for January:

(\$123,987.60)

Difference between Initial Adjustment date (March 1st) and original accrual date (February 6th) = 23 days.

Interest due = \$123,987.60 x (11%/365) x 23 =

(\$859.42)

Interest due Tesoro for next month's billing =

(\$124,847.02)

ENR 807 071 5104
 REVENUE 11 1984
 ENR 807 07 84
 ENR 80 00 10

STATE OF ALASKA
 OIL ROYALTY REPORT SUBSIDIARY
 STATE OF ALASKA DEPARTMENT OF NATURAL RESOURCES

Page 1 of 2

1984 POINCHER DAY
 1985 POINCHER DAY
 1986 POINCHER DAY

Company Address	EXXON CORPORATION P. O. BOX 4196 HOUSTON, TEXAS 77210-4196	REPORT YEAR	1984
		REVISIONS	000
		REPORT DATE	

(A) GROSS OIL REVENUE (BOB)	(B) WORKING INTEREST OWNERSHIP %	(C) WORKING INTEREST OIL	(D) ROYALTY RATE	(E) TOTAL ROYALTY OIL	(F) ROYALTY OIL AND GAS	(G) ROYALTY OIL AND GAS VALUE, BOB	(H) ROYALTY VALUE PER BOB	(I) FIELD COSTS PER BOB	(J) NET OIL AND GAS ROYALTY PER BOB	(K) ROYALTY OIL AND GAS VALUE EXCLUDING
119,817.00	0.000000	711,927.60	0.125000	88,990.95	12,902.43	14,088.32	11.540	0.000	10.220	143,984.7
79.00	0.000000	156.00	0.125000	19.50	11.71	17.28	11.310	0.000	10.740	131.48
140,896.00		714,173.60		108,010.45	17,914.14	14,105.60	*	*	*	144,116.18

*WEIGHTED AVERAGE VALUE

	PRINCIPAL	INTEREST	TOTAL
(1) COSE GRAVITY ADJUSTMENT	0.00	N/A	0.00
(2) LESS FIELD COSTS PER BOB	(10,718.74)	N/A	(10,718.74)
(3) OTHER (LAP, DUCTIVE, CREDIT)	0.00	N/A	0.00
(4) SUBTOTAL (2) THROUGH (3)	113,397.42	0.00	113,397.42
(5) REVISIONS	14,607.50	1,912.91	16,520.41
(6) TOTAL AMOUNT (4) THROUGH (5)	148,004.92	1,912.91	149,917.83

I declare that I have examined this report, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

SIGNED BY	<i>Richard L. ...</i>
PRINTED NAME	LEE ANN KWEL
TITLE	STATE ROYALTY LIMIT SUPERVISOR
PHONE NUMBER	713156-8449
DATE	14 Feb 85
PREPARED BY	EXXON OIL WORK (713) 846-8449

ENR 807 07 84

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STATE OF ALASKA
 GAS ROYALTY REPORT SUMMARY
 STATE OF ALASKA DEPARTMENT OF NATURAL RESOURCES

Page 1 of 1
 DATE PRINTED MAY
 1985 15:00:00
 TIME 15:00:00
 1985 15:00:00

Royalty Address EXCON CORPORATION P O BOX 1796 HOUSTON TEXAS 77104-4796	REPORT FOR REVISION NUMBER REVISION DATE	Jan 85 000 000
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(1) LEASING UNIT PROPERTY NAME (100%)	(2) WORKING INTEREST PERCENTAGE (%)	(3) WORKING INTEREST Pctg	(4) OILFIELD RATE	(5) OILFIELD OILFIELD Pctg	(6) OILFIELD OILFIELD Pctg	(7) OILFIELD OILFIELD Pctg	(8) OILFIELD OILFIELD Pctg	(9) OILFIELD OILFIELD Pctg	(10) OILFIELD OILFIELD Pctg	(11) OILFIELD OILFIELD Pctg	(12) OILFIELD OILFIELD Pctg
11111	0.00000	0.00000	0.00000	0.00000	0.00000	0.00000	0.00000	0.00000	0.00000	0.00000	0.00000
(1) TOTAL											

THE FOLLOWING AVERAGE VALUE

	PRINCIPAL	INTEREST	TOTAL
(1) COINTEGRATED ADJUSTMENT	0.00	0.00	0.00
(2) REVENUE ADJUSTMENT	111.11	0.00	111.11
(3) OTHER ADJUSTMENTS	0.00	0.00	0.00
(4) TOTAL ADJUSTMENTS	111.11	0.00	111.11
(5) OILFIELD	0.00	0.00	0.00
(6) TOTAL ADJUSTMENTS	111.11	0.00	111.11

I declare that I have examined this report, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

SIGNED BY	<i>Theresa J. ...</i>
PRINTED NAME	TERESA J. ...
TITLE	STATE ROYALTY UNIT SUPERVISOR
FOR THE RECORD #	111111
DATE	10/15/85
PREPARED BY	MARK L. ...

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 11/5
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THE ROYALTY STATE
 REVISED 1984
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 1988 10 010

STATE OF ALASKA
 THE ROYALTY REPORT SUMMARY
 STATE OF ALASKA DEPARTMENT OF NATURAL RESOURCES

Page 1 of 1

1001 PRINCKE BAY
 1011 NORTH PRINCKE BAY
 2004 PRINCKE BAY

Company Address	EXXON CORPORATION P O BOX 4700 HOUSTON, TEXAS 77216-4700	REPORT FOR	Jan 91
		REVENUE/INTEREST	0.00
		RENTS/ROYALTIES	

(1) PRODUCE PRODUCTION (MMBBL)	(2) WORKING INTEREST OWNER'S %	(3) WORKING INTEREST DATE	(4) ROYALTY RATE	(5) TOTAL ROYALTY \$	(6) ROYALTY OF AVERAGE DATE	(7) OIL & GAS ROYALTY VALUE DATE	(8) OTHER COSTS DATE	(9) NET PROCEEDS DATE	(10) ROYALTY DATE
112,434.00	0.500000	04/27/80	0.000000	1,216.15	0.31734	1,678.84	0.0000	0.0000	17,137.74
0.00	0.500000	0.00	0.000000	0.00	0.00	12,110.00	0.0000	0.0000	0.00
112,434.00				1,216.15	0.31734	1,678.84			17,137.74

WEIGHTED AVERAGE VALUE

	FROM W/A	INTEREST	NET TOTAL
(1) OIL & GAS ROYALTY	0.00	0.00	0.00
(2) OTHER COSTS	1,678.84	0.00	1,678.84
(3) OTHER (LEASE, EXCLUSIVE, CROFT)	0.00	0.00	0.00
(4) NET TOTAL RECEIPTS	15,881.87	0.00	15,881.87
(5) OTHER (TAXES)	189.00	18.91	207.91
(6) TOTAL AMOUNT DUE LESSEE	16,070.87	18.91	16,089.78

I am/ we have examined this report, including accompanying schedules and attachments, and to the best of my knowledge and belief it is true, correct, and complete.

SIGNED BY	<i>[Signature]</i>
PRINTED NAME	LEANN K. HOLT
TITLE	STATE ROYALTY LEASE SUPERVISOR
PHONE NUMBER	711-154-5400
DATE	14 Feb 91
PREPARED BY	DAVID S. CRISMAN (711)251-5401

STATE OF ALASKA DEPARTMENT OF NATURAL RESOURCES

PC
 11/15/91
 140

OH RPT FORM
 REVISIONS
 DATED 01 86
 ERM TO 000

STATE OF ALASKA
 OH ROYALTY REPORT SUMMARY
 STATE OF ALASKA DEPARTMENT OF NATURAL RESOURCES

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UNIT: FORTYACHTYRE
 FIELD: FORTYACHTYRE
 ZONE: FORTYACHTYRE

Royalty Address	EXXON CORPORATION P. O. BOX 676 IRVINGTON, TEXAS 77210-6766	REPORTING PERIOD	Jan 95
		REPORTING NUMBER	000
		REVISION DATE	

PAGE 02 104
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(A) UNITS UNIT PRODUCTION (BOE)	(B) WORKING INTEREST OWNERSHIP %	(C) WORKING INTEREST OWNERSHIP %	(D) ROYALTY RATE	(E) TOTAL ROYALTY	(F) ROYALTY ON ADDITIONAL	(G) ROYALTY ON VALUE	(H) ROYALTY VALUE	(I) OTHER COSTS	(J) NET ROYALTY	(K) ROYALTY ON VALUE (LOCAL)
1950 124.00	0 100.00	1 421,098.87	0 120000	146,880.00	42,372.84	44,307.22	11,930	0.00	11,930	710,394.78
0.00	0 100.00	0.00	0 120000	0.00	0.00	0.00	-1,110	0.00	10,820	0.00
1950 124.00		1 421,098.87		146,880.00	42,372.84	44,307.22	*			710,394.78

*WEIGHTED AVERAGE VALUE

	PRINCIPAL	INTEREST	TOTAL
DISCOUNTING ADJUSTMENT	0.00	0.00	0.00
LESS OTHER COSTS FOR R.R.	14,012.04	0.00	14,012.04
*Interest portion only (see schedule for details)			
OTHER (TAXP. DEDUCTIBLE ONLY)	0.00	0.00	0.00
NET ROYALTY (TAXP. DEDUCTIBLE)	206,367.74	0.00	206,367.74
TAXES (LOCAL)	1104,578.13	1,718,901.71	2,823,479.84
TOTAL ACCOUNTS DEBIT	402,945.87	1,718,901.71	2,121,847.58

I declare that I have examined this report, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

SIGNED BY: *[Signature]*
 PRINTED NAME: LEE ANNE KOPPE
 TITLE: STATE ROYALTY UNIT SUPERVISOR
 PHONE NUMBER: (907) 485-8649
 DATE: 24 Feb 95
 REPORT NUMBER: 00000000

NOTE: By filing this report, Exxon does not waive any rights to take hold and other case collections from the Ft. McIntyre Participating Area, including, but not limited to, those rights reserved by Exxon in the October 11, 1991, Amended Application for Extension of the Production Stay Limit and Termination of the Ft. McIntyre Participating Area.

*MJ TRAY
 12/15/95
 MS
 EWR*

CRS BUY RPT SUM
 REVISED 1986
 EXHIBIT 86
 FORM 80-6030

STATE OF ALASKA
 GAS ROYALTY REPORT SUMMARY
 STATE OF ALASKA DEPARTMENT OF NATURAL RESOURCES

Page 1 of 2

1001 POINT ACQUITY
 1011 POINT ACQUITY
 2001 POINT ACQUITY
 LEASE POINT ACQUITY

Royalty Address:	EXXON CORPORATION P O BOX 446 HOUSTON TEXAS 77210 446	REPORT FORM	Form 71
		REVISION NUMBER	000
		REVISION DATE	

(A) GROSS UNIT PRODUCTION (DOLLARS)	(B) WORKING INTEREST OWNERSHIP %	(C) WORKING INTEREST DOLLARS	(D) ROYALTY RATE	(E) TOTAL ROYALTY DOLLARS	(F) ROYALTY DOLLARS PER DOLLAR	(G) ROYALTY DOLLARS PER DOLLAR	(H) ROYALTY VALUE PER DOLLAR	(I) FIELD COSTS PER DOLLAR	(J) REPORTED ROYALTY VALUE PER DOLLAR	(K) ROYALTY DOLLARS PER DOLLAR
11,180.00	0.170000	19,007.84	0.001214	2,147.19	1.00642	1,120.11	11.000	0.000	11.000	12,027.11
(J) TOTALS										12,027.11

*WEIGHTED AVERAGE VALUE

	PRODUCTION	INTEREST	TOTAL
(1) CRUDE OIL	0.00	0.00	0.00
(2) LEASED OIL	1,120.11	0.00	1,120.11
(3) OTHER (GAS, CONDENSATE, WATER)	0.00	0.00	0.00
(4) TOTAL (1, 2, 3)	1,120.11	0.00	1,120.11
(5) REVISIONS	2,906.96	211.88	3,118.84
(6) TOTAL AMOUNT DUE (5)-(4)	1,986.85	211.88	2,198.73

I declare that I have examined this report, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

PREPARED BY	<i>[Signature]</i>
PRINTED NAME	ELANN KONE
TITLE	STATE ROYALTY UNIT SUPERVISOR
WORKING NUMBER	(71) 234 8491
DATE	24 JAN 87
PREPARED BY	ELANN KONE (71) 234 8491

NOTES: By filing this report, I agree that our owner has certain rights to take field and other cost deductions from the P1 Allocation Participating Area, including, but not limited to, those rights reserved by Lessee on the October 11, 1981, Amended Application for Extension of the Production Day Lease and Assignment of the P1 Allocation Participating Area.

Handwritten notes:
 11-2-86
 11-2-86
 11-2-86

000 0120 075 0100
 01 0501 01 00
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STATE OF ALASKA
 GAS AND OIL REVENUE BOARD
 STATE OF ALASKA DEPARTMENT OF NATURAL RESOURCES

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1001 PIONEER WAY
 FORT WYLLIE OFFICE
 2100 PIONEER WAY
 FORT WYLLIE OFFICE

Payee Address	EXXON CORPORATION P O BOX 496 HOUSTON TEXAS 77101-496	REPORT TYPE	PERIOD
		REVENUE NUMBER	000
		REVENUE DATE	

(1) GROSS LEASE PRODUCTION (BARRELS)	(2) WORKING INTEREST (PERCENTAGE)	(3) WORKING INTEREST SHARE	(4) RENTAL RATE	(5) RENTAL TOTAL	(6) OIL (BARRELS)	(7) OIL RENTAL TOTAL	(8) NATURAL GAS (CUBIC FEET)	(9) NATURAL GAS RENTAL TOTAL	(10) GROSS OIL AND GAS RENTAL TOTAL	(11) RENTAL TOTAL
28700	0.000000	0.0000	\$17000	\$0.00	0.00	\$0.00	11000	\$0.00	\$0.00	\$0.00
112 111483										\$0.00

*WEIGHTED AVERAGE VALUE

	PRINCIPAL	INTEREST	TOTAL
(1) OIL AND GAS RENTAL	0.00	0.00	0.00
(2) OIL AND GAS RENTAL	148.81	0.00	148.81
(3) OIL AND GAS RENTAL	0.00	0.00	0.00
(4) OIL AND GAS RENTAL	2.18	0.00	2.18
(5) REVENUE	14.81	2.17	16.98
(6) TOTAL PAYMENT FOR PERIOD	16.98	2.17	19.15

I declare that I have examined this report, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

DATE	11/11/83
PREPARED BY	FRANK C. JORDAN (1111111111111111)

11/11/83
 11/11/83
 11/11/83

SENATE COMMITTEE REF RT
First Committee of Referral

DATE: 4/21/95

FURTHER: Finance

Just

Date of 5-Day Notice: 4-20-95
 (in accordance with Uniform Rule 23)

DATE TURNED INTO OFFICE: 4-26-95

Resources Committee considered SB 164

Approving the sale of Prudhoe Bay Unit royalty oil by the State of Alaska to Tesoro Alaska Petroleum Company, etc.

FLSN's

and recommends:

- be replaced with _____ CS _____
- adopt previous _____ CS _____
- attached amendment(s)
- adopt Letter of Intent by _____ Committee
- further referral to the _____ Committee

Senate Bill:
 same title
 new title
 House Bill:
 same title
 technical title
 new SCR# _____

SIGNING TO PASS	DP	OTHER RECOMMENDATIONS	NR	DNP	AM
<i>Richard Halpern</i>	<input checked="" type="checkbox"/>				
<i>Frank B. Frank</i>	<input checked="" type="checkbox"/>				
<i>Tom Hoff</i>					
<i>William I. Taylor</i>	<input checked="" type="checkbox"/>				
<i>Gene Pearce</i>	<input checked="" type="checkbox"/>				
CHAIR: <i>John A. Jensen</i>	<input checked="" type="checkbox"/>				

NEW FISCAL NOTE(S):

Department	Date	Zero	Fiscal

PREVIOUS FISCAL NOTE(S):*

Department	Date	Zero	Fiscal
<i>Revenue</i>	<i>4/22</i>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
<i>DNR</i>	<i>4/22</i>	<input checked="" type="checkbox"/>	<input type="checkbox"/>

APPROPRIATION -- no fiscal note

*include fiscal notes accompanying Governor's bill