

TESORO  
ROYALTY

CON-  
TRACT

BRIEFING  
1995

**SEE**

**ALSO**

**SB 164**

**SALE OF NORTH SLOPE ROYALTY OIL  
TO  
TESORO ALASKA PETROLEUM  
COMPANY**



Alaska Department of  
**NATURAL  
RESOURCES**  
DIVISION OF OIL AND GAS

## CONTRACT TERMS

- Term

Three Years

January 1, 1996 to December 31, 1998

- Quantity

30 percent of Prudhoe Bay Unit royalty production  
About 40,000 barrels per day in 1996 declining to  
35,000 barrels per day by 1998.

- Price

- Purchase Price Reopener

- Security

- In-State Processing

- Local Hire

## Price

### Exxon's West Coast Royalty Value

- For Tesoro: Price certainty. Retroactive price adjustments due to producer "true-ups" and audits are minimized.
- For Alaska: Price exceeds value of royalty-in-value oil (RIV).
- Price compensates for "displacement effect" and "competitive effect."

### Purchase Price Reopener

- Tesoro and the State can renegotiate the price if the export ban is lifted.
- If the State and Exxon renegotiate the Exxon royalty value under the terms of the ANS Royalty Settlement, Tesoro may terminate the contract if the new price is not to its liking.

## Security

- Letter of Credit equal to the value of 75-days delivery of RIK.
- Covers State exposure to "Default Risk" and "Denomination Risk"
- If Tesoro and the State agree to an accommodation that will mitigate the Denomination Risk, the Letter of Credit requirement will be reduced to 60-days.

## In-State Processing

- Tesoro is obligated to refine 80 percent of the RIK in its Nikiski refinery.
- Provides commercial flexibility to Tesoro to optimize its refinery operation
- Provides the State with assurance that benefits of the sale will stay in-state.

## Local Hire

- Tesoro will hire Alaskan citizens to the extent allowed by the Constitution.

## IN-STATE BENEFITS

### Cash Value Offered

- Tesoro will pay a price that exceeds the value of RIV.
- Compensates for potential losses in royalty and severance tax revenues attributed to the “displacement effect.”

AS 38.05.183(1)  
and AS 38.06.050(1)

### Economic and Social Effects

- Tesoro employs 189 people in the Kenai Peninsula Borough and a total of 552 people statewide.
- Tesoro pays \$1.3 million in local property taxes.
- Tesoro pays \$7.6 million in various income, payroll, and excise taxes.
- No incremental effects on local social infrastructure (schools, roads, public safety, land use, etc.) is anticipated as a result of the sale.

AS 38.05.183(2)  
and AS 38.06.070(3), (4), and (5)

## Benefits of In-State Refining

- The State imports 15 percent of its petroleum products requirements.
- Imports will be displaced by in-state refining and more aggressive competition will benefit local consumers.

AS 38.05.183(3)  
and AS 38.06.070(2), (6), and (8)

## Ability of Tesoro to Provide Refined Products

- Tesoro has been in business in Alaska since 1969.
- It commands a 30 percent share of the local market in diesel fuels, jet fuels, and gasoline and it is a major supplier of propane and butane.

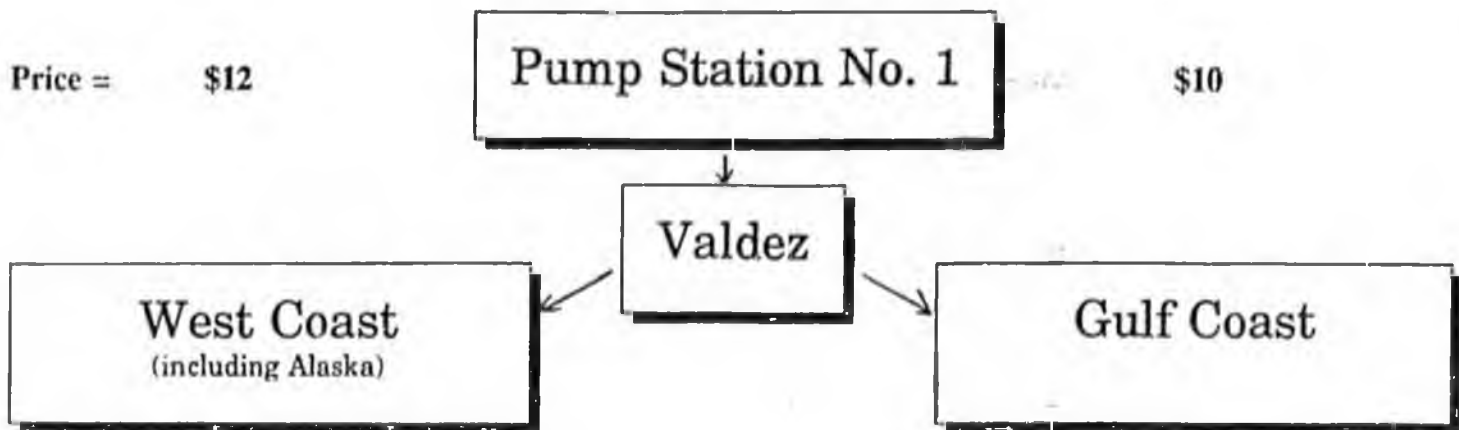
AS 38.05.183(4)  
and AS 38.06.070(6)

## Environmental Effects

- Tankers. No increase in tanker traffic between Valdez and Nikiski is anticipated as a result of the sale. Tesoro's recent refinery expansion means that fewer outbound shipments of products will occur.
- Air Quality. The sale will not contribute to an increase in emissions at the refinery. Tesoro now operates under ADEC Air Quality Control permits.
- Groundwater and Soil Contamination. Under compliance with ADEC and the EPA, Tesoro is undertaking a long term clean-up. The sale will contribute to the continued economic operation of the refinery and the clean-up program.

AS 38.06.070(7)

# DISPLACEMENT EFFECT



If the North Slope producers take all of our royalty oil "in-value," then their shipments will look like this:

40,000 (Tesoro)	+	660,000 (CA and WA)	+	300,000 (Gulf Coast)	= 1,000,000 (Total)
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In percentage terms:

4%	+	66%	+	30%	= 100%
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The calculation of royalty value (and severance tax) is:

$(\$12 \times 4\%) + (\$12 \times 66\%)$	+	$(\$10 \times 30\%)$	= \$11.40
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If the state sells oil to Tesoro, the producer's placements on the West Coast are reduced by 40,000 barrels. Their shipments will now look like this:

0 (Tesoro)	+	660,000 (CA and WA)	+	300,000 (Gulf Coast)	= 960,000
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In percentage terms:

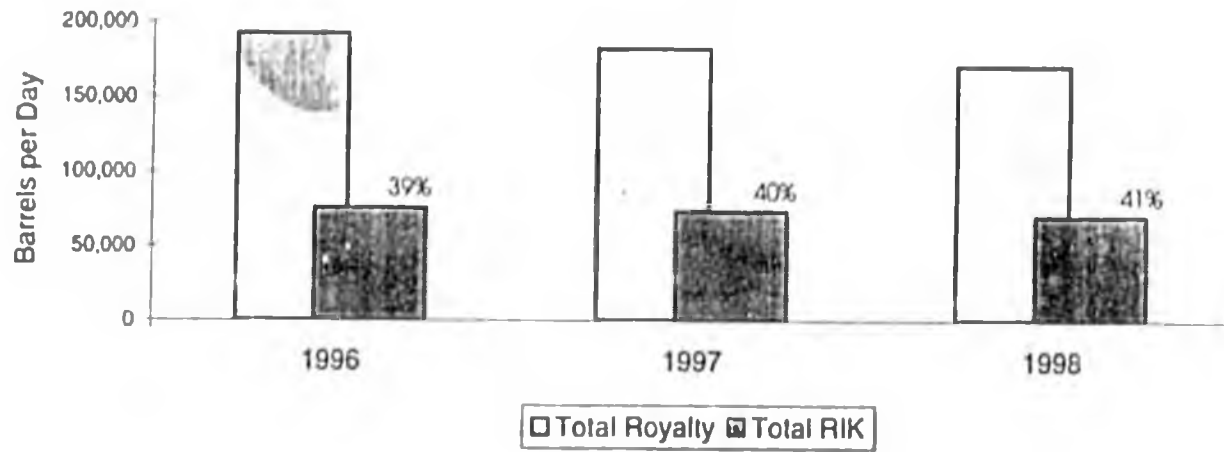
0%	+	68.75%	+	31.25%	= 100%
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The calculation of royalty value (and severance tax) is:

$(\$12 \times 0\%) + (\$12 \times 68.75\%)$	+	$(\$10 \times 31.25\%)$	= \$11.38
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In this example, the state loses two cents on every barrel of royalty and severance tax (together about 25% of 960,000) or \$4,800. To make up the difference, an additional twelve cents has to be added to each Tesoro barrel (40,000 x \$.12 = \$4,800).

### Total ANS Royalty and RIK Sales (Including Mapco and New Tesoro)



**North Slope Royalty Crude Oil Production Forecast**  
(MBOD)

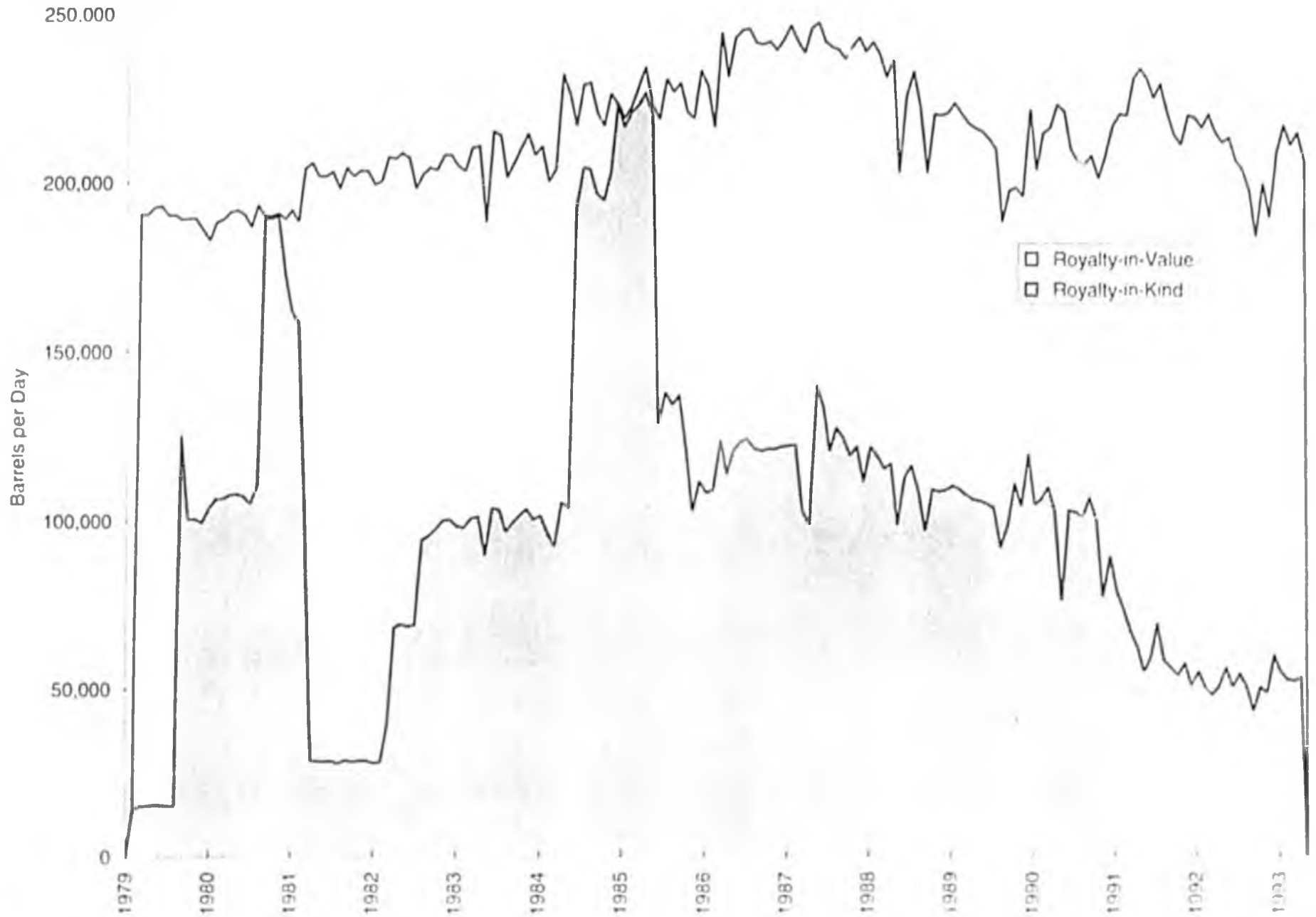
	1995	1996	1997	1998	1999	2000	2001	2002	2003
Prudhoe Bay Unit	143	135	127	116	105	95	85	75	69
Kuparuk River Unit	39	38	38	38	37	37	35	32	29
Milne Point	5	7	7	8	9	8	7	6	6
Endicott	13	12	10	9	8	7	6	5	4
<b>Total Royalty:</b>	<b>200</b>	<b>192</b>	<b>182</b>	<b>171</b>	<b>159</b>	<b>147</b>	<b>133</b>	<b>118</b>	<b>108</b>
minus RIV Req'd for Field Cost Allowance									
Prudhoe Bay Unit	14	14	13	12	11	10	9	8	7
Kuparuk River Unit	3	3	3	3	3	3	3	3	2
Milne Point	0	0	0	0	0	0	0	0	0
Endicott	1	1	1	1	1	1	0	0	0
	18	18	17	15	14	13	12	10	10
minus Current RIK Contracts									
Mapco	35	35	35	35	35	35	35	35	35
Tesoro	39	--	--	--	--	--	--	--	--
<b>Total Current RIK Obligation</b>	<b>74</b>	<b>35</b>	<b>35</b>	<b>35</b>	<b>35</b>	<b>35</b>	<b>35</b>	<b>35</b>	<b>35</b>
<b>ANS Royalty Oil Available to Supply New RIK Contracts:</b>									
	108	140	130	121	110	99	86	73	63
New Tesoro @ 30.0%	--	41	38	35	--	--	--	--	--
<b>ANS Royalty Oil Remaining:</b>	<b>108</b>	<b>99</b>	<b>92</b>	<b>86</b>	<b>110</b>	<b>99</b>	<b>86</b>	<b>73</b>	<b>63</b>

## Major North Slope RIK Contracts to In-State Purchasers Since 1980

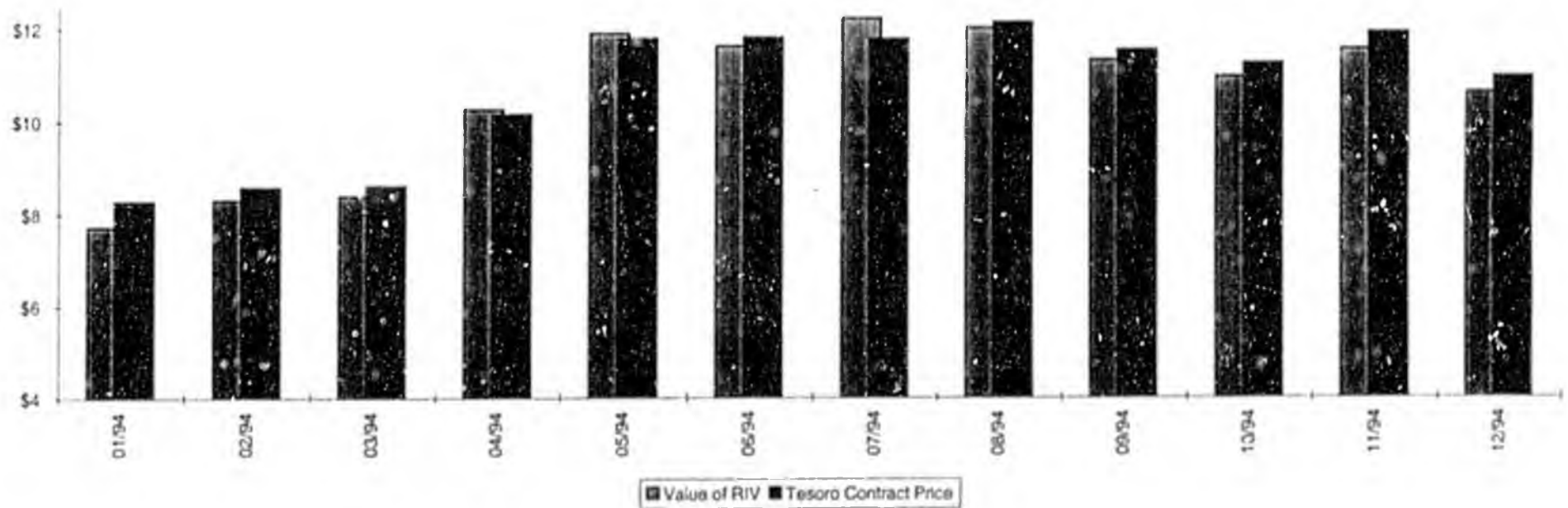
Purchaser Contract	Period	Total Volumes Purchased (Barrels)																			
		1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	
<b>Chevron</b>																					
Chevron 1	7/80 - 6/81																				1,742,342
Chevron 2	5/83 - 5/84																				6,721,236
Chevron 3	5/84 - 7/91																				48,418,344
Kuparuk	12/86 - 12/91																				8,611,247
Petrostar Purchases	12/86 - 12/91																				2,348,070
Subtotal																				67,841,239	
Plus: Tesoro Exchange Barrels																				16,015,527	
<b>Total Chevron</b>																				<b>83,856,765</b>	
<b>Golden Valley Electric Association</b>																					
GVEA 1	6/81 - 5/84																				3,148,152
GVEA 2	6/84 - 9/85																				2,511,064
GVEA 3	10/85 - 12/91																				11,618,844
<b>Total GVEA</b>																				<b>17,278,059</b>	
<b>MAPCO</b>	1/80 - Present																				156,560,265
<b>Petrostar</b>																					
Petro Star	12/86 - 12/91																				3,030,011
Petro Star JV	3/92 - 12/93																				0
<b>Total Petrostar</b>																				<b>3,030,011</b>	
<b>Tesoro</b>																					
Tesoro 1	7/80 - 6/81																				1,737,253
Tesoro 2	7/80																				821,100
Tesoro 3	12/81 - 1/82																				838,299
Tesoro 4	1/83 - 12/94																				171,473,974
Tesoro 5	10/85 - 8/90																				8,657,384
Tesoro 6	1/95 - 12/95																				14,600,000 (estimated)
Tesoro 7 (New Tesoro)	1/96 - 12/98																				41,391,000
Subtotal																				239,519,011	
Less: Chevron Exchange Barrels																				16,015,501	
<b>Total Tesoro</b>																				<b>223,503,510</b>	

Source: Alaska Department of Natural Resources, Division of Oil and Gas

### Total North Slope RIK and RIV Volumes



### Comparison of Tesoro Contract Price and the Value of RIV



**Preliminary 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

March 21, 1995

**Preliminary 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 preliminary finding and recommendation required under AS 38.05.183 for the proposed sale.

The public is invited to comment on the proposed sale. Comments must be received in writing by April 21, 1995 at the address below:

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

The Alaska Royalty Oil and Gas Development Advisory Board (Royalty Board) will be discussing the proposed sale at a meeting scheduled for 11:00 a.m., April 6, 1995, at the hearing room of the Legislative Affairs Agency, 716 West Fourth Avenue, Suite 200, Anchorage, Alaska. The public is invited to attend. If possible, this meeting will be teleconferenced to Legislative Affairs Agency offices throughout the state (contact Kevin Banks at 907-762-2589 for more information):

Fairbanks Office  
119 North Cushman  
Fairbanks, Alaska 99701-2879

Juneau Office  
Room 314  
Goldstein Building  
130 Seward Street  
Juneau, Alaska 99801-2197

Kenai Peninsula Office  
34924 Kalifonsky Beach Road, Suite A  
Soldotna, Alaska 99669-9728

Valdez Office  
Room 13  
State Office Building  
Valdez, Alaska 99686-1969

This finding is preliminary; final conclusions have not been reached. Comments received from the public and recommendations made by the Royalty Board will be used to determine whether the proposed contract is in the state's best interest and, if so, whether changes are needed in the proposed contract. If the commissioner determines that the proposed sale is in the state's best interests, contract terms will be revised, if necessary and a final finding will be prepared that will include an evaluation of any changes to the contract. The final finding, a copy of the signed contract, and the recommendation from the Royalty Board will be forwarded to the Legislature. The sale will not take effect unless it is approved by the Legislature.

## 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 department for a new royalty oil supply contract for which would begin deliveries when this current contract expires.

This finding and determination and the attached copy of the sales contract represent the result of those negotiations. Much of what was written by way of background to the 1995 contract still applies today. Where appropriate, this finding will reference the "Final Finding and Determination to Sell Royalty Oil to Tesoro Alaska Petroleum Company" dated September 9, 1994. In the following section of this finding, the description of the contract focuses on how this new contract differs from the current one-year contract.

## III. Discussions of Contract Provisions

**Quantity** Tesoro will purchase 30 percent, denoted as the "maximum quantity," of the state's royalty share (estimated at 40,500 barrels per day in 1996) from the Prudhoe Bay Unit (PBU). This increases the percentage of PBU royalty oil nominated from the 27.2 percent in the current contract, but, because of the decline in production forecasted for the PBU in 1996, the actual volume taken by Tesoro will not significantly increase. Tesoro also has the right at any time to decrease the maximum quantity of RIK as long as it timely notifies the state, however, Tesoro may not ever increase the maximum quantity.

Because of the terms of the Prudhoe Bay Unit Agreement in force among the producers and the state, the state must combine royalty production from both the Prudhoe Bay field and royalty crude processed currently through the Lisburne Production Center. The 135,000 barrels per day of royalty crude oil forecast for 1996 (Table 1) is the sum of the royalty offtake from Prudhoe Bay, Lisburne, Pt. McIntyre, West Beach, North Prudhoe Bay State, and the Niakuk/Alapah oil fields.<sup>1</sup> Table 1 illustrates the future royalty crude oil supply from the Prudhoe Bay Unit. The

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<sup>1</sup> The state reserves the right to supply 100 percent of Tesoro's volume from just the Prudhoe Bay Unit Initial Participating Areas (IPA) rather than include the production processed through the Lisburne Production Center. This would imply that Tesoro would receive approximately 35.2 percent of the Prudhoe Bay IPA production. Tesoro will be notified 90 days in advance if the commissioner, in his sole discretion, chooses to exercise this right.

state is obligated to supply 35,000 barrels per day to Mapco through 2003. If the proposed Tesoro contract is awarded, the state will still keep 44 percent of its royalty share as RIV in 1996 (declining to about 40 percent by 1998) and maintain the flexibility to nominate more RIK as circumstances warrant, e.g., other in-state refinery requirements, RIK sales to Lower-48 purchasers, or a change in the federal regulations that restrict the export of ANS.

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

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Prudhoe Bay Unit	143	135	127	116	106	95	85	75	69
Kuparuk River Unit	39	38	38	38	37	37	35	32	29
Mine Point	5	7	7	8	7	8	7	6	6
Endcott	13	12	10	9	8	7	6	5	4
<b>Total Royalty:</b>	<b>200</b>	<b>192</b>	<b>182</b>	<b>171</b>	<b>159</b>	<b>147</b>	<b>133</b>	<b>118</b>	<b>108</b>
minus RIV Req'd for Field Cost Allowance									
Prudhoe Bay Unit	14	14	13	12	11	10	9	8	7
Kuparuk River Unit	3	3	3	3	3	3	3	3	2
Mine Point	0	0	0	0	0	0	0	0	0
Endcott	1	1	1	1	1	1	0	0	0
	<b>18</b>	<b>18</b>	<b>17</b>	<b>15</b>	<b>14</b>	<b>13</b>	<b>12</b>	<b>10</b>	<b>10</b>
minus Current RIK Contracts									
Mapco	35	35	35	35	35	35	35	35	35
Tesoro	39	--	--	--	--	--	--	--	--
<b>Total Current RIK Obligation</b>	<b>74</b>	<b>35</b>	<b>35</b>	<b>35</b>	<b>35</b>	<b>35</b>	<b>35</b>	<b>35</b>	<b>35</b>
<b>ANS Royalty Oil Available to Supply New RIK Contracts:</b>									
	108	140	130	121	110	99	86	73	53
Less Tesoro @ 30.0%	--	41	38	35	--	--	--	--	--
<b>ANS Royalty Oil Remaining:</b>	<b>108</b>	<b>99</b>	<b>92</b>	<b>86</b>	<b>110</b>	<b>99</b>	<b>86</b>	<b>73</b>	<b>53</b>

Tesoro may elect to purchase less than the maximum quantity, subject to certain notice requirements. If Tesoro decides to take less than the maximum quantity, it will be subject to a per-barrel reservation fee on each barrel less than the maximum quantity. The per-barrel reservation fee is 0.75 percent of the full purchase price.

**Price** The proposed contract requires Tesoro to pay the same West Coast royalty value received by the state based on the royalty production lifted in the PBU by Exxon. This price meets the statutory requirement that the value of RIK is at least equal to or exceeds RIV. It also differs from the current contract which uses a price based on the volume-weighted average West Coast 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.<sup>2</sup>

<sup>2</sup> 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.

**Table 2: RIK Price Calculations--January 1995**

**Exxon's Royalty Value**  
**Proposed Tesoro Contract Price**

Exxon Production at	Gross Volume	PS-1 Value	Product of Volume Times PS-1 Value	Average Price
Lisburne Production Center	1,762,900.13	\$11.05000	\$19,408,046.44	
Prudhoe Bay IPA	8,807,215.20	\$11.11000	\$97,848,160.87	
<b>Total</b>	<b>8,818,503.20</b>		<b>\$97,972,893.27</b>	
<b>Volume Weighted Average Value:</b>				<b>\$11.09999</b>

**Volume Weighted Average Price--ARCO, BP (West Coast), and Exxon**  
**Tesoro's Current Contract**

Producer	Gross Volume	PS-1 Value	Product of Volume Times PS-1 Value	Average Price
<b>Lisburne Production Center</b>				
ARCO	1,459,347.74	\$11.58000	\$16,899,246.83	
BP Exploration	2,022,440.13	\$10.51000	\$21,255,845.77	
Exxon	1,762,900.13	\$11.05000	\$19,480,046.44	
<b>Prudhoe Bay IPA</b>				
ARCO	8,807,752.40	\$11.61000	\$102,258,005.36	
BP Exploration	12,721,772.40	\$10.61000	\$134,978,005.16	
Exxon	8,807,215.20	\$11.11000	\$97,848,160.87	
<b>Totals</b>	<b>35,581,428.00</b>		<b>\$392,719,310.43</b>	
<b>Volume-Weighted Average Value:</b>				<b>\$11.03720</b>

**Volume Weighted Average Price--All Producers**  
**Value of RIV**

Producer	Gross Volume	PS-1 Value	Product of Volume Times PS-1 Value	Average Price
<b>Lisburne Production Center</b>				
ARCO	1,459,347.74	\$11.58000	\$16,899,246.83	
BP Exploration	2,022,440.13	\$10.51000	\$21,255,845.77	
Exxon	1,762,900.13	\$11.05000	\$19,480,046.44	
<b>Prudhoe Bay IPA</b>				
Amerada Hess <sup>1</sup>	121,673.40	\$11.27400	\$1,371,745.91	
ARCO	8,807,752.40	\$11.61000	\$102,258,005.36	
BP Exploration	12,721,772.40	\$10.61000	\$134,978,005.16	
Chevron <sup>2</sup>	195,833.10	\$11.11000	\$2,175,705.74	
Exxon	8,807,215.20	\$11.11000	\$97,848,160.87	
Louisiana Land and	8,993.30	\$11.61000	\$104,412.21	
Marathon <sup>3</sup>	11,288.00	\$11.61000	\$131,063.68	
Mobil <sup>4</sup>	453,693.20	\$10.61000	\$4,813,684.85	
Phillips <sup>5</sup>	449,246.20	\$10.61000	\$4,766,502.18	
Shell <sup>6</sup>	31,141.00	\$11.61000	\$361,547.01	
Texaco <sup>7</sup>	124,049.00	\$10.61000	\$1,316,159.89	
<b>Totals</b>	<b>36,977,345.20</b>		<b>\$407,760,121.91</b>	
<b>Volume Weighted Average Value:</b>				<b>\$11.02730</b>

Note: Only BP's royalty value, calculated from the volume-weighted average of the prices reported for each market may be made public. The per barrel price listed here is (a) BP's actual West Coast Value. Assume that BP's West Coast value is the volume-weighted average plus \$0.30.

<sup>1</sup>Amerada Hess currently has no prospective formulaic treatment of its royalty value.

<sup>2</sup>Chevron uses a simple average of ARCO, BP, and Exxon.

<sup>3</sup>These producers use ARCO's royalty value formula.

<sup>4</sup>These producers use BP's royalty value formula for West Coast destinations.

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.

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.

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.<sup>1</sup> The "competitive effect" is minimized insofar as the

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<sup>1</sup> 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.

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.

In any case, pricing Tesoro's RIK at the Exxon royalty value should sufficiently compensate the state for these impacts.

**In-state Processing** In the current contract and in the proposed contract, Tesoro has agreed that 80 percent of the RIK it will purchase will be processed in the Nikiski refinery. This clause is designed to prevent Tesoro from re-selling RIK to a third party and possibly profiting from a favorable price charged to Tesoro by the state. If such a benefit is available because the price charged to Tesoro for its RIK based on Exxon's royalty value is less than Tesoro would have to pay for oil from another source, then this benefit should be passed on to the in-state consumers of Tesoro's products.

**Purchase Price Reopener** According to the ANS Royalty Settlement Agreement with Exxon, the state and Exxon have reopener rights in which a new pricing formula may be negotiated, if necessary, or arbitrated by an independent Decision Panel. If this process leads to a price that is not to Tesoro's liking, then Tesoro may unilaterally terminate its contract with the State, subject to specified notice requirements. Tesoro may not reopen the contract with the state over price should the state and Exxon agree to a different royalty value methodology. Tesoro also agrees that it will not intervene in any way in the negotiations or arbitration of a reopener between the state and Exxon.

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 Adjustment, 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."<sup>4</sup> 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 organize 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.

The contract includes language that will allow the 75 day letter of credit to be reduced to 60 days if arrangements can be made to ameliorate the potential of a declaration of *force majeure* by any of the lessees. Since Tesoro will already have marine transportation under charter to move its ANS supply from Valdez to Nikiski, these vessels could be offered to the lessees as an indication that the supply of tankers in the Valdez trade is sufficient. A declaration of *force majeure* by the lessees in the event of a default of the proposed contract by Tesoro may be more difficult to demonstrate with Tesoro's tankers idled and waiting for new customers.

**Local Hire** Like current contract, the proposed contract requires that "Tesoro agrees to employ Alaska residents and Alaska companies to the extent they are available, willing and qualified for all work performed in Alaska in connection with the Agreement." An Alaska resident is defined as one who has lived in Alaska for at least a year at the time of employment. If this provision is found to be unconstitutional, then Tesoro agrees to hire Alaska residents to the extent that the constitution will allow.

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

#### IV. In-State Benefit Analysis

The commissioner must consider, among other things, the effects of the sale of RIK on the economy of the state and the projected benefits of refining or processing the RIK in the state (under AS 38.05.183). In short, the terms of the proposed RIK sale should 1) assure that the state receives at least as much value for the RIK as it would have received for RIV and 2) encourage in-state processing of RIK together with the attendant economic and social benefits. These benefits are measured in terms of jobs, taxes, and economic competition among the state's refineries for their products. The conclusions reached in the best interest finding that accompanied the current one-year contract are still applicable. Some of the information has been updated here.

In the following discussion of in-state benefits, there is one caveat: the degree to which these effects may be attributable to the sale depends on how important the sale is to the continued 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.<sup>5</sup> 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.<sup>6</sup>

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

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

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

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 their may be a benefit to Alaskan consumers if competition from local supplies contribute to lower prices for the consumer.<sup>7</sup>

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.

**Environmental Impacts** Tankers have operated in the Cook Inlet for over 50 years and, for the most part have operated safely.<sup>8</sup> The bulk of tanker traffic in the Cook Inlet carries ANS from Valdez to the Nikiski refinery, petroleum products to Cook Inlet ports, or refined oil and gas to Pacific Rim markets. The sale of North Slope RIK will not materially affect the reliance of the Nikiski refinery on tanker transportation. The refinery's main source of crude oil comes from the North Slope via Valdez and the Cook Inlet, but Cook Inlet crude oil supplies will continue to contribute to 10 percent of Tesoro's requirements. The decision to sell RIK to Tesoro does not authorize its transportation. Federal and state permits will be required.

The Alaska Department of Environmental Conservation (ADEC) requires that the oil industry develop oil spill contingency plans and monitors the implementation of those plans. In 1990, the legislature enacted additional laws to reduce the likelihood of future spills in Alaska and to improve the capability to respond to those that occur. The federal Oil Pollution Act of 1990 created Regional Citizens Advisory Councils to involve local citizens in the process of preparing, adopting, and revising oil spill contingency plans and the regulation of tanker and terminal operations.

The Tesoro refinery now operates under a ADEC Air Quality Control permit to operate (PTO No. 9023-AA008) and under this permit Tesoro must comply with a variety of conditions to control and monitor emissions both from the burning of fuel and the refinery's process equipment. In January 1994, the state issued Tesoro a Prevention of Significant Deterioration air permit (PSD) to allow the refinery to operate some equipment for longer hours. Tesoro then submitted proposed amendments to the PSD permit in February related to the vacuum unit project. Tesoro has also agreed to several conditions that will result in air quality monitoring and improvements at the refinery including an air pollution compliance audit and improvements at the refinery that are recommended in the audit. Most significantly, Tesoro has agreed to reduce emissions of volatile organic compounds from the refinery by 150 tons per year by 1996.

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<sup>7</sup> 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.

<sup>8</sup> Alaska Department of Natural Resources. October 1993. Final Finding of the Director Regarding Oil and Gas Lease Sale 78, Cook Inlet. 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

revenues in the future. The price term of the sale protects the state's interest by ensuring that revenues from this sale will likely exceed the in-value alternative.

2. There are local and regional economic benefits to be derived from the continued operation and expansion of the Nikiski refinery. While the proposed contract may increase the financial viability of the refinery, the extent to which these benefits can be ascribed to the proposed contract cannot be predicted.
3. As described above, Tesoro is an important competitor in the market of refined petroleum products. Vigorous competition in fuel sales in the state may provide for lower consumer product prices.
4. Tesoro provides high-wage jobs to 189 people in the Kenai Peninsula Borough and another 363 people statewide. It is one of the largest private sector employers in a region where unemployment rates often exceed state averages. Both the Kenai Peninsula Borough and the state receive revenues from Tesoro as property taxes and corporate income and excise taxes.
5. Any environmental effects will result from the continued operation of the Nikiski refinery, not from the proposed sale. The sale itself will have no incremental effect. Waterborne movements of ANS through the Cook Inlet will occur with or without the sale (though waterborne movements of residual oil will be reduced with the completion of the refinery expansion). Improvements at the refinery will operate only under air quality permits issued by the ADEC which has a process for assessing the effects of the projects.
6. To the extent that the sale helps provide a consistent and economic supply of crude oil to the refinery, the sale will contribute to ongoing economic stability in the Kenai Peninsula region and maintain a healthy competitor in the in-state market for refined petroleum products.

**Criteria Weights** According to 11 AAC 03.060(b), "In considering the criteria described in AS 38.05.183(e), the Commissioner will state which criteria apply to the proposed disposition and discuss the weight given to the applicable criteria in determining the maximum benefit to the state...."

In making this finding, the department first determined that the state would not lower the total oil revenue, including royalties and severance taxes, due the state by making a disposal to Tesoro. The department next looked at whether the disposal would contribute to robust competition in the in-state refining industry and the extent to which that would lead to lower product prices. Finally, the department examined the criteria to determine that the state would not create any unacceptable environmental or social impacts.

**Royalty Board** This finding and determination will be submitted to the Royalty Board in compliance with AS 38.05.183(e) which requires that commissioner may not waive competitive bidding in a sale of RIK unless prior written notice has been given to the board.

**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.

**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.

**AS 38.06.070. Criteria.** (a) In the exercise of its powers under AS 38.06.040(a) and 38.06.050 the board shall consider

- (1) the revenue needs and projected fiscal condition of the state;
- (2) the existence and extent of present and projected local and regional needs for oil and gas products and by-products, the effect of state or federal commodity allocation requirements which might be applicable to those products and by-products, and the priorities among competing needs;
- (3) the desirability of localized capital investment, increased payroll, secondary development and other possible effects of the sale, exchange or other disposition of oil and gas or both;
- (4) the projected social impacts of the transaction;
- (5) the projected additional costs and responsibilities which could be imposed on the state and affected political subdivisions by development related to the transaction;
- (6) the existence of specific local or regional labor or consumption markets or both which should be met by the transaction;
- (7) the projected positive and negative environmental effects related to the transaction;  
and
- (8) the projected effects of the proposed transaction upon existing private commercial enterprise and patterns of investments.

**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 \_\_\_\_\_, 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           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.

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ARTICLE II

SALE OF ROYALTY OIL

2.1 Quantity.

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

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

The volume of Daily Royalty Oil available to the State will vary and may be interrupted from time to time, and depends upon a variety of factors including the rate of production from the Leases. The State disclaims and Tesoro waives any representation, covenant or warranty, expressed or implied, that a specific quantity or the total or daily, monthly, average, or aggregate volume of Royalty Oil will be sold or tendered under this Agreement. The State warrants that it has good title to the Oil tendered under 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. 1-  
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.

15

1 ARTICLE III

2 REPRESENTATION AND OBLIGATIONS OF TESORO

3 Tesoro warrants, represents, and agrees:

4 3.1 Good Standing and Due Authorization. Tesoro is, and at all times during the  
5 operation of this Agreement shall remain, a corporation organized and existing under and by virtue of  
6 the laws of the United States or of any State, territory or the District of Columbia, and qualified to do  
7 business in, and in good standing with, the State of Alaska. Tesoro has all necessary corporate power  
8 to enter into this Agreement and to perform the covenants and obligation under this Agreement. All  
9 necessary corporate action has been taken to authorize Tesoro to enter into this Agreement and  
10 perform its covenants and obligations under this Agreement.

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

21 3.3 Financial Statements. As soon as possible after the end of the fiscal year of  
22 Tesoro, and in any event within one hundred twenty Days thereafter, Tesoro will furnish to the State,

1 at Tesoro's sole cost and expense, a report or a complete copy of a report in a form to be prescribed  
2 from time to time by the State which will include Tesoro's balance sheet as of the close of the fiscal  
3 year and the income statement for that year, prepared in each case in accordance with generally  
4 accepted accounting principles consistently applied by certified public accountants of recognized  
5 standing. For purposes of complying with this article, Tesoro may submit, and the State will accept,  
6 the annual report of Tesoro Petroleum Corporation filed with the United States Securities and  
7 Exchange Commission pursuant to Sec. 13 or 15 (d) of the Security Exchange Act of 1934.

8  
9 **ARTICLE IV**

10 **MEASUREMENTS AND TESTS**

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



1           5.3    Subsequent Adjustments. Tesoro acknowledges that after the Initial Billing  
2 and Initial Adjustment Invoices, more accurate information concerning the quantity of or purchase  
3 price for Royalty Oil tendered may become available to the State. If any such information should  
4 later become available to the State, it shall furnish a corrected invoice statement of account to Tesoro  
5 ("Subsequent Adjustment Invoice") and the State will adjust the amount previously billed; and Tesoro  
6 will pay, or the State will credit or refund, the amount of any Subsequent Adjustment Invoice plus  
7 interest. If the State should render a Subsequent Adjustment Invoice to Tesoro, any amount to be  
8 credited or refunded from the State to Tesoro or paid by Tesoro to the State will be refunded or paid  
9 within thirty Days after the date of the Subsequent Adjustment Invoice.

10           The parties recognize that subsequent adjustments may be necessary after December  
11 31, 1998, and, accordingly, the provisions of Article V will survive any termination of this  
12 Agreement. Any Subsequent Adjustment Invoice rendered more than six years after the date of  
13 delivery will bear interest for only six years from the date accrued as defined in Article 5.5. This  
14 limitation on interest does not apply to Subsequent Adjustment Invoices resulting from: (1)  
15 regulatory, reopener or court proceeding (including appeals) commenced during the six year period  
16 whether or not the Tesoro or the State is a party and (2) bona fide audits by the State of Exxon  
17 commenced during the six year period.

18           5.4    Payment. Tesoro will pay the Initial Billing Invoice on the third business Day  
19 of the month following delivery or within three business Days after the date of the invoice whichever  
20 is later; and the Initial Adjustment Invoice within three business Days of the date of the invoice and  
21 on any Subsequent Adjustment Invoice within 30 Days of the date of the invoice. Payment shall be

1 made without any deduction, set off, or withholding, by wire transfer of immediately available funds  
2 to the State's account at the following address:

3 State Street Bank & Trust Company  
4 Boston, Massachusetts  
5 ABA #011000028  
6 For credit to the State of Alaska  
7 General Investment Fund, AY01  
8 Account #00657189  
9 Attn: Kim Chan, Public Funds

10  
11 Payment may be made in such other manner or to such other address as the State may  
12 specify in the invoice statement of account or by other written notice. All other payments to be made  
13 under this Agreement shall be paid in the same manner. If payment is due on a Saturday, Sunday, or  
14 legal holiday of the place where payment is to be received, payment shall be made on the next  
15 following business Day. It is recognized that the State may bill, and that Tesoro will pay, amounts  
16 that are based upon confidential information held or received by the State. If confidential information  
17 is used as the basis for a billing, then the State will furnish Tesoro, upon its request, with the certified  
18 statement of the Commissioner that the amounts billed are correct based upon the best information  
19 available to the State. If a dispute concerning a bill arises, Tesoro agrees to pay the full amount billed  
20 by the State, except for obvious clerical mistakes, pending final resolution of the dispute.

21 5.5 Interest. The Amount of all sums, which are not paid when due under this  
22 Agreement or which are later determined to be due as an adjustment, shall bear interest from the date  
23 accrued until paid in full at the rate as provided in AS 38.05.135(d) or as that statutory provision may  
24 later be amended. Currently, that interest rate in a calendar quarter is at the rate of five percentage  
25 points above the annual rate charged member banks for advances by the 12th Federal Reserve District  
26 as of the first Day of that calendar quarter, or at the annual rate of 11 percent, whichever is greater.

1 compounded quarterly as of the last Day of that quarter. The term "date accrued" means the date of  
2 the "Initial Billing plus three business Days." Interest shall apply to both adjustments for  
3 overpayments and underpayments.

4 The following illustrates from what date interest will run:

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

6 February 9, 1996 -- State sends Tesoro the Initial Billing Invoice for 1996 January  
7 production;

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

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

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

16 January 10, 1997 -- State sends Tesoro a Subsequent Adjustment Invoice for January  
17 1996 production. Tesoro is entitled to a credit. State pays interest from  
18 February 14, 1996 through January 10, 1997.

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

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

4 May 17, 2006 -- Tesoro must pay the Subsequent Adjustment Invoice for January  
5 1996 production plus interest from calculated February 14, 1996 through  
6 February 14, 2002. If Tesoro does not pay the Subsequent Adjustment  
7 Invoice on this date, interest will accrue from February 14, 1996 through the  
8 date the payment is made and Tesoro must also pay a late payment penalty.

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

11 November 30, 2006 -- State sends Tesoro a Subsequent Adjustment Invoice. Tesoro  
12 is entitled to a refund which includes interest calculated from February 14,  
13 1996 through November 30, 2006.

14 5.6 Late Payment Penalty. If Tesoro fails to make a full payment within three  
15 business days of the date of either an Initial Billing Invoice or Initial Adjustment Invoice, or within  
16 thirty Days of the date of any Subsequent Adjustment Invoice, then in addition to the amount due  
17 plus interest from the date accrued until the date of actual payment, Tesoro will pay an amount equal  
18 to five percent of the principal payment due as a late payment penalty.

19 5.7 Payment to Lessee. At the request of the State in the invoice statement of  
20 account or otherwise in writing, Tesoro shall pay all or any portion designated by the State of that  
21 payment required to be made to one or more of the Lessees at an address or addresses and in the  
22 manner designated by the State. The payment will be made within the time limit specified in

1 Article V. The State may authorize and designate a third party to make the request and designate the  
2 amount, manner and place of payment under this provision. Unless otherwise specified, the balance  
3 of the payment due, if any, and payment for subsequent Months, shall be made in accordance with  
4 Article V.

5 5.8 Payment to Third Parties. The State may direct that Tesoro pay any amount  
6 due or which may become due directly to a third party in a manner and time as may be directed by  
7 the State in written notice to Tesoro if, in the State's sole discretion, the payment to the third party  
8 will assist the State in monitoring or enforcing this Agreement.

9  
10 **ARTICLE VI**

11 **TERM**

12 This Agreement shall become effective upon execution by the parties. The State's  
13 obligation to sell and Tesoro's obligation to buy Royalty Oil becomes effective immediately.  
14 Deliveries under this Agreement shall begin on January 1, 1996, and shall end December 31, 1998.  
15 The provisions of Article V shall survive the termination of this Agreement.

16  
17 **ARTICLE VII**

18 **DEFAULT OR TERMINATION**

19 7.1 Default. If any one or more of the following events ("Events of Default")  
20 occur, then the State, at the its sole option, may terminate or suspend its obligation to tender and sell  
21 Oil and exercise any one or more of the rights and remedies provided in this Agreement:

- 1 (i) At any time, Tesoro (a) repudiates any of its covenants or obligations  
2 under this Agreement, or (b) fails, within five Days, after written  
3 request from the State to provide the State with written affirmation of  
4 this Agreement and of Tesoro's intention to perform under this  
5 Agreement (together with evidence or assurances of transportation  
6 arrangement pursuant to Article 2.8 reasonably satisfactory to the  
7 State);
- 8 (ii) Tesoro does not pay in full any sum owed under this Agreement at the  
9 time when payment is due;
- 10 (iii) Tesoro fails to observe or perform any of its other covenants and  
11 obligations under Article II;
- 12 (iv) Tesoro does not perform any act required or contemplated under this  
13 Agreement and: (a) the non-performance cannot be cured; (b) the  
14 nonperformance continues for more than thirty Days after the State  
15 has notified Tesoro of its nonperformance; or (c) Tesoro has failed to  
16 perform the same or any other act required or contemplated under this  
17 Agreement;
- 18 (v) There is a material adverse change in Tesoro's condition, business, or  
19 property which may appreciably affect its ability to perform any of its  
20 obligations under this Agreement and Tesoro is unable or unwilling to  
21 give the State adequate assurance of continued performance either  
22 within five Days of a request for such an assurance or within such

1 other shorter time period as the State may request under the  
2 circumstances:

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

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

9 7.2 Failure to Pay Debts. If Tesoro becomes unable to pay any of its debts when  
10 due, or should otherwise become insolvent (regardless how that insolvency may be evidenced),  
11 Tesoro will immediately give written notice of that fact to the State. Whether that notice is given, if  
12 Tesoro becomes unable to pay any of its debts when due or should otherwise become insolvent, the  
13 State's obligation to tender and sell Oil will automatically and immediately terminate without any  
14 requirement of notice or other action by the State; however, Tesoro will nevertheless be and remain  
15 liable for payment and performance of all of its obligations and covenants under this Agreement  
16 regarding Oil actually tendered by the State to and after any such termination. Within thirty Days  
17 after receipt of Tesoro's notice or, if no notice is given, after the State otherwise becomes aware (as  
18 determined in the State's sole discretion) of Tesoro's insolvency, the State will have the right, upon  
19 written notice to Tesoro, to reinstate all of the State's and Tesoro's obligations under this Agreement  
20 retroactively to the date of termination.

21 7.3 State's Remedies. If any Event of Default occurs or if the State's obligation to  
22 tender and sell Oil under this Agreement is terminated or suspended, all of Tesoro's obligations

1 accrued but not otherwise due and payable under this Agreement will immediately be due and  
2 payable in full. In addition, Tesoro will indemnify and hold the State harmless from and against all  
3 other liability, damages (including reasonably foreseeable consequential damages), costs, losses and  
4 expenses (including reasonable attorney's fees and disbursements) incurred by the State and arising  
5 out of the Event of Default, termination, or suspension. The State shall have the right cumulatively to  
6 exercise any and all other rights and remedies and to obtain all other relief available under applicable  
7 law or at equity, including mandatory injunction and specific performance.

8           Additionally, in its sole discretion, the State, upon occurrence of any Event of  
9 Default: (1) may dispose to third parties any or all Royalty Oil to be tendered and sold under this  
10 Agreement and (2) may release Tesoro from the in-state processing obligations set forth in Article  
11 2.12 until the Event of Default no longer exists or the obligation of Tesoro to take Oil under this  
12 Agreement expires. If the State disposes of Oil to third parties, or if Tesoro is released from Article  
13 2.12, whether or not this Agreement is terminated, Tesoro will nevertheless remain liable for the  
14 difference between the purchase price for that Oil under this Agreement and the price received by the  
15 State by disposition, including all of the expenses (including reasonable attorneys' fees and costs), and  
16 losses incurred by the State arising out of the Event of Default or disposition.

17           7.4    Tesoro's Exclusive Remedies. Upon any breach of, or default in performance  
18 of any of the State's covenants or obligations under this Agreement, Tesoro agrees that its remedies  
19 will not include a temporary restraining order or preliminary injunction preventing the State from  
20 taking any action regarding the Royalty Oil which is the subject of this Agreement.

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ARTICLE VIII

DISPOSITION OF OIL

8.1 Disposition of Oil Upon Default or Termination. Tesoro recognizes that the State may be required to give up to six Months notice to the Lessees (or ninety Days if the amount of increase or decrease is less than ten percent of the then current nominations or marine transportation is available) to increase or decrease the amount of Daily Royalty Oil to be taken in-kind. Tesoro agrees that the State's electing to invoke its rights to return to taking its Royalty Oil in-value on less than six Month's prior notice, or to attempt to secure a waiver of any condition or requirement, is at the State's sole discretion. Notwithstanding termination of this Agreement for any reason, Tesoro shall continue to take and purchase the State's Royalty Oil in the amount and for the price set forth in this Agreement for up to six Months following termination if the State, in its sole discretion, so requires.

8.2 Inability to Receive Oil. If for any reason, Tesoro is unable or refuses to accept or receive any Oil tendered under this Agreement, 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 and accepted by Tesoro unless the State, in its sole discretion, elects to waive this requirement. To secure Tesoro's obligations under Article 8.2 and Article 2.9, Tesoro shall, if the State requests, assign or otherwise transfer to the State or its designee all or part right, title and interest of Tesoro under any nominations, Leases, agreements, contracts, charter parties and other arrangements for the transportation of the Oil sold under this Agreement through and away from the TAPS; provided, that the State shall not have any liability or obligations under any such nominations, Leases, agreements, contracts, charter parties or other arrangement unless, and to the extent that, the

1 State shall actually exercise its rights to succeed to Tesoro's interest under them and shall obtain the  
2 benefits of them.

3 8.3 No Right to Storage or Underlift. Tesoro waives and disclaims any interest or  
4 right that it may assert to storage of Royalty Oil, including by underlift or other means, to which the  
5 State is or may become to be entitled under the Leases or any other agreement.

6  
7 **ARTICLE IX**

8 **WAIVER**

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

15  
16 **ARTICLE X**

17 **VALIDITY**

18 If any provision or clause of this Agreement or application of this Agreement is held  
19 invalid, that invalidity shall not affect other provisions or application of this Agreement which can be  
20 given effect without the invalid provision or application. If, however, an invalidity should operate to  
21 impair any material right or remedy of a party to this Agreement, that party may terminate this  
22 Agreement by notice to the other.







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

16           If the State has reasonable grounds for asserting any claims against Tesoro and does  
17 assert those claims in an aggregate amount in excess of the aggregate principal face amount of the  
18 letter of credit then in effect, Tesoro shall, upon the State's request (whether or not Tesoro may deny,  
19 reject or otherwise resist such claims), cause the principal face amount to be increased by an amount  
20 equal to the excess. Tesoro shall also automatically increase the principal face amount, without  
21 request from the State, whenever the face amount is less than the expected purchase price of seventy  
22 five Days of Oil tenders, to an amount equal to the expected purchase price of seventy five Days of

1 Oil tenders. Upon approval of the State in its sole discretion, Tesoro may decrease the principal face  
2 amount if the face amount is more than the expected purchase price of seventy five Days of Oil  
3 tenders to an amount equal to the expected purchase price of seventy five Days of Oil tenders.

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

8 15.2 Reduction of Term. The term of the letter of credit required under Article XV  
9 shall be reduced from seventy five Days to sixty Days, if Tesoro and the State can reach an agreement  
10 regarding the transportation of Oil if Tesoro defaults under this Agreement. If the parties cannot  
11 reach an agreement, then the letter of credit shall remain at seventy five Days or Tesoro shall have the  
12 right, in its sole discretion, to terminate this Agreement as provided in Article 2.1.

## 13 14 ARTICLE XVI

### 15 PREFERENTIAL HIRING AND NON-DISCRIMINATION

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

18 "Alaska resident" means an individual who has resided in Alaska for one year at the time of  
19 employment and "Alaska companies" means companies incorporated in Alaska or whose principal  
20 place of business is in Alaska.







1 law or regulation, Tesoro may request that information be held confidential by the State and the State  
2 will keep this information confidential.  
3

#### 4 **ARTICLE XXIII**

##### 5 **INTERPRETATION OF TERMS AND CONDITIONS**

6 Any disagreement about the meaning or application of a word, term, or condition in  
7 this Agreement will be decided according to the dispute resolution procedure set forth in this article.  
8 Either party may give the other written notice of a disagreement. Within 60 days after written notice,  
9 Tesoro must present any argument and evidence supporting its view in writing to the Commissioner  
10 for consideration. Tesoro shall not have the right to civil litigation-type discovery or a civil litigation-  
11 type trial with the right to call or cross-examine witnesses unless granted by the Commissioner in his  
12 sole discretion. The Commissioner will subsequently issue a finding on the meaning or application of  
13 the disputed word, term, or condition, setting forth the basis for the conclusions. Tesoro agrees to  
14 accept findings by the Commissioner under this article which are supported by substantial evidence.  
15

#### 16 **ARTICLE XXIV**

##### 17 **COUNTERPARTS**

18 This Agreement may be executed in multiple counterparts, the parties need not sign  
19 the same counterpart. Each counterpart shall be deemed to be an original and all of which taken  
20 together shall be one and the same instrument.  
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**SIGNATURES**

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the State:

THE STATE OF ALASKA

\_\_\_\_\_  
Commissioner  
Department of Natural Resources

Date: \_\_\_\_\_

Tesoro Alaska Petroleum Company:

TESORO ALASKA PETROLEUM COMPANY

By: \_\_\_\_\_

Its: \_\_\_\_\_

Date: \_\_\_\_\_

Tesoro Petroleum Company

TESORO PETROLEUM COMPANY

By: \_\_\_\_\_

Its: \_\_\_\_\_

Date: \_\_\_\_\_

ACKNOWLEDGEMENT

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State of Alaska            )  
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Third Judicial District    )

THIS IS TO CERTIFY that on the \_\_\_\_\_ day of \_\_\_\_\_, 1995, before me, appeared \_\_\_\_\_, the commissioner, Department of Natural Resources, State of Alaska; that Harry A. Noah 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.

\_\_\_\_\_  
Notary Public in and for Alaska  
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>

$$\text{Exxon's Royalty Value} = \$117,328,207.31 \div 10,570,115.33 = \$11.09999$$

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)

Credit due Tesoro for next month's billing =

(\$124,847.02)

### Example 3: Subsequent Adjustment

This adjustment is assumed to occur after true-up of BP transportation costs, a reopener for one of the Royalty Settlement Agreements, or for some other reason. It is assumed to occur June 5th.

#### Assumptions:

1. Month is June.
2. Royalty Oil delivered to Tesoro in January = 1,240,000 barrels.
3. Adjusted Monthly Price for January = \$11.11000.
4. Annual interest rate charged member banks for advances by 12th Federal Reserve District as of January 1 assumed to be three percent; as of April 1 and through the third quarter, seven percent. Annual interest rate for contract = 11 percent for the first quarter; 12 percent for the second and third quarter.
5. Tesoro is sent notice of underpayment on June 5th.
6. Tesoro's payment is received on July 5th.

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

Volume	x	Price	=	Revised Billing
1,240,000	x	\$11.11000	=	\$13,776,400.00

Amount Paid by Tesoro for January deliveries (calculated in Example 2): \$13,640,000.00

Underpayment for January deliveries: \$136,400.00

Days of interest in first quarter (Initial Billing date plus 3 business days through March 31st) = 53

Days of interest in second quarter (April 1 through June 30th) = 91

Days of interest in third quarter (July 1 through July 5) = 5

Interest for first quarter =  $\$136,400.00 \times (11\%/365) \times 53 =$  \$2,178.66

Interest for second quarter =  $(\$136,400.00 + \$2,178.66) \times (12\%/365) \times 91 =$  \$4,145.97

Interest for third quarter =  $(\$136,400.00 + \$2,178.66 + \$4,145.97) \times (12\%/365) \times 5 =$  \$234.62

Payment from Tesoro due to the State within 30 days of invoice date = \$142,959.25

If payment in full not received by or on July 5th then additional interest will accrue from July 6th through the payment receipt date, plus a late payment penalty will be assessed.

# STATE OF ALASKA

## DEPARTMENT OF NATURAL RESOURCES

### DIVISION OF OIL AND GAS

TONY KNOWLES, GOVERNOR

3601 C STREET, SUITE 1380  
ANCHORAGE, ALASKA 99503-5948  
PHONE (907) 762-2549

March 21, 1995

MAR 27 1995

Dear Alaskan:

The State of Alaska proposes to sell royalty oil to Tesoro Alaska Petroleum Company (Tesoro). Under the proposed agreement, Tesoro would agree to buy approximately 40,000 barrels of royalty oil per day from the Prudhoe Bay Unit over a three year period. This oil will be processed in Tesoro's refinery at Nikiski on the Kenai Peninsula.

Enclosed is a copy of the Preliminary Finding and Determination and the proposed contract. The Alaska Royalty Oil and Gas Development Advisory Board will discuss this proposal at a public meeting at 11:00 a.m., Thursday, April 6, 1995, in the hearing room of the Legislative Affairs Agency, 716 West Fourth Avenue, Suite 200, Anchorage, Alaska. This meeting will be teleconferenced to Legislative Affairs Agency offices in Fairbanks, Juneau, Soldotna, and Valdez. The public is invited to attend.

These findings are preliminary, final conclusions have not been reached. Comments received from the public and from the Alaska Royalty Oil and Gas Advisory Board will be used to determine whether the proposed contract is in the state's best interest, and if so, whether changes are needed. If the commissioner determines that the proposed sale is in the state's best interests, the contract will be signed and a final finding and determination will be issued. Approval by the Legislature is required for this sale.

Comments must be received by April 21, 1995, and should be mailed to the Director, Division of Oil and Gas, 3601 C Street, Suite 1380, Anchorage, Alaska 99503-5948. If you have any questions, please contact Kevin Banks at 762-2589. Thank you for your interest.

Sincerely,



*for* Kenneth A. Boyd  
Acting Director

Enclosures