

ALASKA LEGISLATURE

1373

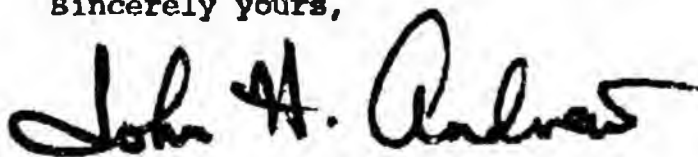
HOUSE and SENATE FINANCE COMMITTEE FILES, 1995-1996

Mr. George Dozier  
Alaska House Committee on Labor and Commerce  
January 22, 1996  
Page 2

for Governor Tommy Thompson and the Wisconsin Legislature and will be used to support of legislation with the same intent as Section 11 of H.B. 319 which will be introduced in the current session of the Wisconsin legislature. In our experience the conclusions in the "Merchant Credit" section of that report are as relevant to Alaska as they are to Wisconsin.

Your assistance in distributing these materials to the committee members for their consideration is appreciated.

Sincerely yours,



John H. Andrew  
Senior Government Relations Counsel

Enclosures

cc: Jerry Reinwand (w/encl.)  
William J. Doss " [JCPenney, Anchorage]  
Fred C. Lugar "  
Susan Walters Bizé "

## ALASKA RETAIL CREDIT GRANTORS CURRENT SERVICE, DELINQUENCY AND DISHONORED CHECK CHARGES

RETAILER	STATE LAW GOVERNING ACCOUNTS	LEGAL SERVICE CHARGE RATE	SERVICE CHARGE RATE IN ALASKA	DELINQUENCY CHARGE IN ALASKA	DISHONORED CHECK CHARGE IN ALASKA
Chevron	Alaska	18% to \$1,000; 10% above	18% to \$1,000; 8% above		
Firestone	Ohio	25%	21.84%	-0-	-0-
Lamonte	Ohio	25%	19.8%	\$10	\$10
Fred Meyer	South Dakota	No statutory rate limit	22.44%	Lesser of \$10 or 5% of missed payment	\$15
Nordstrom	Colorado	21%	18% to \$1,000; variable above	\$10	\$10
JCPenney	Alaska	18% to \$1,000; 10% above	18% to \$1,000; 7.92% above	-0-	\$10
Radio Shack	Tennessee	24%	22.3%	\$15	\$10
Sears	Arizona	No statutory rate limit	21%	-0-	\$10
Texaco	Nebraska	No statutory rate limit	21%	Lesser of \$5 or 5% of missed payment	\$15
Zales	Alaska	18% to \$1,000; 10% above	18% to \$1,000; 8% above	-0-	-0-

The information in this chart is based upon credit applications collected in 1994 and 1995.

January 22, 1996

JUN 23 '95 12:39 PM JCF JMI TEL: JUNE 91844:1626 TO 19074652815 P.04/17

## THE CASE FOR LATE FEES FOR ALASKA RETAIL CREDIT GRANTORS

### BACKGROUND FOR ALASKA HOUSE BILL NO. 319

A "late fee" or "delinquency charge" is a fee imposed by a credit grantor on an overdue account. Retail credit customers who fail to remit their monthly minimum payment by the agreed due date cause the retailer to incur additional costs in attempting to collect the past due accounts. These collection costs are in addition to the normal costs incurred in extending credit and servicing the credit customer. (One retail credit grantor operating under Alaska law estimates those costs to average approximately \$7.80). These additional costs, if not recouped by the credit grantor, may show up in higher merchandise prices, meaning that cash customers and those who properly make their payments provide a subsidy to those who don't adhere to agreed payment terms. Besides allowing the retailer to offset the additional costs incurred, late payment fees also provide an incentive for the customer not to miss the payment in the first place.

The best public policy response to this situation is to allow retailers to assess a late payment fee on delinquent credit customers at an amount which encourages the customer to make timely payment and enables the retailer to recover the additional costs which it incurs when the customer does not do so. Thus the Alaska Retail Installment Sales Act (RISA) has, since its enactment in 1982, authorized reasonable late fees on retail installment contracts; that is, closed-end (single purchase) credit contracts. However, unlike the law in over three-quarters of the states in the country, the Alaska act is silent with respect to the imposition of late fees on the now-prevalent revolving credit accounts.

Under federal law, some credit grantors can and do charge late fees on retail charge agreements. Such retailers extend credit through a federally-chartered "credit card bank" or through a national or state bank located in another state under whose laws they can legally impose late charges on delinquent accounts in Alaska. Several such retailers are currently imposing late fees on Alaska resident customers. This puts retailers operating under the Alaska RISA at a competitive disadvantage because customers will first pay those bills with a late fee. As a result, the bills from retailers operating under Alaska law go to the bottom of the stack and those from out-of-state creditors get paid first.

### PROPOSED LEGISLATION - ALASKA HOUSE BILL NO. 319

The proposed legislation, House Bill No. 319, would (in Section 10) correct the current inequity in the Alaska Retail Installment Sales Act by allowing the imposition of a reasonable delinquency fee not only when a payment on a retail installment contract is late, but also when a payment on a retail charge agreement is late. House Bill No. 319 restores fairness to creditors operating under Alaska's law and the vast majority of credit accountholders who pay their bills on time and should not be required to subsidize those who do not.

RETAIL CREDIT (2 PARTY)

<u>State</u>	<u>Maximum Late Payment Fee Authorized</u>
Arizona	Not to exceed \$5.00 for installment less than \$25.00, \$10.00 for over \$25.00.
Arkansas	No statutory limit. Must equal that assessed in at least one other state
California	Not to exceed \$10.00
Colorado	Not to exceed \$15.00
Connecticut	Lesser of 5% of monthly payment or \$10.00
District of Columbia	Not to exceed \$10.00
Florida	Not to exceed \$10.00
Georgia	Maximum of \$10.00
Hawaii	Lesser of 5% of monthly payment or \$50.00
Idaho	Greater of 5% of payment or \$5.00
Illinois	Not to exceed \$10.00
Indiana	Not to exceed \$15.00 adjusted yearly
Iowa	Not to exceed \$10.00
Kansas	Not to exceed \$10.00 or 5% of monthly payment with a \$25.00 maximum \$5.00 for installment less than \$25.00, \$10.00 for over \$25.00.
Kentucky	Ceiling unspecified
Louisiana	Parity with late fees being exported into state by out of state banks
Maine	Lesser of \$10.00 or 5% of delinquent installment
Maryland	No statutory limit
Massachusetts	Not to exceed the lesser of 10% of balance or \$10.00
Michigan	No statutory limit
Minnesota	Equal to fee permitted by National Banks under MN law (greater of 5% or \$5.00)
Mississippi	Maximum of \$10.00
Missouri	Not to exceed \$5.00 for instalments less then \$25.00, \$10.00 for installments over
Montana	Lesser of 5% of monthly payment or \$15.00
Nebraska	The greater of 5% of installment or \$5.00
Nevada	Agreed upon amount, no statutory limit
New Hampshire	Agreed upon amount
New Jersey	Not to exceed \$10.00
New York	Agreed upon amount, no statutory limit
North Carolina	\$5.00 on balance of less then \$100.00 and \$10.00 on balance of \$100 or greater
Ohio	Lesser of 5% of monthly payment or \$3.00
Oklahoma	Greater of 5% of the monthly payment or \$12.50
Oregon	No Statutory limit other then the charge be reasonable
Pennsylvania	Not to exceed \$12.00
Rhode Island	Not to exceed \$12.00
South Carolina	5% of payment not to exceed \$10.00 or 40% of \$10.00
South Dakota	Agreed upon amount
Tennessee	Ceiling unspecified
Texas	Not to exceed \$10.00
Utah	Greater of 5% of monthly payment or \$20.00
Virginia	Agreed upon amount
Washington	No statutory limit other than amount must be reasonable
West Virginia	Lesser of 5% of monthly payment or \$5.00
Wisconsin	Not to exceed of \$10.00

**Not intended as legal advise, opinion of local counsel should be obtained**



A

## RETAIL CREDIT SERVICE CHARGES GOVERNMENT-IMPOSED RATE CEILINGS

<u>STATE</u>	<u>ANNUAL RATE CEILING</u>
1. Arizona	Competitive Market Rate (No Government-Imposed Ceiling)
2. California	Competitive Market Rate
3. Connecticut	Competitive Market Rate
4. Delaware	Competitive Market Rate
5. Idaho	Competitive Market Rate
6. Illinois	Competitive Market Rate
7. Kentucky	Competitive Market Rate
8. Maine	Competitive Market Rate
9. Montana	Competitive Market Rate
10. Nevada	Competitive Market Rate
11. New Hampshire	Competitive Market Rate
12. New Jersey	Competitive Market Rate
13. New Mexico	Competitive Market Rate
14. New York	Competitive Market Rate
15. North Dakota	Competitive Market Rate
16. Oregon	Competitive Market Rate
17. Rhode Island	Competitive Market Rate
18. South Carolina	Competitive Market Rate
19. South Dakota	Competitive Market Rate
20. Utah	Competitive Market Rate
21. Virginia	Competitive Market Rate
22. Washington	Competitive Market Rate
23. Florida	Parity (Highest rate imported into state by out-of-state bank)
24. Louisiana	Parity
25. Ohio	25%
26. Hawaii	24%
27. Maryland	24%
28. Colorado	21%
29. Georgia	21%
30. Indiana	21%
31. Mississippi	21%
32. Oklahoma	21%
33. Tennessee	21%
34. Vermont	21%
35. Wyoming	21%
36. Texas	Parity (with maximum of 21%)
37. North Carolina	21% on first \$500 of balance, 18% on remaining balance
38. Alabama	21% on first \$750 of balance, 18% on remaining balance
39. Kansas	21% on first \$1,000 of balance, 14.4% on remaining
40. Nebraska	21% on first \$500 of balance, 18% on remaining
41. Michigan	20.4%
42. Missouri	20.04%
43. Iowa	19.8%
44. Massachusetts	18%
45. Minnesota	18%
46. Pennsylvania	18%
47. West Virginia	18%
48. Wisconsin	18%
49. Alaska	18% on first \$1,000 of balance, 6% plus the Federal Discount Rate (currently 5%) on remaining balance
50. Arkansas	5% plus the Federal Discount Rate (currently 5%) [Constitutional provision]

Note: Legislation which would remove government-imposed rate ceilings is currently pending in Alaska, Indiana and Missouri.

1/22/98

**RETAIL REVOLVING CREDIT (2 PARTY)**

**OPEN COMPETITIVE CREDIT MARKET STATES  
(NO STATUTORY FINANCE CHARGE RATE CEILING)**

- ARIZONA
- CALIFORNIA
- CONNECTICUT
- DELAWARE
- IDAHO
- ILLINOIS
- KENTUCKY
- MAINE
- MONTANA
- NEVADA
- NEW HAMPSHIRE
- NEW JERSEY
- NEW MEXICO
- NEW YORK
- NORTH DAKOTA
- OREGON
- RHODE ISLAND
- SOUTH CAROLINA
- SOUTH DAKOTA
- UTAH
- VIRGINIA
- WASHINGTON

**"PARITY" STATES"**

**(IN-STATE RETAILERS MAY USE HIGHEST RATE  
BEING IMPORTED INTO STATE BY OUT-OF-STATE BANKS)**

- FLORIDA
- LOUISIANA

**Note: Legislation which would remove government-imposed rate ceilings is currently pending in Alaska, Indiana and Missouri.**

**1/22/96**

C

**The Economic Impacts of Revolving Credit  
Regulation in Wisconsin**

**April 1995**

**James M. Johannes  
Professor and Chair  
Department of Finance, Investment & Banking  
School of Business  
University of Wisconsin-Madison**

## Appendix C

### Government and Academic Studies of Usury Laws: Sample Conclusions

"In general, various empirical studies on consumer credit and mortgages support the idea that when usury ceilings are binding the volume of loans declines, lenders try to upgrade quality to the detriment of lower income individuals and noninterest methods of compensation increasingly are employed." (James Van Horne, *Financial Market Rates and Flows*, p. 222).

"Interest rates have always been an object of suspicion. No longer is lending at interest a crime but in most place a maximum rate is set by law. Unfortunately, the ceiling is often far below what would be set by the competitive supply and demand market after account is taken of riskiness and administrative expense connected with small loans. The result? Funds dry up. The cheap money you can't get does you little good. Veterans who tried to get mortgages learned this in the 1950's. College students trying to get tuition loans..learned this in the 1960's and 1970's." (Paul Samuelson, *Economics*, 11th ed., p. 370)

"We have learned too slowly and painfully that while government interest rate ceilings may hold down the cost of a loan, they frequently result in a customer's getting no loan at all." (Peter S. Rose, *Money and Capital Markets*, p. 360).

"A significant finding by this government sponsored study (*Report of the National Commission on Consumer Finance, 1972*) is that 'state legislation especially has tended to restrain competition and unnecessarily segment the consumer credit market'...the commission studied numerous other aspects of consumer lending in terms of their overall effect on the public. Generally, the legislation (such as usury laws) which seeks one improvement produces undesirable side effects such as reduced credit availability or service...In addition to advocating the repeal of restrictive state legislation the commission recommended improving consumer knowledge and industry competition." (Robert Edmister, *Financial Institutions, Markets and Management*, pp. 262-3)

"Nevertheless, a number of states have succeeded in liberalizing their usury laws, in some cases tying the ceiling rate to a market rate. However, other states have encountered serious difficulties in obtaining revision, and their consumers have suffered as a consequence." (*Economic Perspectives*, Federal Reserve Bank of Chicago, Sept/Oct 1980, p. 17)

Table 2

Cost and Revenue Ratios for Selected Types of Bank Credit, 1991<sup>1</sup>

Item	Credit Card		Installment		Real estate mortgage		Commercial and other	
	Percent of outstanding balances <sup>1</sup>	Percentage distribution	Percent of outstanding balances <sup>1</sup>	Percentage distribution	Percent of outstanding balances <sup>2</sup>	Percentage distribution	Percent of outstanding balances <sup>1</sup>	Percentage distribution
<b>Revenue</b>								
Interest	14.9	57	11.5	97	10.2	95	10.0	97
Noninterest <sup>3</sup>	11.0	42	.4	3	.5	5	.3	3
Total Revenue	26.0	100	11.9	100	10.7	100	10.3	100
<b>Cost</b>								
Operating	13.1	57	3.4	33	1.4	18	2.1	23
Credit losses	3.5	15	.7	7	.3	4	.8	9
Cost of funds	6.2	27	6.2	60	6.3	79	6.2	68
Total Cost	22.8	100	10.3	100	8.0	100	9.1	100
<b>Net earnings before taxes</b>	3.1	...	1.7	...	2.7	...	1.1	...

1. Data reflect averages of cost and revenue categories weighted by average outstanding balances for three size groups presented in the 1991 National Average Report. Components may not sum to totals because of rounding.
2. Outstanding balances are average amounts outstanding for the year.
3. For credit cards, includes merchant discounts, and penalty and cash advance fees.

Source: Federal Reserve Bulletin, September 1992

**Table 3**

**Cost and Revenue Ratios for Merchant Provided Credit 1992**

<u>Revenue</u>	<u>Percent of Outstandings</u>	<u>Percent Contribution</u>
Interest	15.10	100
Noninterest	-	
Total	15.10	100
<u>Cost</u>		
Operating	7.28	41
Credit Losses	3.45	20
Cost of Funds	6.94	39
Total	17.67	100
Net Earnings before taxes	-2.57	

Source: Ray McAlister, "Consumer Credit: An Introduction," University of North Texas

## VI. Merchant Credit

This study, like many others, has focused primarily on the bankcard market. Another significant player in the revolving credit market is retail stores. Retail open-end credit, or "merchant credit," is different than bankcard credit.

As Table 5 illustrates, retail credit accounts for about 19% of all outstanding open-end credit, but 48% of all outstanding open-end accounts. The penetration of retail accounts in this market attests to the importance of availability of open end credit to consumers and merchants. One reason 48% of the accounts make up only 19% of the outstanding balances is that balances carried on retail credit cards are typically much smaller. GE Capital, for example, reports average outstanding balances on retail credit it issues for firms like Montgomery Ward, Casual Corner and American TV of about \$230. A recent study by Professor Ray McAlister at the University of North Texas [8] reports that over 80% of retail customers sampled in California had outstanding balances less than \$200.

As mentioned in Section II, there are several significant differences between bankcard and retail card revenues and expenses. Tables 2 and 3 show that retailers receive little fee income and rely primarily, if not exclusively, on finance charges for revenue. They also show that on the expense side, interest expense is typically higher than it is on bankcards because retailers must borrow money from banks.

Less revenue and higher expenses imply that retailers have a very difficult time running profitable credit operations when all they can charge is 18%. Unprofitable operations create three problems. The first is that merchants attempt to recover losses on credit operations not by charging higher fees but by charging higher prices. The problem this creates is that all purchasers, not just credit users, pay the higher prices. As a result, cash payers subsidize credit users. This phenomenon is well-known as the last quote in Appendix C from a Federal Reserve Study of Retail Credit attests.

The second problem is that this can put local merchants at a serious competitive disadvantage when they, because of usury ceilings, cannot charge the market clearing rate for retail open-end credit. In this situation, local merchants must raise prices to cover credit losses such as those illustrated in Table 3. National merchants, who import rates from National Banks they have set up in other States, charge market clearing rates at which their credit programs are profitable. Because the credit operations of those national merchants at least break even at the higher rates, they do not have to charge higher prices to recover losses on credit operations. Hence their prices are lower and put them at a competitive advantage over local merchants.

A third problem usury limits create for merchants is that merchants abandon in house credit in favor of bankcards and thereby lose an important tool to create customer allegiance. In the process consumers lose a local source of credit.

Table 18 illustrates the fact that many national chains operating in Wisconsin are currently importing these higher rates through their banking affiliates. This raises an important issue.

1 merchants who do not want to play this cash price subsidy game can always contract with a national bank to offer credit from a neighboring state. The problem with this is that it results in the export of credit operations and jobs to neighboring states, consumers are denied access to local credit, and local residents just end up paying the higher rate anyway. As interest rates in the economy are again rising, several banks have indeed positioned themselves to provide these credit services from states where finance charges are deregulated. Household Bank, Illinois, for example, issues these "private label" cards for companies like Builders Square. GE Credit issues Home Depot private label cards through its affiliate Monogram Bank in Georgia. The list of merchants they provide credit for in regulated States is growing.

Like the bankcard discussion above, however, it is important to consider two issues. Is there enough competition in retail credit to ensure that consumers will pay a fair price for retail credit, and, what has the experience been on the retail side when retail rates are deregulated?

The answer to the first question is that most merchants accept bankcards as well. If the merchant's rate is not competitive, consumers will just use bankcards to purchase goods. This is true of many major retailers like Penney's, Sears, Goodyear, Marshall Field's, Limited, etc. In other words, for the most part, this market is just as competitive as the bankcard market because they are typically one and the same market.

As for experience with deregulation, a recent study by McAlister [8] found that two years after Washington deregulated open end credit in 1992, nearly 75% of retailers had not changed their finance charge even though State law allowed them to do so. Indeed only one of the largest eight companies raised its finance rate. This evidence is entirely consistent with the view that competition dictates the finance charges on revolving credit, not State Statutes.

## Bibliography

1. Board of Governors of the Federal Reserve System, "The Economic Effects of Proposed Ceilings on Credit Card Interest Rates". *Federal Reserve Bulletin* (January, 1987), pp. 1-13,
2. Board of Governors of the Federal Reserve System, "Developments in the Pricing of Credit Card Services", *Federal Reserve Bulletin* (September, 1992), pp. 652-666.
3. Calem, Paul S., "The Strange Behavior of the Credit Card Market," *Business Review*, Federal Reserve Bank of Philadelphia (January/February 1992), pp. 3-14.
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9. National Credit Union Administration, "Regional Directors Action Taken Under Authority Report", Washington, DC (1994)
10. Villegas, Daniel J., "The Impact of Usury Ceilings on Consumer Credit," *Southern Economic Journal*, (July, 1985) pp. 126-141

H. Lee Rowell  
Vice President  
Director  
Government Affairs



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February 20, 1996

The Honorable Mark Hanley  
Co-Chairman, House Finance Committee  
Alaska State Legislature  
State Capitol (MS 3100)  
Juneau, AK 99801-1182

Re: **HB-319 and SB-157**

Dear Co-Chairman Hanley:

Avco Financial Services, who is headquartered in Costa Mesa, California but has an operating branch located in Anchorage, supports HB-319 and SB-157. These bills make certain positive changes by updating the Alaskan Statutes that affect small loans and retail installment transactions. If passed into law, these bills will help both the industry and the consumer. Their passage will also allow further expansion of our services within the State of Alaska.

I want to thank you and the members of the Finance Committee for considering these bills and would like to urge their passage.

Sincerely,

H. Lee Rowell

HLR:cb

D

HOUSE COMMITTEE REPORT

2/2/96

(7)

Date Referred: April 22, 1995

FURTHER REFERRALS:

Finance

Date of Committee Action: 1-31-96

The LABOR AND COMMERCE Committee considered:

HB 319

HOUSE BILL NO. 319

SMALL LOANS & RETAIL INSTALLMENT SALES

"An Act relating to the regulation of small loan and retain installment transactions."

recommends it be replaced

with the following committee substitute

CS HB 319 (L&C)

[x] the same title  
[ ] a new title

[ ] additional referral to \_\_\_\_\_ Committee

[ ] attached amendment(s)

ADOPTS: \_\_\_\_\_ Letter of Intent

ATTACHES NEW FISCAL NOTE(S): (Dept)

APPROVES PREVIOUS: (Dept/Date)

[ ] fiscal note(s) \_\_\_\_\_

[ ] fiscal note(s) \_\_\_\_\_

[x] zero fiscal note(s) CED

[ ] zero fiscal note(s) \_\_\_\_\_

SIGNING WITH RECOMMENDATIONS	DP	DNP	NR	AM
Norm Kokeberg	✓			
K. Elton	✓			
Jane Kubina	✓			
Brian Porter	✓			
Pepe Kott	✓			
Jerry Sanders	✓			
	(6)			

CHAIR'S SIGNATURE

Pepe Kott

Kott

**HB**

**320**

**HFIN**

**FILE**

HOUSE COMMITTEE REPORT

(11)

Date Referred: April 22, 1995

FURTHER REFERRALS:

Date of Committee Action: 4/27/95

The FINANCE Committee considered:

HB 320

HOUSE BILL NO. 320

APPROVE TESORO ROYALTY OIL AGREEMENT

"An Act approving the sale of Prudhoe Bay Unit royalty oil by the State of Alaska to Tesoro Alaska Petroleum Company; and providing for an effective date."

recommends it be replaced with the following committee substitute \_\_\_\_\_  the same title  a new title

additional referral to \_\_\_\_\_ Committee  attached amendment(s)

ADOPTS: \_\_\_\_\_ Letter of Intent

ATTACHES NEW FISCAL NOTE(S): (Dept) APPROVES PREVIOUS: (Dept/Date)

fiscal note(s) \_\_\_\_\_  fiscal note(s) \_\_\_\_\_

zero fiscal note(s) \_\_\_\_\_  zero fiscal note(s) DNR 4/22/95 (#1)  
Rev 4/22/95 (#2)

SIGNING WITH RECOMMENDATIONS		DP	DNP	NR	AM
<i>Richard J. Jolley</i>	Fraser	X			
<i>Mark Hanley</i>	Hanley	X			
<i>Allen Mulder</i>	Mulder	X			
<i>Terry Martin</i>	Martin	X			
<i>Sean Parnell</i>	Parnell	X			
<i>Vic Kohring</i>	Kohring	X			
<i>Ben Grossendort</i>	Grossendort	X			
<i>Mike Navarre</i>	Navarre	✓			
<i>Tim Brown</i>	Brown	✓			
<i>Pat Kelly</i>	Kelly	✓			
<i>Gene Theriault</i>	Theriault	✓			

CHAIR'S SIGNATURE *Mark Hanley* *Richard J. Jolley*  
Hanley Roster

STATE OF ALASKA  
 1995 LEGISLATIVE SESSION

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

(Thousands of Dollars)

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

(Thousands of Dollars)

FUND SOURCE	FY96	FY97	FY98	FY99	FY00	FY01
1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1006 GF/MHTIA						
Other						
<b>TOTAL</b>	0.0	0.0	0.0	0.0	0.0	0.0

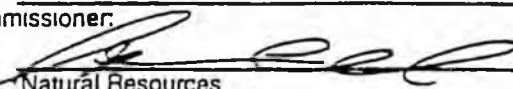
Estimate of any current year (FY95) cost: \$ 0.0

**POSITIONS**

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

**ANALYSIS:** (Attach a separate page if necessary)

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

Prepared by: Kevin Banks Phone: 762-2589  
 Division: Oil & Gas Date: 19-Apr-95  
 Approved by Commissioner:  Date: 4/29/95  
 Agency: Natural Resources

# FISCAL NOTE

STATE OF ALASKA  
 1995 LEGISLATIVE SESSION

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

**Expenditures/Revenues** (Thousands of Dollars)

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

CAPITAL EXPENDITURES	0.0	0.0	0.0	0.0	0.0	0.0
----------------------	-----	-----	-----	-----	-----	-----

CHANGE IN REVENUES ( )	0.0	0.0	0.0	0.0	0.0	0.0
------------------------	-----	-----	-----	-----	-----	-----

**FUND SOURCE** (Thousands of Dollars)

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

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

**POSITIONS**

FULL-TIME						
PART-TIME						
TEMPORARY						

**ANALYSIS:** (Attach a separate page if necessary)

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

Prepared by: Bob Baratko Phone: 465-2312  
 Division: Administrative Services Date: 4/19/95  
 Approved by Commissioner: Deborah Vogt Date: 4/19/95  
 Agency: Department of Revenue

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**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

### 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.

## Local Hire

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

## 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.

## 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.

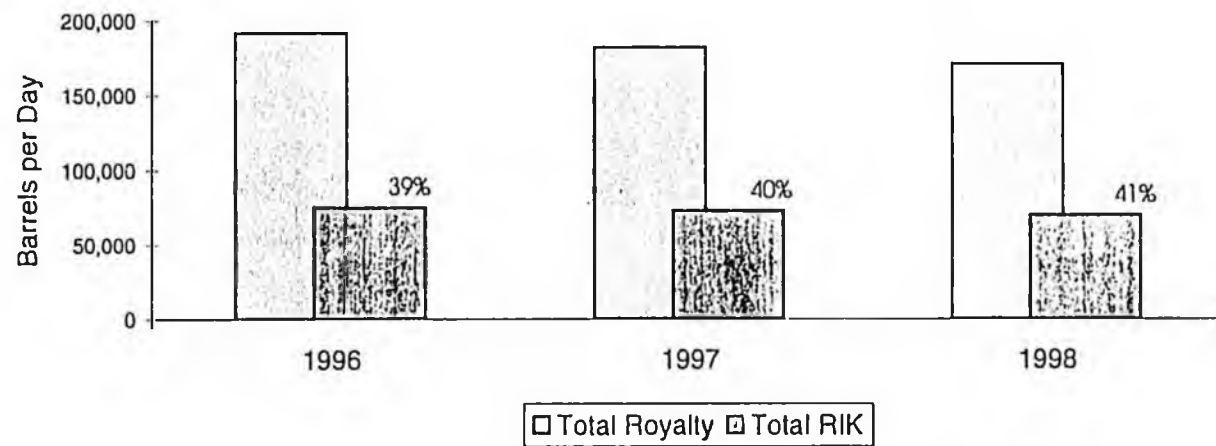
AS 38.05.183(4)  
and AS 38.06.070(6)

## Environmental Effects

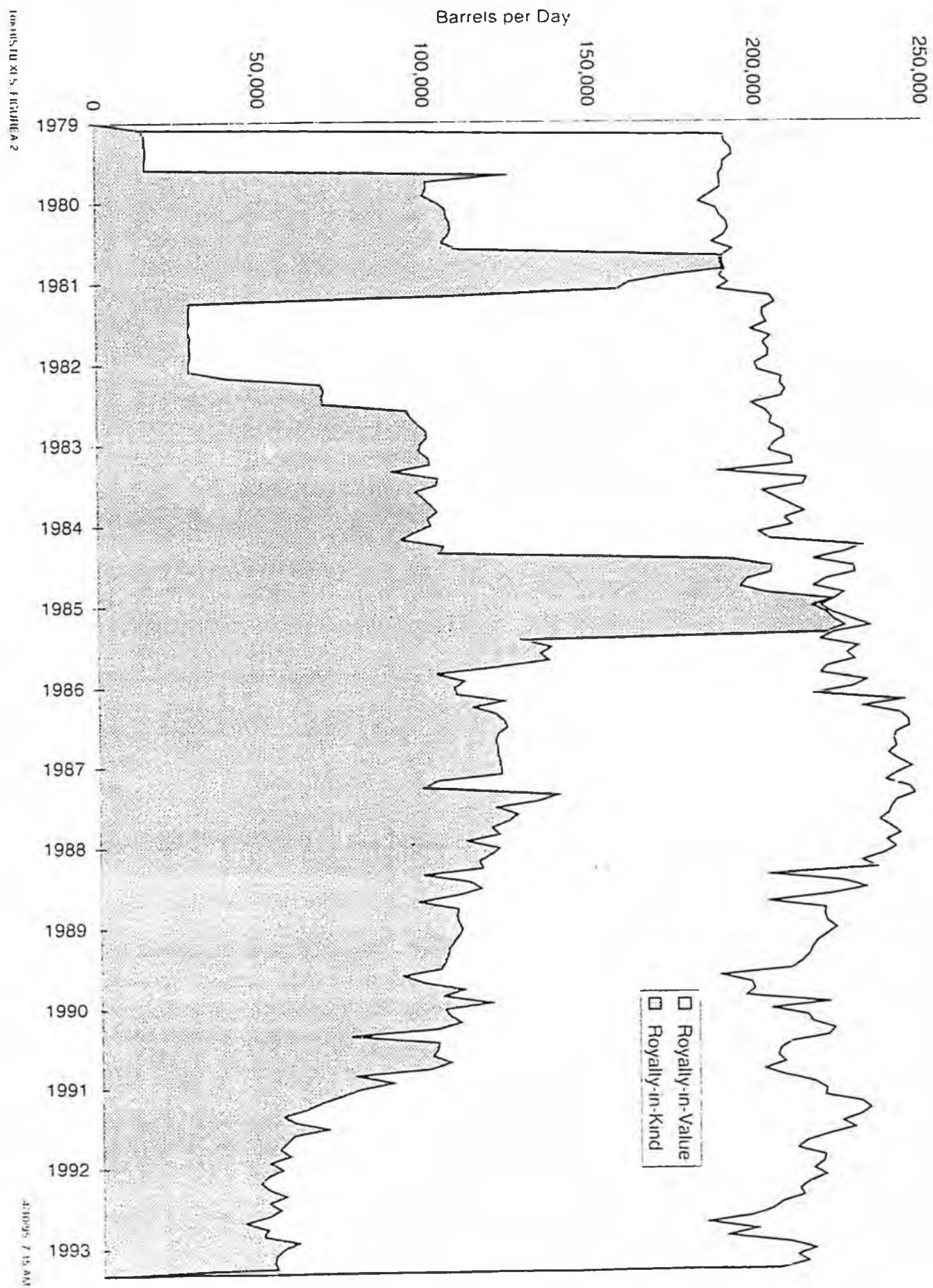
- Tankers. No increase in tanker traffic between Valdez and Nikiski is anticipated as a result of the sale. Tesoro's recent refinery expansion means that fewer outbound shipments of products will occur.
- Air Quality. The sale will not contribute to an increase in emissions at the refinery. Tesoro now 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)

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



# Total North Slope RIK and RIV Volumes

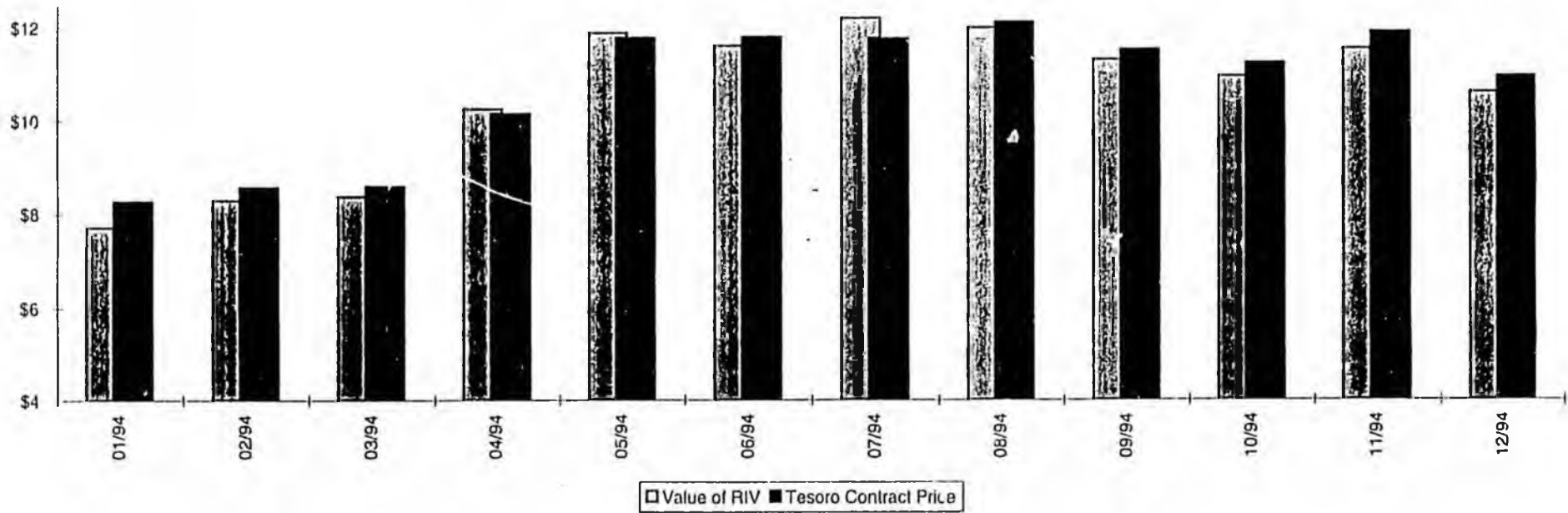


## Major North Slope RIK Contracts to In-State Purchasers Since 1980

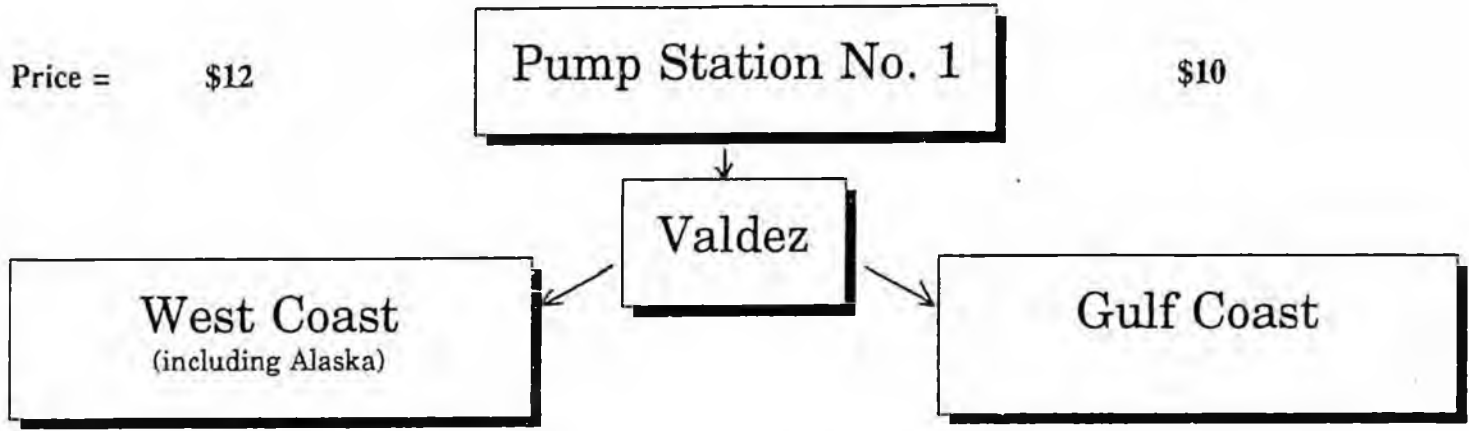
Purchaser Contract	Period																		Total Volumes Purchased (Barrels)	
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997		1998
<b>Chevron</b>																				
Chevron 1	7/80 - 6/81																			
Chevron 2	5/83 - 5/84																			
Chevron 3	5/84 - 7/91																			
Kuparuk	12/86 - 12/91																			
Petrostar Purchases	12/86 - 12/91																			
Subtotal																				
Plus: Tesoro Exchange Ba																				
<b>Total Chevron</b>																				83,856,765
<b>Golden Valley Electric Association</b>																				
GVEA 1	6/81 - 5/84																			
GVEA 2	6/84 - 9/85																			
GVEA 3	10/85 - 12/91																			
<b>Total GVEA</b>																				17,278,059
<b>MAPCO</b>																				
MAPCO	1/80 - Present																			156,560,265
<b>Petrostar</b>																				
Petro Star	12/86 - 12/91																			
Petro Star JV	3/92 - 12/93																			
<b>Total Petrostar</b>																				3,030,011
<b>Tesoro</b>																				
Tesoro 1	7/80 - 6/81																			
Tesoro 2	7/80																			
Tesoro 3	12/81 - 1/82																			
Tesoro 4	1/83 - 12/94																			
Tesoro 5	10/85 - 8/90																			
Tesoro 6	1/95 - 12/95																			
Tesoro 7 (New Tesoro)	1/96 - 12/98																			
Subtotal																				
Less: Chevron Exchange Barrels																				
<b>Total Tesoro</b>																				223,503,510

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

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



# DISPLACEMENT EFFECT



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

40,000	+	660,000	+	300,000	=	1,000,000
<i>(Tesoro)</i>		<i>(CA and WA)</i>		<i>(Gulf Coast)</i>		<i>(Total)</i>

In percentage terms:

4%	+	66%	+	30%	=	100%
----	---	-----	---	-----	---	------

The calculation of royalty value (and severance tax) is:

$(\$12 \times 4\%) + (\$12 \times 66\%)$	+	$(\$10 \times 30\%)$	=	$\$11.40$
--	---	----------------------	---	-----------

**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	+	660,000	+	300,000	=	960,000
<i>(Tesoro)</i>		<i>(CA and WA)</i>		<i>(Gulf Coast)</i>		

In percentage terms:

0%	+	68.75%	+	31.25%	=	100%
----	---	--------	---	--------	---	------

The calculation of royalty value (and severance tax) is:

$(\$12 \times 0\%) + (\$12 \times 68.75\%)$	+	$(\$10 \times 31.25\%)$	=	$\$11.38$
---	---	-------------------------	---	-----------

**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).**

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

Tesoro Alaska Petroleum Company  
March 29, 1995

copy on file

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

*I. Summary*

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

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

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

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

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

---

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

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

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

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

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

---

<sup>2/</sup> AS 38.06.050(a).

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

Among the document's more rigorous requirements are these:

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

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

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

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

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

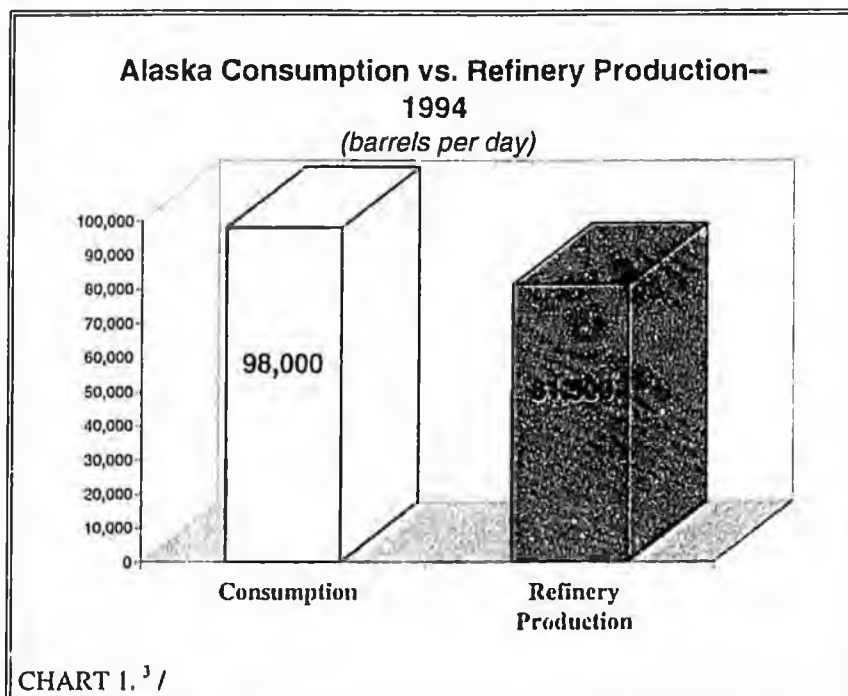
*Nonetheless, the contract does meet Tesoro's need for a stable source of crude--albeit for only three years. As a result, the contract deserves legislative approval.*

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

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

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

refined products, those imports reflect shipments to Southeast Alaska and the Arctic-- which are beyond the effective distribution reach of in-state refiners.<sup>4/</sup> As Chart



1 illustrates, except

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

<sup>3/</sup> Source: (1) Consumption: DNR, "Historical and Projected Oil and Gas Consumption," Feb. 1994 at 23; (2) Production: Tesoro internal production estimates.

<sup>4/</sup> DNR, "Preliminary Finding and Determination to Sell Royalty Oil to Tesoro Alaska Petroleum Company," March 21, 1995 ("1995 Tesoro Findings") at 9.

The impact on Alaska consumers has been considerable. A 1992 MAPCO Petroleum study, for example, documented a \$.30/gallon difference in gasoline prices between Anchorage and Southeast Alaska--the higher prices in the Panhandle being attributable, in material part, to the lack of refiner competition in that region.<sup>5/</sup> As that study explains, even if only 1/3 of that price differential were attributable to the keen competition encouraged by state royalty oil policy, that policy would still be responsible for a \$450 million savings to Alaska consumers in the 1980's. *Id.* at 1.

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

All these benefits flow directly from the Alaska Legislature's clear direction to manage Alaska's royalty oil and gas in a way that encourages in-state energy self-sufficiency. For example, royalty oil can't be exported unless it's surplus to in-state needs,<sup>6/</sup> and non-competitive sales must always be made to the buyer that "offers the maximum benefits to citizens of the state"--including the "benefits of refining or processing the oil or gas in the state." AS 38.05.183(e).<sup>7/</sup>

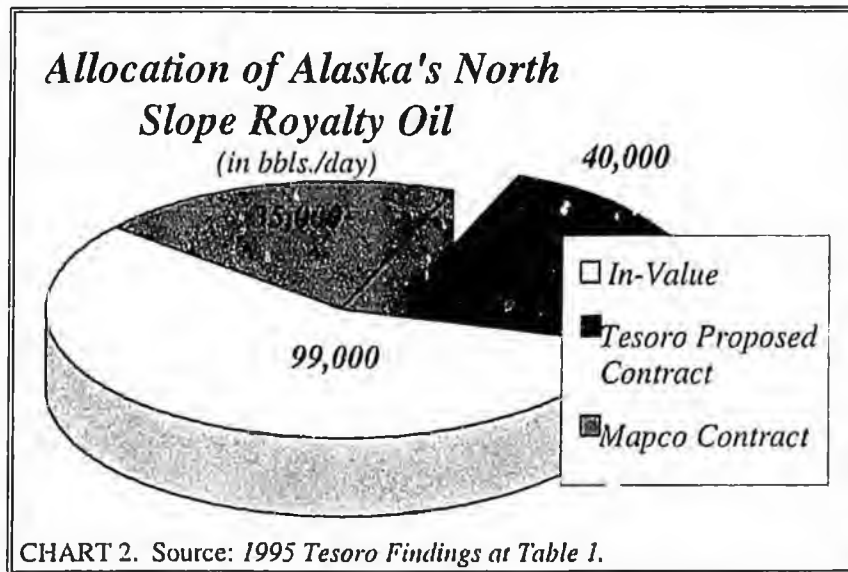
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<sup>5/</sup> Purvin & Gertz Study, prepared for MAPCO Petroleum (1992) at 4.

<sup>6/</sup> AS 38.05.183(d).

<sup>7/</sup> The statutes governing the Alaska Royalty Oil and Gas Development Advisory Board likewise create a pronounced bias towards in-state use of royalty oil. AS 38.06.070(a) and (b).

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



refiners. As Chart 2 shows, even if the legislature approves the proposed Tesoro contract, only 43% of the state's ANS royalty oil would be sold to in-state refiners. The rest would still be taken in value.<sup>8/</sup>

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

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

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

<sup>8/</sup> A 1992 contract to sell approximately 30,000 bbls./day of royalty oil to Petro Star JV over a 10-year period was terminated by DNR when Petro Star declined to take oil under the contract.

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

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

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

*1. The Absence of Any Alternative Source of Supply*

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

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

Indeed, in 1994 Tesoro lost one of the few private sources of ANS crude heretofore available to it. In 1993, Tesoro purchased about 3,500 bbl./day of Milne Point production from Conoco. However, Conoco sold its Milne Point interest to British

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

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

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

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

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

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

# CORRECTION

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

MAPCO's and Petro Star's proximity to the pipeline not only affords them cheaper crude; it also enables them to dispose of unmarketable refinery product at only a nominal charge--while Tesoro, conversely, must pay dearly to ship that same product south. In particular: Tesoro and MAPCO both produce substantial quantities of heavy "residual" oil, which has no market in Alaska. MAPCO is able to return that product to the TAPS line, paying only a \$.25-\$1.30/bbl. "quality bank" penalty. Tesoro, conversely, must ship its residual oil to the West Coast at a transportation cost of \$3.40/bbl. All tolled, Tesoro receives a much lower value for that product than does MAPCO.

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

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

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

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

\* \* \*

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

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

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

#### *A. Price*

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

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

*DNR, Final Finding and Determination to Sell Royalty Oil to Petro Star Valdez Refinery Joint Venture ("Petro Star Findings"), March 4, 1992 at 6.*<sup>9/</sup> Moreover, DNR has declined to ask for any "premium," above the in-value price, from in-state refiners. In the past, DNR considered charging "premiums" for in-state sales out of its concern that its royalty oil, when taken and sold in-kind anywhere on the West Coast (including Alaska), tended to "displace" other ANS crude from the Pacific Coast, forcing it to the Gulf Coast

---

<sup>9/</sup> As noted previously, the Petro Star JV sale was terminated when Petro Star declined to take oil under the contract.

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

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

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

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

In its *Amerada Hess* settlements with the principal ANS producers, DNR defined "value" as a volume-weighted average of the values of ANS oil in different markets. ANS crude is sold along both the West and Gulf coasts, and, of late, Gulf Coast prices have generally been \$.90-\$1.00/bbl. less than West Coast prices. By pegging "value" to a volume-weighted average of these sales, the aggregate "value" is thus lower than if "value" were defined solely with reference to West Coast sales.

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

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

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

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

*ANS Royalty Settlement Agreement between BP Exploration (Alaska) Inc. and State of Alaska, ("BP Settlement") December 31, 1991, Art. 3.2(d).<sup>12/</sup>*

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

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

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

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<sup>12/</sup> While "market baskets" of oil are used to calculate BP's royalty obligations, there is a separate market basket for Gulf Coast placements, so the volume-weighted influence of Gulf Coast prices remains unaffected.

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

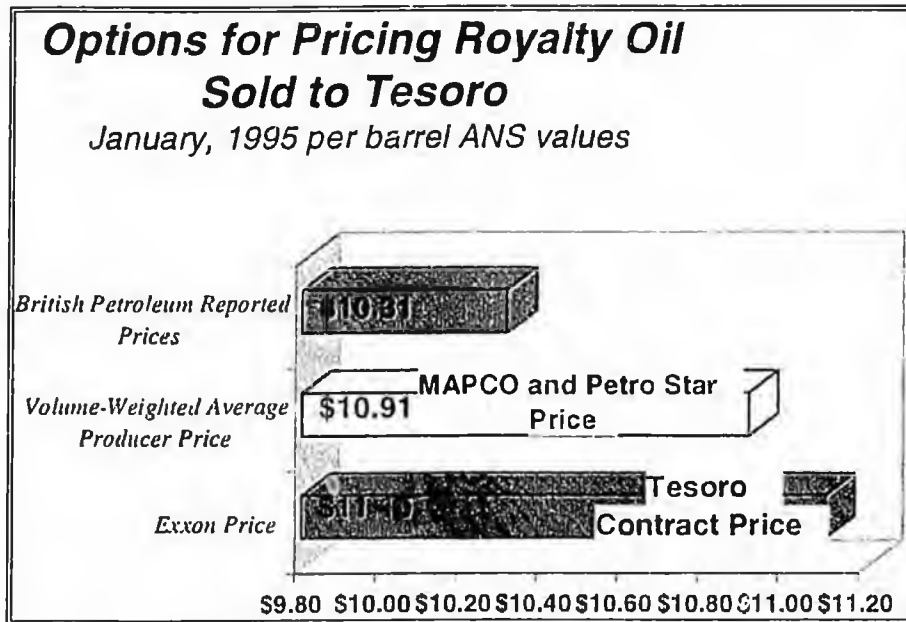


CHART 3. Source: 1995 Tesoro Findings at Table 2.<sup>13</sup>

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

Moreover, the

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

## B. Security

### 1. The Letter of Credit

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

<sup>13</sup>/ Table 2 of the 1995 Tesoro Findings mistakenly lists the January, 1995 volume-weighted average of all producer prices as \$11.027. This is due to an inadvertent failure to include British Petroleum Gulf Coast sales, and the correct figure of \$10.91/bbl. was agreed to in a phone conversation with DNR Division of Oil and Gas' Kevin Banks on March 24, 1995.

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

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

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

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

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

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

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

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

Nor would Risk (1) seem to warrant anything more than the traditionally-acceptable 60-day LOC. Nonetheless, DNR did require a 90-day LOC in its 1992 royalty oil sale to Petro Star JV.<sup>14/</sup> In justifying that requirement, DNR imagined that 70 days of unpaid-for oil might be delivered before the state could declare a default. A 90-day LOC, DNR reasoned, was necessary to secure payment for that oil--the remaining 20 days' value in the LOC being in the nature of liquidated damages for Risk (2).<sup>15/</sup>

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<sup>14/</sup> This is the only royalty oil contract to contain the 90-day LOC requirement, and the Petro Star contract was a special case. The contract was intended to aid Petro Star's plan to build a then-nonexistent Valdez refinery. It was thus a speculative endeavor that presented the State with some of the same risks that it faced with the Alpetco contract years previous.

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

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

<sup>15/</sup> *Petro Star Findings* at 14.

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

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

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

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<sup>16/</sup> *Id.* at Art. 7.1(ii).

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

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

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

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

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

## 2. *Tesoro's Solvency*

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

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

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

*1994 Tesoro Findings at 9-10.*

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

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

The document continues:

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

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

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

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

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

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

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

### *C. DNR's Retained Flexibility to Manage Royalty Oil*

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

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

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

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

#### *IV. Conclusion*

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

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

The Alaska Royalty Oil and Gas Development Advisory Board

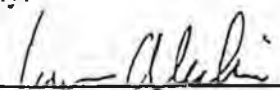
Resolution 95-1

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


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

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

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

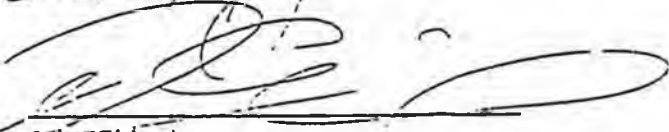
  
Lynn Aleshire

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Tom Cook

  
Wilson Condon

  
Becky Gay

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Willie Hensley

  
John Shively

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The Alaska Royalty Oil and Gas Development Advisory Board

Resolution 95-1

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Lynn Alestire

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Tom Cook

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Wilson Condon

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Becky Gay

*Willie Hensley* 4/6/95  
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Willie Hensley

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John Shively

**Final Finding and Determination**

**to Sell Royalty Oil**

to

**Tesoro Alaska Petroleum Company**



Alaska Department of

**NATURAL  
RESOURCES**

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

April 21, 1995

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

I. Summary

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

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

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

II. Background

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

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

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 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.

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

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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.

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>

**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	105	95	85	75	69
Kuparuk River Unit	39	38	38	38	37	37	35	32	29
Milne Point	5	7	7	3	9	8	7	6	6
Encicort	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 Rea'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
Encicort	1	1	1	1	1	1	0	0	0
	18	18	17	15	14	13	12	10	10
minus Current RIK Contracts									
Marco	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>

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.

<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**

<i>Exxon Production at:</i>	<i>Gross Volume</i>	<i>PS-1 Value</i>	<i>Product of Volume Times PS-1 Value</i>	<i>Average Price</i>
Usburne 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**

<i>Producer</i>	<i>Gross Volume</i>	<i>PS-1 Value</i>	<i>Product of Volume Times PS-1 Value</i>	<i>Average Price</i>
<b>Usburne 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	3,207,215.20	\$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 RJV**

<i>Producer</i>	<i>Gross Volume</i>	<i>PS-1 Value</i>	<i>Product of Volume Times PS-1 Value</i>	<i>Average Price</i>
<b>Usburne Production Center</b>				
ARCO	1,459,347.74	\$11.58000	\$16,899,246.83	
BP Exploration	2,022,440.13	\$10.51000	\$20,649,113.73	
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	\$10.31000	\$131,161,473.44	
Chevron <sup>2</sup>	195,833.10	\$11.01000	\$2,156,122.43	
Exxon	8,807,215.20	\$11.11000	\$97,848,160.87	
Louisiana Land and Exploration	8,993.30	\$11.61000	\$104,412.21	
Marathon <sup>3</sup>	11,288.00	\$11.61000	\$131,053.68	
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>\$403,317,274.84</b>	
<b>Volume Weighted Average Value:</b>				<b>\$10.90715</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 not 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.

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

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

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

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

The "displacement effect" will diminish insofar as the proportion of total ANS sold on the Gulf Coast will continue to decline over the next few years. As above, the effect appears both in RIV royalty value and severance taxes. Now at less than 15 percent of total ANS production, Gulf Coast deliveries may cease in 1996.<sup>3</sup> The "competitive effect" is minimized insofar as the volumes of royalty crude considered for noninflation 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.

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<sup>3</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.

In any case, pricing Tesoro's RIK at the Exxon royalty value should sufficiently compensate the state for these impacts. As the volumes of ANS oil delivered to the Gulf Coast decline, the volume-weighted average royalty value for RIV should rise and the difference between the Exxon royalty value (Tesoro's price) and the RIV royalty value will diminish.

One of the people testifying at the Royalty Board meeting of April 6, 1995 suggested that the proposed price term should not be based on a "West Coast" price.<sup>4</sup> Rather, he recommended a price that would be higher to reflect the difference in marine transportation cost between Valdez and Nikiski versus the cost to deliver ANS oil to the West Coast. This is based on the observation that West Coast Pump Station No. 1 (PS-1) West Coast prices are higher than the Gulf Coast PS-1 price. In a market that was perfectly competitive, one would expect that market at each destination, Gulf Coast, West Coast, and Alaska, would just clear at a destination price at which the producers would be indifferent about where to send the marginal barrel of oil. Said another way, deliveries to the Gulf Coast would be made only as long as buyers there are willing to cover the added transportation cost. If the destination price at the Gulf Coast is too low, the producer's will sell in the West Coast or, similarly, sell in Alaska if the West Coast price is too low to offset the marine transportation cost.

The ANS oil market is not perfectly competitive; it is dominated by a single seller. This creates the situation where the Pump Station No. 1 price of West Coast deliveries is actually higher than the Gulf Coast (and the difference in the destination price between the Gulf Coast and West Coast is less than the incremental transportation cost) and, hence, the observation of the commentator. To expect the state to charge a higher PS-1 price for deliveries in Alaska suggests that the state could manipulate price terms to take advantage of the lack of competition among suppliers in the local market. Even if it were possible to secure a higher price, it would not serve the goal of promoting in-state refining.

**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.

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<sup>4</sup> Richard Fineberg testified by teleconference from Juneau, Alaska.

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

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

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

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

**Security** Supplies of RIK under the current contract are secured by an irrevocable letter of credit equal to 60 days worth of oil deliveries. The proposed contract will require a letter of credit equivalent to the value of 75 days worth of RIK to secure the state in the event that Tesoro, for any reason, fails to pay its bills or to take delivery. The increase in the value of the letter of credit is required to protect the state from its exposure to "denomination risk."<sup>5</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 find a new RIK purchaser or negotiate with the lessees to take back the RIK. In either event, the state is in a distress sale situation and the letter of credit instrument is intended to protect the state from this event.

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<sup>5</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.

The state's risk exposure is measured as follows:

30 days	RIK is tendered but not billed
2 days	Initial Billing
3 days	Initial Billing due
<u>4 days</u>	Default declared
39 days	Default Risk

Volumes subject to 180 day denomination as per ANS Royalty Settlements times 80 percent of value should the state be forced to sell RIK =

<u>36 days</u>	Denomination Risk
75 days	Total risk exposure

The letter of credit is valued at the price of RIK volume per day times the number of days of total risk exposure.

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.

#### 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>6</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>7</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 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>8</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.

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<sup>6</sup> Tesoro Alaska Petroleum Company. March 14, 1995. Letter to Kevin Banks from Bernie Smith.

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

<sup>8</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.

**Environmental Impacts** Tankers have operated in the Cook Inlet for over 50 years and, for the most part, have operated safely.<sup>9</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.

A second commentator at the Royalty Board meeting on April 6, 1995 expressed concerns about tanker traffic in the Cook Inlet.<sup>10</sup> He voiced the concern that the vessels now under charter by Tesoro met only minimum safety and operational standards. These standards should be raised to a level similar to those required in the Prince William Sound. He advocated the use of tanker escort vessels in the Cook Inlet. Tesoro indicated in its reply to this concern at the meeting that their vessels would be hydrostatically loaded to avoid a catastrophic spill in the event of a tanker collision and that the new facilities at the Nikiski refinery meant that fewer total tanker trips will be required.<sup>11</sup> Nonetheless, the volume of oil transported through the Cook Inlet will not increase as a result of this contract nor is this agreement the appropriate venue to change the regulatory oversight of Cook Inlet tanker operations.

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>9</sup> Alaska Department of Natural Resources, October 1993. Final Finding of the Director Regarding Oil and Gas Lease Sale 78, Cook Inlet. Anchorage, Alaska.

<sup>10</sup> Ken Kastner testified by teleconference from Homer, Alaska.

<sup>11</sup> See also page 20, Final Finding and Determination to Sell Royalty Oil to Tesoro Alaska Petroleum Company, Alaska Department of Natural Resources, September 20, 1994.

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(c) which requires that commissioner may not waive competitive bidding is 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.

  
\_\_\_\_\_  
John T. Shively, Commissioner

4/21/95  
\_\_\_\_\_  
Date

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

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

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

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

- (1) the sale, exchange, or other disposition of oil or gas for one year or less if the sale, exchange, or other disposition is entered into to relieve storage or market conditions;
- (2) contracts for the sale of state-owned royalty gas or oil that specify the sale and delivery of not more than
  - (A) 400 barrels of crude oil per day;
  - (B) 460 barrels of natural gas liquids per day; and
  - (C) 2,400 Mcf of natural gas per day.

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

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.

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

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

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



# WORLD OIL CORP.

P.O. BOX 1966

SOUTH GATE, CA 90280-1966

TEL (310) 928-0100

FAX (310) 928-3234

March 30, 1995

Kenneth A. Boyd  
Acting Director  
State of Alaska  
Department of Natural Resources  
Division of Oil and Gas  
3601 C Street, Suite 1380  
Anchorage, Alaska 99503-5948

APR 07 1995  
1380

Dear Mr. Boyd:

World Oil Corp. is in its 55th year as a petroleum marketer and refiner.

We respectfully urge the State of Alaska to sell royalty oil to Tesoro.

Tesoro is a supplier of petroleum products to the independent segment of the industry, and it is to the consumer's benefit that Tesoro remain a vital, vibrant factor in the independent field.

Sincerely,

WORLD OIL CORP.

  
Bernard B. Roth  
Chairman and Chief Executive Officer

BBR056

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

RECEIVED

APR 20 1995

April 18, 1995

Dear Mr. Banks,

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

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

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

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

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

Yours truly,  
  
Karl Pulliam

*Sea Breeze Inn & Charters*  
Karl & Nancy Pulliam, Box 31, Seldovia, Alaska 99663  
ph/fax 907-234-7641/7699

The Alaska Royalty Oil and Gas Development Advisory Board

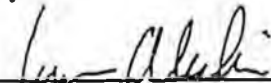
Resolution 95-1

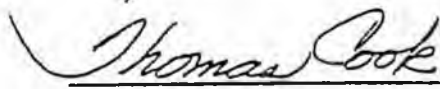
On March 21, 1995, the acting director of the division of oil and gas ("director") provided the Alaska Royalty Oil and Gas Development Advisory Board ("Board") with preliminary findings and proposed contract for a three-year sale of approximately 40,000 barrels per day of Prudhoe Bay Unit royalty oil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


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

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

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

  
\_\_\_\_\_  
Lynn Aleshire

 04-06-95  
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Tom Cook

  
\_\_\_\_\_  
Wilson Condon

  
\_\_\_\_\_  
Becky Gay

\_\_\_\_\_  
Willie Hensley

  
\_\_\_\_\_  
John Shively

## The Alaska Royalty Oil and Gas Development Advisory Board

## Resolution 95-1

APR 10 1995  
10:28 AM

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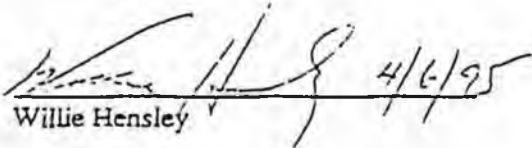
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\_\_\_\_\_  
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Tom Cook

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Wilson Condon

\_\_\_\_\_  
Becky Gay

 4/6/95  
\_\_\_\_\_  
Willie Hensley

\_\_\_\_\_  
John Shively

AGREEMENT FOR THE SALE AND PURCHASE  
OF  
STATE ROYALTY OIL

to

TESORO ALASKA PETROLEUM COMPANY

THE STATE OF ALASKA  
Department of Natural Resources

Dated as of April 21, 1995

**COMMITTEE COPY**

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